Improving Accountability and Enforcement of directors` liability in Company under the Companies Act 2006 in UK

A thesis submitted in partial fulfilment of the requirements of Liverpool John Moores University for the degree of Doctor of Philosophy

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*Re a Company, ex parte Glossop [*1988] BCLC 570

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Re Ipcon Fashions Ltd [1989] 5 BCC 773

Re Landhurst Leasing Plc [1999] 1 BCLC 286

Re Lo-Line Electric Motors Ltd [1988] Ch 477

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The Company Act 1985

The Companies Act 2006

UK Companies Act 1856

UK Companies Act 1862

UK Companies Directors Disqualification Act 1986

DECLARATION

I, Cletus Kadzirange, do hereby certify for this thesis that, except where due acknowledgement has been made, the work is that of myself. I have done everything I can to make sure the work is original and hasn't already been approved for a higher degree at another university.

…………………….

Cletus Kadzirange

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DEDICATION

This thesis honours the people's lovely, reassuring, and lasting recollections who meant a lot to me, and who taught me how to live and love, my late sister, Christine (Kadzirange) Mbizvo, sister-in-law, Catherine Kadzirange and my father-in-law- Bishop Gideon Utedzi. May their loving memories be a blessing.

ABSTRACT

Directors` liability is of special interest and a problem since a striking balance must be made between shielding and holding a director accountable for breaching their obligations. A regulatory structure that can keep directors responsible must be established and handled efficiently to avoid corporate failures due to undesirable conduct. It is necessary to determine the causes of such behaviour and to ensure that steps are taken as a preventive mechanism for such failures. This thesis proposes expanding the Senior Managers Certificate Regime (SMCR) to all UK companies to ensure individual accountability.

This thesis attempts to improve accountability and enforcement of directors` liability by ensuring that companies are managed responsibly. This thesis strives to bring clarity to statute law and case law regarding directors` roles. It also points out gaps and inconsistencies in the legislation governing the directors' obligations. This thesis finds upon examination and analysis of literature that, governance instruments, for instance, the UK Companies Act, Walker Review and UK Combined Code have not gone far enough to hold directors accountable.

This thesis argues that the legal structures are not sufficient to function as a deterrent, to raise the director`s knowledge of the need to execute wise judgement for the sake of the business. Lack of personal consequences for directors is argued to be the cause of repeated bad behaviour at institutions. This thesis calls for a more radical approach to corporate governance using an effective tool, to ensure robustness in having competent, trained and qualified directors in companies. This thesis proposes Director Education as a model of accountability for company directors. Implementing mandatory pre-appointment director education would enhance standards by establishing a fundamental level of understanding. Consequently, the author argues that this would lead to a drop in misconduct, resulting in a reduction in the number of insolvencies and ultimately safeguarding creditors. Since this would encompass understanding of the applicable consequences, it would also function as deterrence. Therefore, Director Education offers

a higher level of protection for creditors by preventing misconduct from happening in the first place.

Chapter One

General Introduction

1.1 Introduction

Educators and entrepreneurs have been debating how to hold company leaders accountable for a long time. [1]High-profile business failures such as BHS's demise in 2016 and Carillion's in 2018 prompted a public outcry for personal liability against company directors. The importance of director liability is emphasised in company law under sections 170- 177.[2] It outlines the precise responsibilities of directors because directors have such broad powers, the law imposes such responsibilities on them to safeguard the interests of other parties, including stockholders. Therefore, an appropriate balance must be achieved between shielding the directors and holding them accountable for failing to fulfil their obligations.[3] As a result, any legal interpretation that deals with the purpose of a company must address directors' responsibilities.

Directors of the company oversee daily business decisions. The major aspects that will determine a company's success are the duties imposed on directors and how they respond to these legal responsibilities.[4] The fall of corporate giants such as Northern Rock, BHS and Carillion demonstrate that the existing system may be working in favour of directors who take excessive risks.[5] For instance, the 2007-9 economic crisis saw the nearly disastrous economic situation of RBS. The bank directors were accused of taking aggressive acquisitions for expansion without adequate due diligence.[6] Although the top

[1] Lynn A Stout, 'Director Accountability and the Mediating Role of the Corporate Board' [2001] Cornell Law Faculty Publications 759.
[2] Parker Hood, 'Directors' Duties Under the Companies Act 2006: Clarity or Confusion?' (2013) 13 Journal of Corporate Legal Studies 1.
[3] ibid.
[4] Andrew Keay, 'Ascertaining the Corporate Objective: An Entity Maximisation and Sustainability Model' (2008) 71 MLR 663.
[5] Tomasic Roman, *The Failure of Corporate Governance and the Limits of Law: British Banks and the Global Financial Crisis* (Cambridge University Press 2011) pp 50-74
[6] Iris H-Y Chiu, *The Law on Corporate Governance in Banks* (Edward Elgar Publishing Ltd, 2015).

management of the bank was criticised in a report[7] for inadequate risk judgements, no one was held personally liable under the directors` duties.

To ensure that firms are managed appropriately, directors must have a clear grasp of their responsibilities.[8] The primary reason for this is to ensure that businesses are managed appropriately, without 'harming' other stakeholders.[9] For instance, directors are required to have regard for other stakeholders while making company decisions under s172 of the CA 2006. The appalling actions of the directors of Carillion, who gave huge bonuses and pay-outs to shareholders at the expense of the business, left a lot to be desired. The collapse of companies such as HBOS and Carillion, as well as government bailouts of companies such as Northern Rock, was a clear indication that businesses suffered losses. Therefore, if there is a risk of loss to the company, directors' liabilities are inescapable.[10]

However, if the loss is defined in terms of shareholders' losses, then the shareholder hypothesis will prevail, just as stakeholder theory is defined by a loss to society.[11] The abstract goal of maximising shareholders or stakeholders' interests, according to Macey, cannot be sustained by any company.[12] The importance of directors' responsibilities to their companies is undeniable in terms of business management. However, it is critical that an effective and comprehensive enforcement mechanism is in place if their responsibilities are not met; otherwise, these responsibilities will have no significant impact on company boards.

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[7] *FSA, The failure of the Royal Bank of Scotland: Financial Service Authority Board Report (De 2011).*

[8] Andrew Keay, *The Corporate Objective: Corporations, Globalisation and the Law* (Edward Elgar Publishing 2011).

[9] Ahmed Anam, 'A Critical Analysis of the UK Company Law Corporate Objective: Purposive, Practical and Possible: Longitudinal Corporate Objective to Remedy the Enlightened Shareholder Value Approach of the Companies Act' [2006] SSRN: https://ssrn.com/abstract=2117591 accessed 28th June 2017.

[10] ibid.

[11] ibid.

[12] Andrew Keay, *Board Accountability and The Entity Maximisation and Sustainability Approach* (Cambridge University Press 2017).

This thesis's objective is to critically evaluate how to pursue enforcement measures against breach of directors' duties, leading to improved corporate governance, and profitable firms for shareholders and the public. This chapter will follow the following format: Section 1.2.1 looks at ESV, examining the reform process that resulted in ESV's enactment. A critical analysis concludes that ESV constitutes stronger support of shareholder value than was previously needed by the common law. Section 1.2.2 then looks at The Application of Good Faith Test and concludes that the standard that directors are held to is extremely low, as it allows directors to evade liability if they can justify their actions. A stronger good faith responsibility, rather than the weak reference in CA 2006, is proposed by this thesis as a preferable way to keep directors accountable. Section 1.3 follows with the Mechanisms to Deal with Company Directors` Conduct and the limitations to these mechanisms. Section 1.4 looks at The Research Aims and Objectives that runs through the chapters. Section 1.5 then concludes with Methodology, critically explaining how the research is conducted and how the methodology would help to achieve the objective of the research.

1.2 Background to the problem

Following business scandals like the 2016 collapse of BHS and the 2018 collapse of Carillion, raised the question of whether essential components of company law, such as directors' duties, should be altered, was discussed.[13] However, masked by policymakers' response and changes to business law, there remains a deeper underlying issue: reforming opposition to more basic components of the law for instance the ESV approach of company law under s172. Unlike common law, ESV judges a company's performance based on the merits of its owners. This can be explained by the fact that s172 emphasises the importance of what shareholders value. ESV eliminates any chance of the court interpreting directors` responsibilities without giving precedent to shareholders, even if it

[13] *Corporate Governance Reform—The Government response to the green paper consultation, August 2017,* available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/640470/corporate-governance-reform-government-response.pdf accessed 27th August 2017.

means hurting the corporation.[14] Directors must, however, act honestly under both ESV and shareholder primacy situations. What is required is for directors to explain their decisions and prove that they were for the company's good. It is true that s 172 obliges directors to be in a sound mental state when considering what is good for the company. If directors can act in subjective belief and such belief is held in good faith, then the courts cannot question the director's decisions.[15] Looking at the decisions made by some bank directors such as the directors of RBS and HBOS, it would be difficult to say that they would be held liable for breaching directors' duties, even though risky choices made in the banking industry were in violation of directors' duties. Therefore, the thesis argues that the directors' duties regulatory regime has been ineffective in addressing these weaknesses. Therefore, enhancing the enforcement mechanism might be the key to progress. This thesis proposes a paradigm change, of expanding SMCR to the non-financial sector. The SMCR is an effective tool for deterring undesirable behaviour and promoting market trust.[16] Financial institutions must be directed by persons who are fit and acceptable, have strong corporate ethics, and have a high degree of experience.

1.2.1 Research Aims and Objectives

This thesis aims to critically evaluate the current weaknesses in case law, and legislation relating to the obligations and accountability of directors. The inclusion of the duty of good faith has provided directors with a defence in situations where there is a significant amount of culpability. This thesis will critically analyse the SMCR and then argue that the SMCR should be expanded into the non-financial sector to improve good character and accountability in company directors, which promotes public and market trust.

[14] Andrew Keay, `*Board Accountability and The Entity Maximisation*` (n 12).
[15] *Regentcrest plc v Cohen (Regentcrest)* [2001] BCC 494.
[16] Bank of England`s PRA Report: 'Evaluation of the Senior Managers Certification Regime' December 2020. https://www.bankofengland.co.uk/prudential-regulation/publication/2020/evaluation-of-the-senior-managers-and-certification-regime accessed 16 December 2020.

1.2.2 ESV

The Companies Act 2006 (CA 2006) established several common law director responsibilities. However, this framework has since been improved, resulting of the enlightened shareholder value model.[17] Aiming to give directors more responsibilities while keeping the internal management paradigm intact.[18] The goal is to instil directors with the ability to make decisions that are focused on long-term objectives.[19] Employees, consumers, suppliers, and the local community are all mentioned in the ESV under s172 (1) as non-exhaustive factors that directors must consider. The major issue with the ESV model is that it does not enforce directors' responsibilities sufficiently; it is a shareholder-oriented paradigm, as opposed to common law.[20] The definition of 'with respect to' revealed that the members' interests take precedence above the numerous stakeholders mentioned under the s172 list of criteria.[21]

This obligation is difficult to implement due to the shareholders' apparent priority, and it is useless in guaranteeing that directors would really regard stakeholder interests.[22] The ESV model evaluates a company's success based on the merits of its owners. It eliminates any chance of the court interpreting directors` responsibilities without giving precedent to shareholders, even to the detriment of the corporation.[23] There is no longer any difference between shareholders and company interest, a difference that did exist

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[17] Andrew Keay, *The Enlightened Shareholder Value Principle and Corporate Governance* (Routledge 2012) 230.
[18] Andrew Keay, 'The Duty to Promote the Success of the Company: Is it Fit for Purpose?' 2011 (32) Co Law 138.
[19] ibid.
[20] ibid.
[21] Catherine Pedamon, Corporate Social Responsibility: A new approach to promoting integrity and responsibility (2010) Company Lawyer Review 31(6) pp. 172-180.

[22] Ibid.
[23] Andrew Keay, `*Board Accountability and The Entity Maximisation*` (no 12).

with common law.[24] ESV now define the corporate goal of administering the business for shareholders` purpose, a strong statement of shareholder value.

The ESV model makes a bold statement about shareholder value, a statement that common law would never make.[25] Directors are compelled to consider a list that includes employees, customers, suppliers and the local community.[26] The provision is difficult to enforce, as it gives precedence to stockholders over other stakeholders. This allows the obligation to be viewed by courts as a mandate to put the interests of investors first, even if that means putting the interests of the corporation last. It has been argued that s.172 is meaningless because it just codifies the ordinary conduct of directors.[27]

The ESV model is a more sophisticated version of shareholder primacy that aims to find a solution between opposing stakeholder interests for the benefit of shareholders. Shareholder priority has been widely discussed,[28] however, the assumption that it is the foundation of English law is unfounded. Questions have been asked as to whether shareholder primacy was the fundamental principle of English law before the enactment of the CA 2006.[29] This ambiguity stems from the previous application of partnership concepts to company law,[30] which, it is argued, is a complicated and misunderstood field of law.[31] In order to better comprehend the uncertainty that led to CA 2006's assertion of shareholder primacy, reviewing the development of English corporation law is essential.

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[24] John Quinn, 'The Duty to Act in the Interests of the Company: Simply a Duty to Increase Shareholder Wealth?' [2015] UCD Working Papers in Law, Criminology and Socio-Legal Studies Research Paper 7 SSRN: https://ssrn.com/abstract=2625982 accessed 2nd July 2015

[25] Alistair Alcock, 'An Accidental Change to Directors' Duties' (2009) 30 Co Law 362.

[26] Companies Act (CA) 2006, s 172(1).

[27] Catherine Pedamon, Corporate Social Responsibility: A new approach to promoting integrity and responsibility (2010) Company Lawyer Review 31(6) 172,180.

[28] For example, Gordon Smith, 'The Shareholder Primacy Norm' (1998) 23 Journal of Corporate Law 277.

[29] Jonathan Mukwiri, 'Myth of Shareholder Primacy in English Law' [2013] E B L Rev 24 (2) 217,241.

[30] ibid.

[31] Paul Davis Gower, *Principles of Modern Company Law* (6th ed, Sweet & Maxwell 1997).

The important decision in *Salomon v Salomon* established the change from partnership principles to viewing shareholders as being the same as a corporation, a legally separate entity on its own.[32] From this, it is impossible to argue for shareholder primacy without violating *Salomon's* core concept of independent legal persons. Shareholders are not recognised as firm owners in English commercial law.[33] The court in *Bligh v Brent*[34] dismissed the concept of shareholders as owners with interests only in profits. The same decision was affirmed in *Short v Treasury Commissioners*.[35]

Although the company is recognised as a distinct entity, the ESV model was built on the incorrect belief that shareholders own the business.[36] Based on the 19th-century concept of shareholder ownership, legal reform groups fought for shareholder primacy.[37] It was affirmed in the Cadbury Report that shareholders own the company and that it is their responsibility to choose the directors that will manage their company and hold them accountable for their failures.[38]

The Company Law Review (CLRSG) asserted, businesses ought be managed to serve its shareholders.[39] However, the CLRSG derives this viewpoint from scholarly arguments that are based on efficiency, rather than on English law.[40] Quoting Easterbrook and Fischel, the CLRSG has observed that shareholders are exposed to greater risk and that they stand to lose due to management failure and, as such, that precedent should be given to them.[41] The CLRSG promoted the ESV concept on the premise of these ideas.[42]

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[32] [1897] AC 22.
[33] Sarah Worthington, 'Share and Shareholders: Property, Power and Entitlement' (2001) 22 Co Law 258.
[34] (1837) 2Y & C Ext 268.
[35] [1948] 1 KB 116,122.
[36] Ross Grantham, 'The Doctrinal Basis of the Rights of Company Shareholders' (1998) 57 CLJ 3.
[37] Mukwiri (n 29).
[38] Adrian Cadbury, *Report of the Committee on the Financial Aspects of Corporate Governance* (Gee & Co Professional Publishing Ltd 1992).
[39] CLRSG, *Modern Company Law for a Competitive Economy: The Strategic Framework* (Department of Trade and Industry (DTI) 1999) 5.1.
[40] ibid.
[41] Frank Easterbrook and Daniel Fischel, 'Economic Structure of Corporate Law' (1991) 11 Harv L Rev 28, cited by Author, 'Paper Title' [1999] Co Law Rev 5.1.5.
[42] ibid.

The ESV was purportedly placed in the provision, but it appears that s 172 was derived from economic considerations, rather than any English legal authority.[43] Therefore, this thesis asserts that directors should operate a firm for business advantage, separate of its members, as per *Salomon v Salomon*,[44] the inference being that the corporation, as a business entity, enforces its directors' responsibilities.

In s172, the answer to how UK companies should be managed is found in Keay`s Entity maximisation and sustainability model. The purpose behind the organisation's overall maximisation and sustainability approach is to benefit its members and the corporation.[45] The more effective and productive the company is, the more shareholders will benefit. In his comment, Hoffmann LJ draws on a judicial comparison that a company is a legal individual, just like a person who experiences birth and death.[46] English law treats a company as its own being, rather than as a collection of stockholders. The company-centred approach considers how the entity's value can be created and increased;[47] it consists of two parts. First, it demonstrates a dedication to increasing the value of the company. As a result, management should strive to maximise the enterprise's total wealth. Second, it focuses on assuring its continuing survival as a concern.[48]

Though the organisation is recognised as a separate business, the incorrect premise that shareholders own the business forms the foundation of the ESV model. Therefore, directors are obliged to run companies to serve shareholders` interest.[49] This declaration makes the provision difficult to enforce since it prioritises stockholders above other interests. The clause allows the courts the discretion to see the responsibility as a mandate to give precedence to shareholders first, even if it means placing the corporation's interests last. This makes it difficult to enforce the provision against

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[43]Granthan (n 36).
[44] *Salomon* (n 32).
[45] Andrew Keay, 'Ascertaining the Corporate Objective: An Entity Maximisation and Sustainability Model' (2008) 71 MLR 663.
[46] *Stanhope Pension Trust Ltd v Registrar of Companies* [1994] BCC 84, 85.
[47] Mark McCann and Sally Wheeler 'Gender Diversity in the FTSE 100: The Business Case Claim Explored' (2011) 38(4) Journal of Law and Society 542.
[48] Keay, 'Ascertaining the Corporate Objective' (n 4).
[49] CLRSG, *Modern Company Law for a Competitive Economy: The Strategic Framework* (Department of Trade and Industry (DTI) 1999) 5.1.

directors. Therefore, it is vital for this thesis to develop a company's fair and correct purpose to ensure its long-term success. The long-term sustainability of a corporation, independent from its shareholders can only be achieved through Keay`s entity maximisation. Entity maximisation, according to Keay, fosters justice between opposing interests while also increasing the company's efficiency.[50] Jensen asserts that society is best served when all businesses strive to maximise their overall value.[51] More stockholders will profit from the company's increased effectiveness and productivity.

1.2.3 The Application of the Good Faith Test

Directors are obliged to behave honestly in both ESV and shareholder primacy situations. Applying s 172 to both situations, directors would be required to exercise sound decision to determining what`s good for the corporation and its stockholders. In both cases, a subjective test is used, with the director's opinion set against the court's opinion to determine whether the directors have met their fiduciary obligations.[52]

A stronger good faith responsibility, rather than the weak reference in CA 2006, is proposed by this thesis as a preferable way to keep directors accountable. This thesis proposes that the standard that directors are held to is extremely low, as it allows directors to evade liability if they can justify their actions. The director must behave in a manner that they feel would benefit the firm, not in the way that a court might think is best for the company, as per *Extrasure Travel Insurance Ltd v Scattergood.*[53] The emphasis is very much on the director's own opinions; the court will not act as a referee to determine whether the decision made was for the company's good, nor will it hold the director liable simply because their actions brought harm to the company.[54] Furthermore, no reasonableness test is used under CA 2006.[55] However, previous judicial decisions that

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[50] Keay, 'Ascertaining the Corporate Objective' (n 4).
[51] Michael Jensen, 'Value Maximisation, Stakeholder Theory and the Corporate Objective Function' (2001) 7(3) European Financial Management 297.
[52] *Re Smith & Fawcett Ltd* [1942] Ch 304*; Regentcrest plc v Cohen (Regentcrest)* [2001] BCC 494.
[53] [2003] 1 BCLC 598.
[54] ibid.
[55] Keay, 'The Duty to Promote the Success of the Company' (n 18).

were made before the Act are still relevant. If a director acts unreasonably and merely states that s/he acted in the way that s/he thinks, s/he will be held liable if another director in a similar position act differently the court will disregard any assertions of acting honestly.[56]

To determine a breach of duty, a director's state of mind would have to be proven wrong. However, when demonstrated that the director acted with clear intention and in the company's best interest, the director could not be held in violation. Parker in *Regentcrest plc v Cohen,*[57] regarding the obligation to act honestly for the company's interest, stresses that as long the directors can prove, acted honestly to support the company`s good cause, then a breach cannot be established. It was asserted[58] that the court will not play an advisory role in decisions made using the management's legitimate powers. The goal of good faith is to reduce the likelihood of a lawsuit arising from a director's action. The Rt Hon Margaret Hodge, then MP, stated in relation to s 172 that good faith judgement should be the sole application used by directors when deciding what is good for the corporation, and shouldn't be a case of discussion.[59]

In *Re a Company*[60], it was stated and argued that holding that a director has complied with s 172 simply because they have considered the company's best interest in good faith fails to account for accountability, as it is open to abuse by directors. Any director can claim to have been acting honestly for company good, even if their actions were contrary to it. This shortfall in the subjective test exposes the company to great harm. This thesis contends that the low requirement poses a way for directors to act with no regard, since it provides a convenient way out in that director to claim that they had good intentions for their actions, regardless of the outcome.

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[56] Keay, 'Ascertaining the Corporate Objective' (n 4).14,15.
[57] *Regentcrest* (n 15).
[58] *Howard Smith Ltd* [1974] AC 821.
[59] Margaret Hodge, *Company Law Reform Bill*: *Standing Committee D* (HC 11 July 2006, 15th sitting) cols 591,593.
[60] [1990] BCC 526.

This was a contributing factor in the financial crisis of 2007/2008, as some choices were made by directors for personal gain and against company interests.[61] Significant losses in big corporations were attributed to improper pay practices.[62] There is no yardstick that can be used to judge directors' objectives. As a result, s 172 imposes primarily subjective criteria; this contrasts with the common law's objective element, which seeks company success. However, there are situations in which the court has taken objective concerns into account.[63] It was stated that, in situations where it can be shown that a director fails the interest of the company through their actions, the court can use an objective test to find the director liable for their actions.

Kershaw asserted that using the objective test would help a company succeed for the benefit of its members.[64] Therefore, this thesis defines a means to clarity on the issue of good faith in accordance with the judgement in *Ivey v Genting Casinos (UK) Ltd*;[65] across all branches of the law.

This clarification will make it obvious when a director has breached their duties, increasing the likelihood of a derivative action being taken. Therefore, a possible way of enforcing the responsibility to behave honestly in the firm's best interest is to extend the ability to make derivative action to stakeholders against directors who breach their obligations. It is crucial to highlight that, while s 172 (1) identifies and protects stakeholders' interests, there is no provision regarding what action should be taken if the clause is violated by directors, and any right with no remedy is useless.[66] Keay stresses that stakeholders are disadvantaged when bringing a derivative case against directors[67] because they are not specifically defined as company members.[68]

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[61] Andrew Lo, *Hedge funds, Systemic Risk and the Financial Crisis of 2007/2008: Written Testimony for the House Oversight Committee Hearing on Hedge Funds* November 13, 2008.
[62] Financial Services Authority (FSA), *Reforming Remuneration Practices in Financial Services* (2009).
[63] *Charterbridge Corp Ltd v Lloyds Bank Ltd* (*Charterbridge*) [1970] Ch 62. Ch D
[64] David Kershaw, *Company Law in Context: Text and Materials* (OUP 2009).
[65] *Ivey* [2017] UKSC 67.
[66] Mukwiri (n 29).
[67] Keay, 'Ascertaining the Corporate Objective' (n 4).
[68] ibid.

1.3 Mechanisms to Deal with Company Directors` Conduct.

Several mechanisms have been put in place to deal with company director conduct. CA 2006 establishes several legal measures that shareholders can take against business directors. The annual general meeting gives shareholders power over the corporation[69] that is derived from the articles of incorporation and allows them to nominate and dismiss directors.[70] Bebchuk believes that the legal process provides a solid foundation for shareholder action.[71] However, it is claimed that these legal approaches are hindered by impediments that prohibit shareholders from using them.[72] For example, voting rights on sorts of resolutions is one example of a restriction. These rights can be changed, or even waived. It has been established[73] that shareholders cannot override the board's delegated powers unless the articles of association permit their doing so.

Shareholder activism is a powerful tool that can be used to challenge directors` conduct and dominance in corporate governance. The Companies Act 2006 is a shareholder-centred model which gives precedence to shareholders` benefits. Shareholder activism requires shareholders to be more active and involved in the decision-making process to deter directors` undesired conduct. However, shareholder activism has its own critics, apart from shareholders being busy administering the business and their lack of expertise. Shareholders are criticised for conflicts in the use of their powers towards the goal of maximising shareholder`s wealth. [74] Some shareholders may pursue short-term profit by encouraging directors to focus on share price performance instead of the company's continued prosperity. An example, the cause of the Northern Rock crisis was blamed upon shareholders for causing directors to take unnecessary risks which resulted in the collapse of the bank. [75]

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[69] CA 2006 s 168 (n 26).
[70] ibid.
[71] Lucian Bebchuk, 'The Case for Increasing Shareholders Power' (2005) 118 Harv L Rev 833.
[72] Ibid.
[73] *Shaw & Sons (Salford) Ltd v Shaw* [1935] 2 KB.
[74] Michael Jensen, 'Value Maximisation, Stakeholder Theory and the Corporate Objective Function' (2001) 7(3) European Financial Management 297.
[75] Hyun Shin, "Reflections on Northern Rock: The Bank Run that Heralded the Global Financial Crisis," Journal of Economic Perspectives (2009) 23 (1)101-19.

Market forces can also be used to control corporate directors' behaviour. According to Manne, vigorous markets can act as checks on bad management because, in such an environment, directors will constantly endeavour to deliver best company practices to avoid their company being taken over by other firms and thereby losing their employment.[76] Weak businesses cannot hide their numbers in a functioning market, because it will reveal how they are doing. If a firm is underperforming, it can be purchased, and the acquirer will take the required steps to improve the firm's performance (which usually includes replacing management).[77] However, there are criticisms of market forces as a tool to control the undesired conduct of company directors.

Looking back to the financial crisis of 2007-9, the market failed to prevent all forms of mismanagement and misconduct. It's debatable whether fear of ruining one's professional reputation can be totally relied upon as a means of keeping company directors in check. Furthermore, market forces may be eager to penalise organisations and directors' ex-post because of their failure but fail to recognise and remedy issues ex-ante. For instance, none of the rating agencies was able to detect the risk presented by mortgage securities during the financial crisis of 2007-9. However, as the negative news was revealed, the market hurried to downgrade bonds and assets.[78] Other analysts, however, contend that excellent corporate governance structures are a better way to provide legal protection for investors, rather than sole reliance on inherently unreliable market forces.[79]

One of the ways to influence corporate directors' behaviour is to use reputational factors. Board members are believed to be motivated by reputational concerns to do a better job

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[76] Henry Manne, 'Mergers and the Market for Corporate Control' (1965) 73 (2) Journal of the Political Economy 110.

[77] Jonathan R Macey, *Corporate Governance Promises Kept, Promises Broken* (Princeton University Press 2010).

[78] John Hunt, Credit Rating Agencies and the Worldwide Credit Crisis, 2009 Colum. Bus. L. Rev. 109.

[79] Andrei Shleifer & Robert Vishny, 'A Survey of Corporate Governance' (1996) National Bureau of Economic Research Working Paper 5554 https://doi.org/10.1111/j.1540-6261.1997.tb04820.x accessed 18th April 2017.

since they care about their image.[80] There is a social component to reputation. Having a solid reputation and being able to find someone who can attest to good character are still vital elements in today's world.[81] In professional and business dealings, reputation, albeit intangible and difficult to define, is extremely important.[82] Thus, company directors will aim to establish a positive reputation in the market by providing investors with rewards.[83]

When there is a breach of directors' obligations, derivative action is another avenue by which to bring legal action. The focus of derivative action is on the company's wrongdoings; therefore, a lawsuit can be brought against a director in the name of a corporation. Despite derivative action's appropriateness as a company's chosen enforcement mechanism against directors, it has proven ineffectual in enforcing directors' duties, due to its procedural difficulties.[84] The CA 2006 requires a member who wants to bring claim to gain consent from the court.[85] For that permission to be granted, the member has an obligation to satisfy a two-stage procedure. It is at the beginning of the process that satisfaction is given by a court that a derivative claim warrants permission because of the existence of a prima facie case.[86] Failure to establish a case, then the application must be dismissed.[87] As a result, only a few derivative actions have been brought forward, since it was introduced.[88]

The Company Directors Disqualification Act 1986 came to keep unsuitable directors off the board of directors and to safeguard the public from persons who have a history of creating a risk to creditors and others.[89] Legal precedents such as *Re Bearings plc (No*

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[80] David Yermick, 'Remuneration, Retention, and Reputation Incentives for Outside Directors' (2004) 5 J Fin 2281.
[81] Avner Grief, 'Reputation and Coalitions in Medieval Trade' (1989) J Econ Hist 857.
[82] Ibid.
[83] Omar Daoud, 'A Model for the Role and Effectiveness of Non-Executive Directors' (2013)
[84] Arad Reisberg, *Derivative Actions and Corporate Governance: Theory and Operation* (Oxford University Press 2007).
[85] CA 2006 s 261(1) (n 26).
[86] ibid, s 261.
[87] CA 2006 (n 26) s 261(2)(a).
[88] Andrew Keay, 'The Public Enforcement of Directors' Duties: A Normative Inquiry' (2014) 43 C L W R 81.
[89] Company Directors Disqualification Act (CDDA) 1986.

5)[90] cite recklessness and gross incompetence as reasons for disqualification due to unfitness. Unfitness, according to Parker, can be demonstrated by either dishonesty or mere incompetence.[91] Despite the fact that the fear of disqualification appears effective, research has shown that it is rather ineffectual in terms of incentivising board members to treat their companies with care.[92] The study also found that disqualification has no effect on a director's ability to find work, as most directors were able to re-establish themselves, usually as self-employed individuals.[93]

The alarming number of board failures[94] (not to mention bank failures) is frightening. There is a long history of inept directors who do not have even the bare minimum of skills required for their positions. A few instances include the directors of Northern Rock, HBOS and RBS. Matt Ridley, for example, was not a certified banker when he joined Northern Rock; rather, he was a zoologist and a science writer.[95] These flaws raise major concerns about the quality of the directors who occupy these boards and highlight the need for drastic changes in how directors conduct their businesses. There is currently a disqualification system in place, but it lacks the effective measures that would allow it to bring directors to justice for violations of their responsibilities.

First, this resilience can only be achieved by addressing the issue of director credentials and training as preventative measures. Second, director disqualification can be used to hold directors accountable for their failures. This thesis suggests that the Senior Managers and Certification Regime (SMCR) should be extended to all non-financial businesses in the United Kingdom (UK). The thesis argues that the SMCR is an effective instrument with which to deter bad behaviour and promote market trust. The SMCR

[90] [2000] 1 BCLC 523.
[91] ibid.
[92] R3 Directors' Disqualification Paper 2010–11.
[93] ibid.
[94] Tomasic Roman, 'The failure of corporate governance and the limits of law: British banks and the global financial crisis,' *Corporate governance and the global financial crisis*: international perspectives. (Cambridge University Press 2011), pp. 50-74.
[95] Paul Myners, *Institutional Investment in the UK: A Response* (HM Treasury 2001).

mandates that financial institutions be led by people who are fit and appropriate and who have strong business ethics and a high level of expertise.

This thesis will argue that the SMCR improves the quality of governance in institutions.[96] In its use as a supervisory tool, according to an internal poll performed in 2019, around 70% of bank supervisors felt the SMCR has assisted them in holding individuals accountable.[97] This is confirmed by the Financial Conduct Authority (FCA), which states that 'the SMCR's fundamental principle is accountability and responsibility.[98] A good example is the case of Jes Staley, the former CEO of Barclays bank. For seeking to expose a whistle-blower twice in 2016, Staley was personally penalised over £650,000 and compelled to return £500,000 of his bonus.[99] Companies can have a variety of business strategies, but without good management, they will fail.[100]

1.4 Original Contributions to Existing Research

This thesis provides an essential contribution to prior knowledge and offers new discoveries or ideas. The specific contribution of this work begins with the benefits of the entity maximisation approach. How an accountable board can create value and success for the company. The directors see continual wealth creation for company groupings as the optimum way for shareholders' ability to profit from their investments on a regular basis.

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[96] Bank of England`s PRA Report: 'Evaluation of the Senior Managers Certification Regime' December 2020. https://www.bankofengland.co.uk/prudential-regulation/publication/2020/evaluation-of-the-senior-managers-and-certification-regime accessed 16 December 2020.

[97] Ibid.

[98] FCA, 'Financial Statements in Relation to RBS GRG' (2018) https://www.fca.org.uk/news/press-releases/fca-publishes-final-report-relation-rbs-grg accessed 13th June 2019.

[99] 'Whistleblowing Complaints to UK Regulator Rise 24 Percent' *Financial Times* (London, 3 March 2019) https://www.ft.com/content/da9e0cce-3c52-11e9-b72b-2c7f526ca5d0 accessed 3 March 2019.

[100] 'The EU Corporate Governance Framework' (Green Paper) COM (2011) 164.

Secondly, this study adds something new to the body of literature by critically evaluating the effectiveness of the SMCR`s enforcement approach. This, study further adds something new to scholarly literature by advocating that the SMCR be extended to all non-financial sectors in the UK, as an effective way to increase director accountability and transparency. This thesis will argue that increasing accountability through the SMCR to the non-financial sector will benefit all stakeholders and the corporate entity in general. The SMCR presents a workable framework with which to implement Keay`s entity maximisation and sustainability model.

Lastly, this thesis adds something new to the body of literature by advocating for Director Education as a model of accountability for company directors. Implementing mandatory pre-appointment director education would enhance standards by establishing a fundamental level of understanding. Consequently, the author argues that this would lead to a drop in misconduct, resulting in a reduction in the number of insolvencies and ultimately safeguarding creditors. Since this would encompass understanding of the applicable consequences, it would also function as deterrence. Therefore, Director Education offers a higher level of protection for creditors by preventing misconduct from happening in the first place.

1.5 Methodology

Doctrinal research looks at the purpose of the law in a specific situation. The main objective is to examine the legal doctrine and its development and application. Doctrinal research entails a conceptually rigorous analysis of all applicable statutes and case law to the relevant issue at hand.[101] After reading Hutchinson's statement above, many researchers would argue that using a doctrinal approach to legal study is still valid. Hutchinson expressly indicates that doctrinal study entails a rigorous critical examination of case law and legislation, two of the most significant aspects of the law. Doctrinal methodology`s merits cannot be denied when it can provide thorough scrutiny of case law and legislation on the subject at hand.

[101] Terry Hutchinson, 'The Doctrinal Method: Incorporating Interdisciplinary Methods in Reforming The Law.' Erasmus Law Review (2016) (3) 130,138.

This thesis will use a doctrinal approach. The thesis critically examines the wording of the CA 2006 s172 and its effectiveness in holding company directors to account. The doctrinal methodology seeks to determine whether the remedy of directors` duties is suitable to bring accountability and market trust within companies. The methodology seeks to address contentions suggested by the CLRSG that its primary objective was to establish a legal framework that encourages businesses to promote openness, clarity and responsibility[102] hence the introduction of the ESV approach. A critical analysis of the legal interpretation of cases and existing literature will enable the researcher to draw conclusions and propose a better alternative way of holding company directors to account. The methodology will also look at soft law sources, for instance, governance codes to establish the persistent problem of company directors` conduct as the main cause of company collapses. Case studies of near-collapse companies such as RBS and Carillion will be used to demonstrate the weaknesses of directors` duties in dealing with corporate behaviour.

When using doctrinal as a methodology, this thesis accepts that law is normative in the sense that it directs and justifies behaviour. Therefore, the results of this study are not based on a prediction but on accuracy and clarity. Doctrinal methodology gives an understanding and clarity on the legislation, allowing a company director to act according to laws he/she knows about. This serves as a benchmark for good behaviour in directors who strives to act in good faith by following a set of rules. The basic goal of the doctrinal methodology is to enhance a significant component of the law so that the greater goal of law can be achieved. The methodology process involves the researcher taking propositions for a start and focusing on the problem of the subject and critically evaluating judicial opinions, with the goal of suggesting a settlement to any problems that arise between the rulings of different courts. The main objective of the law is to bring justice and not legal jargon.

[102] CLRSG, *Modern Company Law for a Competitive Economy: The Strategic Framework* (Department of Trade and Industry (DTI) 1999).

This thesis does not use socio- legal research because the outcomes of socio-legal research are contingent on how the results are understood, and social science conclusions are unstable.[103] However, some analysts[104] believe doctrinal research is intellectually rigorous, unyielding, and inwardly focused. On the other hand, many doctrinalists see socio-legal research as unprofessional with ideas and procedures that the researchers don't completely comprehend.[105] The doctrinal methodology does not seek to be strict or to prove any claims to the socio-legal method. The major goal of this study is to give a comprehensive analysis of the legislation under directors' duties and to create a solid structural foundation on which to build the thesis. For instance, this thesis cannot establish the weaknesses in directors` duties to hold company directors to account, if the legislative and case-law meanings and definitions aren't scrutinised.

The doctrinal approach will be used in this thesis to examine the CA 2006 s172's language and ability to hold corporate directors accountable. The doctrinal methodology is to establish whether the remedy of directors' obligations is appropriate to promote market trust and responsibility within corporations. The doctrinal approach aims to dispel claims made by the CLRSG that its main goal was to create a legal framework that would encourage companies to promote transparency, accountability, and responsibility. Therefore, this thesis will propose a better, more effective mechanism instead, for promoting transparency, accountability and responsibility through expanding the SMCR into the non-financial sector.

1.6 Research Methodology

In terms of the methodology, a doctrinal approach will be used. Doctrinal study comes from Latin word *doctrina*, meaning 'to instruct a lesson or precept.'[106] The doctrinal approach is unique, rather than simply noticing pertinent social realities associated with law, doctrinal critically explores theoretical and analytical features of law as it is. Even though the researcher begins his/her work by identifying the research issue he/she wants

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[103] Moti Nissan, Fruits, Salads and Smoothies: A Working Definition of Interdisciplinarity (1995) 29 Journal of Education Thought 121, 124.

[104] Douglas Vick, Interdisciplinarity and the Discipline of Law (2004) 31 JL & Soc 163,164

[105]Ibid

[106] Bruce Berg, *Qualitative Research Methods* (Pearson Publishing 2007).

to investigate, the procedure used in the research is distinct. After determining the research subject, the researcher searches bibliographic databases for secondary sources; these could include textbooks, scholarly publications and legal encyclopaedias. In doctrinal research, secondary sources are significant because they direct the researcher to fundamental legal sources, such as legislation and cases.[107]

The research study will focus on understanding a study inquiry.[108] The applicability of the approach employed to deal with the subject matter will be the deciding factor for the relevant problem.[109] This study will attempt to critically address the provisions under the CA 2006 s172. When doing so, it is important to examine the provision's text and legislative history. Various discussions will be examined to establish the broad concepts that underpin these legal standards by looking at the legislative history that resulted in the creation and adoption of s 172. A review of the current commentary on CA 2006 s 172 will be conducted to provide insight into its meaning and offer clarity to the situation at hand.

This thesis will provide essential secondary data and a clearer understanding of a director's responsibility to the company. The research topic benefits from a doctrinal approach in several ways. The doctrinal approach gives continuity and consistency to the subject matter because the objective of this thesis is to uncover and understand a provision and its underlying principles. It will be difficult to demonstrate that the features in s 172 make it impossible for directors to fulfil their responsibilities for the company good without first knowing the meanings and definitions of laws and cases. The doctrinal method does, however, have its critics. Slater and Mason[110] have claimed that using a doctrinal approach is overly formalistic and oversimplifies legal doctrine and that it is unable to provide sufficient evidence to support the thesis and concerns at hand. The doctrinal method is merely the starting point in this thesis. Black-letter law will be used to

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[107] ibid.
[108] Ian Parker, *Qualitative Psychology: Introducing a Research Guide* (Open University Press 2005).
[109] Alan Bryman, Quality and Quantity in Social Research (Rutledge Press 1998).
[110]Michael Slater and Julie Mason, *Writing Law Dissertations: An Introduction and Guide to the Conduct of Legal Research* (Longman Publishing 2007).

achieve a constant result. However, how a researcher examines and breaks down their material (in other words, how they determine which topics to introduce for investigation) is up to the individual researcher themselves.

This thesis uses a comparative approach as a research method, rather than as a methodology. This method was used to keep the thesis from focusing on comparative law as a way of determining whether the UK's CA 2006 can learn from other countries like Australia, New-Zealand and Singapore by adopting a comprehensive approach to strengthening directors' responsibility. Collins has emphasised that it is necessary to establish and justify why the researcher picked a comparative technique as a valid strategy.[111]

Whether one is trying to identify similar concepts across jurisdictions or analysing legal standards across jurisdictions to discover the optimal solution,[112] Collins doubts whether adopting legislation from another jurisdiction is a viable option.[113] However, comparative law, he believes, is a tool for improving and understanding how other countries have addressed similar issues.[114] This thesis will look at how violations of directors' duties can be dealt with through public enforcement. It will do so by referring to courts in Singapore and New-Zealand to identify whether English law offers a progressive issue resolution to a similar problem and, if not, what else could be done.

Qualitative research, according to Denzin and Lincoln,[115] emphasises the process of understanding how social meaning is formed and the interaction between the investigator and the topic under study. Comparatively, quantitative research focuses on the measurement and study of incidental correlations between variables.[116] Denzin and Lincoln, when defining qualitative and quantitative research, state that qualitative research focuses on the meanings, conceptions, definitions and descriptions of things,

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[111] Hugh Collins, Methods and Aims of Comparative Contract Law (1991) 11(3) OJLS 396.
[112] ibid.
[113] ibid.
[114] ibid.
[115] Norman Denzin and Yvonna Lincoln, *Handbook of Qualitative Research* (Sage Publications 1994) 769-782.
[116] ibid.

while quantitative research refers to the measurements and counting of items.[117] The qualitative approach has been chosen for this thesis because it allows the researcher to discuss a variety of non-statistical inquiry techniques and processes that are used to collect data on phenomena.[118] The study is classified as qualitative since it aims to identify a social problem by offering arguments that aim to influence policy and law in regard to the study's topic.[119] This methodology was chosen because the study's findings would not have been mathematical. Statistical correlations may be based on variables that are arbitrarily defined by the researchers, according to critics of quantitative research.[120]

1.7 Reports on Company Failures

Reports from government and non-governmental organisations on reasons for the company`s failures will be examined to show how the study topic is perceived and to reflect contemporary sentiments towards the subject. These reports, which deal with big company failures, are available to the public. Following notable corporate failures, these assessments have repeatedly stated that conduct issues were the main causes.

The Cadbury Report of 1992, for example, will be investigated because it was issued to enhance and strengthen corporate governance practices and restore investor trust. The report made various recommendations related to the behaviour of all directors, with the main one being that all publicly traded businesses' boards adhere to the code.[121] The Greenbury Report was published in 1995 in reaction to public outrage over chief executive officer compensation; i.e. the British Gas 'fat cats'; this will be examined in light of the recommendations it makes to the non-executive directors' compensation committees.[122] NEDs' effectiveness was also the focus of the Higgs Report from 2003. To support the scope of the problem, relevant case law and legislation will also be employed.

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[117] ibid.
[118] Denzin and Lincoln (n 115).
[119] ibid.
[120] ibid.
[121] Cadbury, *Report of the Committee* (n 38).
[122] Greenbury Committee, *Directors Remuneration: Report of a Study Committee Chaired by Sir Richard Greenbury* (London Gee & Co Ltd 1995).

The Walker Review, published in 2009, was prompted by the financial crisis of 2007–2009 and the resulting losses. The report includes suggestions on the board's role and composition, among other things.[123] The recommendations it provides with respect to board-member behaviour are of particular interest. Walker unequivocally states that board-member behaviour must be regulated.[124] The report suggests that directors should be subjected to independent examination at the time of office and periodically thereafter, with particular attention paid to traits such as behaviour, experience, knowledge, motivation and intellect.[125]

The most important point to note here is that considering recent business failures, the lack of required skill, knowledge and experience has been highlighted as a source of worry. The alarming number of board failures not to mention banks. Unprecedented cases of incompetent directors lacking even the rudimentary skills required for their jobs for example Northern Rock, Matt Ridley, then finance director was not a qualified banker, but a zoologist and science writer.[126]

The Turner Review, released in March 2009, examines the financial and regulatory flaws that were discovered during the 2008-9 global financial crisis. The report focused on the specific causes, as well as on changes in UK laws, the difficulties and potential conceivable remedies, such as upgrades made to then Financial Services Authority (FSA).[127] The ineffectiveness of market discipline is of particular significance here and is particularly related to subject behavioural deficiencies of corporate directors. In section 1.4, the review asserts that any progress in dealing with the origins of the problems

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[123] David Walker, 'Review of Corporate Governance in UK Banks and other Financial Industry Entities: Final Recommendations' 26 November 2009.
[124] ibid.
[125] ibid.
[126] Tomasic Roman, 'The failure of corporate governance and the limits of law: British banks and the global financial crisis,' *Corporate governance and the global financial crisis*: international perspectives. (Cambridge University Press 2011), pp. 50-74.

[127] FSA, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (March 2009).

requires fundamental adjustments to the approach taken to institutional activities.[128]

In June 2009, an Institute of Chartered Secretaries and Administrators (ICSA) study provided the Walker Review with an insightful report on boardroom behaviour and conflicts of interest.[129] According to the research, a growing opinion (considering the 2008-2009 financial crisis) is that the corporate governance structure is not intrinsically flawed, but that it fails to monitor acceptable boardroom conduct.[130] In light of this, this thesis will examine and analyse case studies from Northern Rock, HBOS, RBS, and Carillion to expose the consistent corporate governance challenges caused by company directors` conduct that requires responsibility and accountability

This thesis will also examine the OECD Report 2009. According to this report, issues of corporate governance require immediate attention, namely through incentive systems and risk control methods, among other approaches.[131] Additionally, negative appraisals of remuneration practices and risk management all point at company directors as both a problem and solution-solving factor.[132] The financial crisis exposed many examples of dysfunctional financial company boards that were not capable of making objective and independent decisions.[133] Major scandals and massive corporate failures later occurred, necessitating the formation of these reports. In addition, this thesis will demonstrate the urgency of the situation by examining court cases and judgments that originated from corporate failures.

Lastly, this thesis will review the SMCR,[134] which was accompanied at the time by increased regulatory accountability for senior executives and staff who had irresponsibly

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[128] ibid.
[129] Institute of Chartered Secretaries and Administrators (ICSA), 'Boardroom Behaviours: A Report Prepared for Sir David Walker by the Institute of Chartered Secretaries and Administrators' (June 2009).
[130] ibid.
[131] OECD, *Annual Report* (2009).
[132] ibid.
[133] ibid.
[134] FCA, 'Extending the Senior Managers & Certification Regime to FCA Firms' (Policy Statement, PS18/14, July 2018).

mismanaged and harmed the financial sectors. Senior executives are controlled by a code of conduct and are liable for breach by being knowingly involved in regulatory violations of any involved financial institution.[135] The rules allow senior management to ensure that monitoring and oversight are implemented effectively. Upon any breach of the conduct rules, senior executives will be fined and disqualified from working within the financial sector. This thesis will argue and propose for SMCR to be expanded to the non-financial sector because of its effectiveness.[136] Non-financial misbehaviour is a violation of the Conduct Rules that has an influence on the assessment's fit and properness.[137] The requirement to act with integrity (Rule 1) is included in the Conduct Rules.

Conduct and financial soundness are used to judge fit and properness.[138] The three cases regarding non-financial misconduct of Russell Jameson, Mark Horsey and Frank Cochran demonstrate the effectiveness of expanding SMCR to the non-financial sector to promote public and market trust. Jameson, a financial advisor was found guilty of producing, possessing, and disseminating obscene photos of children. Jameson received a five-year term for his crimes and was banned for life from working in the financial sector and was ordered to indefinitely sign the sex offender's register.[139] Horsey, a director in insurance,

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[135] Iris H-Y Chiu, 'Regulatory Duties for Directors in the Financial Services Sector and Directors duties in Company Law' [2016] J B L 465.

[136] Bank of England`s PRA Report: 'Evaluation of the Senior Managers Certification Regime' December 2020. https://www.bankofengland.co.uk/prudential-regulation/publication/2020/evaluation-of-the-senior-managers-and-certification-regime accessed 16 December 2020.

[137] FCA (n 134).

[138] Non- Financial Misconduct in Financial Services Regulation- Where do we stand? December 2020.

https://www.cliffordchance.com/content/dam/cliffordchance/briefings/2020/12/non-financial-misconduct-in-financial-services-regulation-where-do-we-stand.pdf. Accessed December 2020.

[139] FCA bans three individuals from working in the financial services industry for non-financial misconduct (5 November 2020) https://www.fca.org.uk/news/press-

in 2018 was found guilty of voyeurism in violation of sexual acts. Horsey received a nine-month sentence with an 18-month suspension and was put on sex offenders list and to perform therapeutic activities. Lastly, Cochran, a director was found guilty of sexual assault and harassment.[140]Cochran received a seven-year sentence and was ordered to sign the sex offender's register.[141] The three were barred from undertaking any duty related to any regulated activity. All non-financial wrongdoing is considered misconduct. The SMCR promotes high standards of integrity, morality, and appropriateness in company directors.[142] This thesis will argue that expanding SMCR to the non-financial sector promotes good conduct and accountability in company directors and enhances public and market trust.

1.8 Thesis Outline and Structure

Chapter One

Contains an introduction to the objective(s) of the thesis and how they will be presented throughout the thesis.

Chapter Two

Chapter two is a literature review relating to corporate governance theories, company directors and corporate failures. This literature review focuses on recent advancements in various fields and helps to form a comprehension of the problems that prompted the research inquiries. In addition, this chapter lays the groundwork for the thesis by advocating for the entity maximisation approach. This chapter will conclude by advocating that the SMCR is an effective tool for accountability and transparency and argue why the SMRC should be expanded to the non-financial sector.

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releases/fca-bans-three-individuals-working-financial-services-industry-non-financial-misconduct#:~:text=non%2Dfinancial%20misconduct-FCA%20bans%20three%20individuals%20from%20working%20in%20the,industry%20for%20non%2Dfinancial%20misconduct&text=The%20Financial%20Conduct%20Authority%20(FCA,are%20not%20fit%20and%20proper. Accessed 5 November 2020.

[140] Ibid.

[141] Ibid.

[142] Ibid.

Chapter Three

Chapter three discusses directors' responsibilities under the CA 2006 including the evolution of common law. This chapter will also explore the traditionalist view of directors' responsibilities, before moving on to the ESV model. There will be a critical discussion on whether the ESV model has been achieved or whether more changes to directors' duties are necessary. The chapter will also cover the good faith approach and investigate the possibility of holding directors accountable through good faith responsibility. The *Ivey* test[143] is recommended as a means of clarifying the good faith responsibility to hold directors accountable for their activities.

Chapter Four

This chapter critically reviews two case studies RBS and Carillion against s172 and s174 of the Companies Act 2006, and the bad choices their management made. These case studies are used to demonstrate the inadequacies of the directors` duties to deal with undesired conduct of company directors. These responsibilities were developed with the expectations that directors should act in the best interest of the company. Therefore, this chapter will also evaluate what could have looked different on Carillion and RBS under the entity maximisation approach. Had the directors applied the company centred approach would that have made a difference in given circumstances. How could the entity approach have saved the collapse of both companies.

Chapter Five

Chapter 5 introduces the derivative action. The author is predictably implying that the derivative action will be a solution to bridge up directors' duties. However, the author will show that the derivative action hasn't been up to the job because of the uncertainty and complexities of Part 11 of the CA 2006, lack the potential to have an impact on directors' duties. It has proven ineffectual in enforcing directors' duties, due to its procedural difficulties. However, even if the derivative action works would it have worked in Carillion and RBS circumstances. Could the statutory derivative action have

[143] [2017] UKSC 67.

solved the problems in Carillion and RBS cases. Why couldn't the shareholders bring a claim out of these crises? These are the matters chapter 5 will be trying to address.

Chapter Six

The author introduces the Company Directors Disqualification Act 1986 (CDDA) in this chapter, hopping to provide the solution to the inadequacies of the derivative action. The CDDA grants authority to the courts to issue orders or accept commitments that prevent persons from serving as directors or participating in any capacity in the establishment, creation, or administration of a business upon disqualification. The author predictably implies that the CDDA will be a solution to bridge up directors' duties by removing rogue directors from companies and prevent additional misbehaviour. This is the thinking part behind the introduction of the CDDA in this chapter.

Chapter Seven

This chapter will turn its attention to the SMCR on why it is advocated as an alternative framework to the inadequacies posed by other regimes in holding directors to account. This chapter will argue that increasing accountability through the SMCR in the non-financial sector will benefit all stakeholders and the corporate entity in general. This chapter will present a workable approach on how the SMCR can be embedded to all companies across the sectors including large and small. However, the absence of enforcement measures results in a lack of certainty and promptness in the SM&CR regime. The dependence on financial penalties also leads to a lack of seriousness in the imposed punishments, which hinders deterrence and increases the likelihood of persons engaging in misbehaviour. Therefore, to address the challenges with enforcement the author proposes implementing a mandatory pre-appointment director education[144] as a model of accountability for company directors. This would enhance accountability and enforcement among business directors.

[144] Yatin Arora, What Went Wrong With Wrongful Trading? (2022) Business Law Review 43 (4) 164-177.

Chapter Two

2. A Theoretical Analysis of the Firm

2.1 Introduction

This chapter discusses relevant theoretical foundation of the study by laying groundwork and developing an awareness of the problem of directors` liability. Recent literature will be examined to address the persistent problem of directors` accountability. To deal with the problem of accountability in company directors, it is crucial to understand what businesses are, how and why they act the way they do, and how they are perceived. Therefore, a discussion of company theories is important to accomplishing these objectives. This chapter will examine the existence of companies and discuss why they are important. This thesis will also show that companies are created to achieve certain goals and to necessitate the participation of individuals in company management.

A key and essential aspect of the corporate governance process is having directors who fulfil a company's objectives. This chapter will argue that company success can only be achieved when directors operate for the company good, on its own, separate from its owners. Therefore, an entity maximisation approach built upon Keay's model of entity maximisation and sustainability[145] will be advocated as a replacement to the enlightened shareholder approach, as it attempts to maximise the entity and to ensure that it is sustained.

The format of this chapter will be as follows: Section 2.2 evaluates what the corporation is about, how and why they act the way they do, and how they are perceived. Section 2.3 discusses the requirement for corporate governance because of conflicts of interests between various stakeholders and how to prevent harm to corporations and incentivise good behaviour. Sections 2.4.1 and 2.4.2 assesses the theoretical aspect of what role directors should play and know in the company and what they are expected to

[145] Keay *The Corporate Objective* (n 4).

do. Section 2.4.3 examine the entity maximisation approach as a replacement to shareholder theory approach. Sections 2.5.1, 2.5.2, 2.5.3 and 2.5.4 explores the benefits of the entity maximisation approach. Section 2.6 explains how the Covid-19 pandemic established the purpose of a corporation in supporting of the entity maximisation approach. Section 2.7 explains the precise status of company directors in their firms, their responsibilities to their day-to-day operations and their liabilities. Section 2.8 analyses the purpose of directors in companies and their duties. Section 2.9 explains the role of boards in influencing corporate decisions. Section 2.10 assesses the enforcement of directors` liability and its effectiveness. Section 2.11 focuses on the conduct of directors that led to the collapse of many banks. Section 2.12 examines the regulatory gaps under the directors` duties in failing to deal with directors` undesired conduct. Section 2.13 assesses the inadequacy of the directors` duties in dealing with conduct and how this problem is better tackled by the SMCR. Section 2.14 gives the conclusion by arguing that the SMCR could be used as an enforcement tool under the entity maximisation approach to improve the nature of accountability and responsibility of company directors.

2.2 The Firm's Neoclassical Theory

This section evaluates what the corporation is about, how and why they act the way they do, and how they are perceived. In 1932, Berle and Means presented the beginnings of present-day hypotheses concerning the firm through their neoclassical model.[146] Berle and Means` concept of a company is different to the modern concept. The model examines the existence of companies and analyses the effective distribution of limited information. Consequently, the neoclassical model is often said to be a theory of markets, in which companies are essential actors.[147] Besides efficient aid allocation, there are further assumptions that shape the neoclassical model of the firm; these include single ownership, which is a traditional theory that states there is no separation of ownership

[146]Adolph Berle and Gardiner Means, *Modern Corporation and Private Property* (Commerce Clearing House 1932).
[147] Michel Jensen and William Meckling, 'Theory of the Firm, Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3(4) Journal of Financial Economics. Journal of Financial Economics, October 1976, V. 3, No. 4, 305,360.

and management and that the owner is responsible for all decisions.[148] All firms' issues are believed to be handled by payments to the firm's factors,[149] and a single owner is assumed to have all the freedom and flexibility to pursue those goals that maximise the company's profits. However, the assumptions are clearly implausible.

In today's business environment, a firm is a complicated organisation in which ownership and management are separate. This leads to the principal and agent problem. The agency theory state that, company directors use the basic experience and managerial skills of their company to gain an advantage over the company shareholders, who are absent from the running affairs of the company.[150] Because company directors oversee the corporation, there is a risk of self-interest competing with the interests of the shareholders. As Smith pointed out, this principal–agent problem leads to issues with corporate governance; firm directors faced with managing other people's money are more likely to act carelessly than they would with their own.[151]

To understand corporate governance, it is important to know why businesses exist and what exactly a corporation is.[152] Company theory not only tries to address why businesses are structured as corporations but also how the relationships within a company and between a company and society generally look like.[153] Therefore, knowledge of corporate governance is pivotal in establishing the corporate purpose.

Even though Coase's neoclassical model was once questioned for its applicability to corporations, Coase is now known for pioneering the principles of the modern firm.[154] One of the greatest economists of his time, Coase addressed two fundamental questions: why

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148 Harold Demsetz, 'The Structure of Ownership and the Theory of the Firm' (1983) 26(2) Journal of Law and Economics University of Chicago Press, 375.
149 Ibid.
150 Jensen and Meckling (n 147).

151 Keay (n 12).

152 Udo Braendle, *Theories of the Firm, Strategy, Economic Policy, and Legal Affairs* (Kommunalkredit Austria 2013).
153 ibid.
154 Ronald H Coase, 'The Nature of the Firm,' (1937) 4(16), 386,405.

do firms exist, and why is each firm a certain size?[155] More than almost anyone else, he realised that the company was an alternative to the commercial system employed by transaction organisations.[156] There is a major evolutionary implication of the contrast between companies and markets. When a company is founded, it becomes a facilitator to meet the market's fitness requirements in several ways.[157] However, Coase found that a large amount of economic activity was organised not through the market but through the sophisticated structures of top-down, communist styles of management called companies.

Why are there such persistent entities at all? When do corporations merge, and when do they divorce themselves from their components?[158] A firm's philosophy deals with these issues. Coase's answer to these questions is that there are transaction costs, and they are especially high outside the business;[159] that is, business transactions are not free. The size of the company is calculated from the point in which the bureaucracy issues within the company outweigh the advantages of reducing transaction costs from daily transactions.[160]

Alchian and Demsetz advocate that companies should be characterised not by the presence of authority but by a contractual relationship network.[161] The firm's contractual view identifies the company as a nexus of contracts between individuals.[162] This brings a whole new notion of ownership. In other words, in the contractual concept of the company regarding control and decision rights, ownership becomes less relevant.[163] Each of the firm's contractual partners is a stakeholder and has an interest in managing the decisions

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[155] ibid.
[156] ibid.
[157] ibid.

[159] ibid.
[160] ibid.
[161] Armen Alchian and Harold Demsetz, 'Production, Information Costs and Economic Organisation' [1972] American Economic Review 777.
[162] ibid.
[163] ibid.

of the corporation. It could be said that the company's contractual framework creates teamwork and motivation issues since contracts are made for the common good.

The corporation is seen as an entity consisting of individuals with various views and priorities.[164] The fundamental premise of transaction theory explains how the corporations have grown to be so big that the distribution of capital has been replaced by the market;[165] in other words, price and output can be calculated by the organisation and structure of a company. In transaction cost theory, transactions are the units of measurement. As a result of the coupling of people and transactions, transaction managers seek to pursue personal interests.[166]

The nexus of contract theory contends that businesses arise when contractual agreement deals in the industry fail[167] – for instance, the diverging interests of principals and agents, presented by Jensen`s,[168] agency theory, a relationship between business owners and managers.[169] Managers are recruited by shareholders (the owners of the companies) to work on behalf of the principals. In turn, the principals assign the task of managing the firm to the executives, who are representatives of the shareholders. Daily and others[170] state that shareholders in the agency principle require directors to operate in the principal`s best interests. This result in directors pursuing self-interests that are contrary to shareholders' interests. Despite such setbacks, agency theory was implemented to address concerns about ownership and control.[171] The notion behind agency theory is

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[164] Abdullah Haslinda and Valentine Benedict, 'Fundamental and Ethics Theories of Corporate Governance' (2009) 4 Middle Eastern Finance and Economics, 88,96.
[165] ibid.
[166] ibid.
[167] Keay, 'The Duty to Promote the Success of the Company` (no 18).
[168] Jensen and Meckling, 'Theory of the Firm, Managerial Behaviour, Agency Costs and Ownership Structure.' Journal of Financial Economics, October 1976, V. 3, No. 4, 305,360.
[169] Ibid.
[170] Daily and others, 'Meta Analyses of Financial Performance and Equity: Fusion or Confusion?' (2003) 46(1) The Academy of Management Journal,13,26.
[171] Alnoor Bhimani, 'Making Corporate Governance Count: The Fusion of Ethics and Economic Rationality' (2008) 12(2) Journal of Management and Governance, 135,147.

that firms should balance management's needs with those of shareholders and reduce agency costs by utilising the appropriate rewards and control systems.

2.3 The Requirement for Corporate Governance

What gave rise to corporate governance codes lies in the misgovernance and unethical practices that prevailed in certain companies.[172] The requirement for corporate governance was a result of conflicts of interests between various stakeholders;[173] i.e., employees, creditors, suppliers and shareholders for example, therefore, to prevent harm to corporations and to incentivise good behaviour in directors, effective control measures were necessary.

Corporate governance focuses on accountability, which requires individuals and companies to be answerable for their actions when executing their duties.[174] Corporate governance is said to be as old as the corporation itself.[175] However, experts still differ in their opinions about the definition of the term 'corporate governance.[176] Good and effective governance should create enough incentives for company directors to achieve goals that benefit the company and its shareholders.[177] Cadbury stressed the need for companies to be managed and directed through corporate governance.[178]

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[172] Omkar Goswami, *Legal and Institutional Impediments to Corporate Growth* (OECD Development Centre 1996).
[173] Munshi Samaduzzaman, 'Literature Review on Corporate Governance Structure and Performance in Non-Financial Firms in Bangladesh' (2015) 7(1), 96, Asian Journal of Finance and Accounting.
[174] Tony Nwanji and Kerry Howell, 'A Review of The Two Main Competing Models of Corporate Governance: The Shareholder Ship Model Versus the Stakeholder Ship Model, Corporate Ownership and Control' (2007) 5(1) Corporate Ownership and Control Journal.
[175] Jean Duplessis, *Principles of Contemporary Corporate Governance* (Cambridge University Press 2005).
[176] Guler Aras and David Crowther, *Global Perspectives on Corporate Governance and CSR* (Gower Publishing 2009).
[177] OECD, *Principles of Corporate Governance* (OECD 1999).
[178] Cadbury, *Report of the Committee* (n 38).

Said[179] clearly stated that effective oversight is the primary goal for corporate governance. This is a responsibility bestowed on company directors, as they are the custodians of corporate governance. Therefore, corporate governance has no boundaries; it merely sets a precedent for conduct from top to lower management.[180]

These varying definitions of corporate governance have emanated from the principles that define corporate objectives.[181] In 1999, the OECD describes governance to be, the arrangement of relationships and corresponding responsibilities among a core group of shareholders, board members and managers structured in such a way to best facilitate the competitive output needed to achieve the company's primary goal.[182] This definition aims to identify corporate governance as broadly as possible, including various types of corporate governance structures.[183]

The above concepts explain corporate governance theory and indicate how crucial internal controls are to aligning shareholders` interests with those of other stakeholders. However, it can be argued that company managers always need to be supervised when accomplishing the corporate target, regardless of the governance theory that has been embraced. It is clear from the literature that corporations need to be governed by directors.

2.4 CORPORATE GOVERNANCE THEORIES

2.4.1 An Analysis of the Shareholder Model

This section examines what role the directors should play and know in the company, and what they are expected to do. The problematic issue of corporate governance has centred on the difference between shareholders and stakeholders, the question of which

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[179] Nasser Said, 'Corporate Governance and Business Ethics in Lebanon' (28 April 2004).
[180] Robert Tricker, *Corporate Governance: Practices, Procedures and Powers in British Companies and Their Boards of Directors* (Gower Publishing 1984).
[181] Okoye Ngozi, *Behavioural Risks in Corporate Governance: Regulatory Intervention as a Risk Management Mechanism* (Routledge Publishing 2017).
[182] Virtus, 'Interpress, Corporate Ownership and Control' (2007) 5(1) Corporate Ownership and Control Journal.
[183] ibid.

of the two models is better for companies and the method that the board should follow when handling the company's affairs.[184] Some have argued that the company should be operated for shareholders' interests.[185] In contrast, the stakeholder approach argues that directors should consider all stakeholders' interests when making decisions.[186] The shareholder primacy theory supports the view of shareholder profit maximisation as the company's ultimate target.[187] Berle also affirmed[188] that acting solely in shareholders' interests is the ultimate objective of a firm's directors. The basis of agency theory is the observation of the division between ownership and power.[189] According to agency theory, corporate directors utilise their company's fundamental experiences and managerial abilities to gain an edge over the company's shareholders.[190] Since directors preside over the company, there is a risk that they may diverge from serving the interest of the shareholders.[191]

The question of separation of ownership and management has been of discussion. Berle articulated that a stockholder is an incapable passive recipient in essence, they are functionless.[192] Berle hypothesised that corporations exist to profit their shareholders, actively ignoring other vital groups in the organisation; this is unmistakably demonstrative of profit maximisation and does not concur that stakeholders have an interest in the company.[193]

Jensen and Meckling[194] claimed that the company's claimants are shareholders who are entitled to all the advantages. Their clarification was an endeavour to adjust the board and shareholders` interests. Meckling trusted that aligning interests would leave

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[184] ibid.
[185] Charles Phillip Jr 'What is Wrong with Profit Maximisation?' (1963) 6(4) Business Horizons 73.
[186] ibid.
[187] *Dodge v Ford Motor Company* 204 Mich 459, 170 N W 668 (Mich 1919).
[188] ibid.
[189] Berle and Means (n 146).
[190] Ibid.
[191] Ibid.
[192] ibid.
[193] ibid.
[194] Jensen and Meckling (n 147).

executives in situations in which they would act to the greatest advantage of the corporation by diminishing organisation costs.[195] This contention is on the basis that executives do not own corporate assets and can commit moral dangers to further their own riches. The only way to handle this apparent issue, was through contracts.[196]

Friedman further asserted that, in business, a director has sole responsibility under their employers: to maximise profits while observing basic societal rules.[197] Shareholders are viewed as proprietors of profits because they invest their money in the company with the hope of maximising their profits.[198] Therefore, directors have an obligation to give precedent to shareholders' own goals, which is to generate profits. Any action not to the shareholders' benefit would be a violation of this duty.

However, some academic researchers have challenged the theory of shareholders' profit maximisation.[199] It is argued that shareholders have no proprietorship and control;[200] essentially, proprietors control their properties, and shareholders have no control over those properties.[201] Blair makes the case that shareholders' lack of control over company assets disqualifies them from being part of the corporate governance, as directors have been bestowed with the ultimate power to use their discretion in making decisions over company assets.[202] One of the principal economic defences for investor power is that shareholders are the residual claimants.[203]

According to Stout, shareholders cannot be exclusive beneficiaries of the corporation's profits since they do not deserve the privileged position.[204] Stout further argues that there

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[195] ibid.
[196] ibid.
[197] Milton Friedman, 'Article Title' *New York Times* (New York, 13th September 1970).
[198] ibid.
[199]Julian Velasco, 'Shareholder Ownership and Primacy' [2010] Ill L Rev, 897,956.
[200] ibid.
[201] ibid.
[202] Margaret Blair, *Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century 34* (Brookings Institution Press 1995).
[203] Frank H Easterbrook and Daniel Fischel, 'Voting in Corporate Law' (1983) 26 J L 395,427.
[204] Margaret Blair and Lynn Stout, 'A Team Production Theory: Corporate Law' (1999) 85(2) Virginia Law Review 247.

are other stakeholders who are indirectly risk bearers, such as creditors in the event of company insolvency.[205] Moreover, by law, it is not guaranteed that shareholders will receive residuals from the firm unless authorised by company management.[206] Stout argues, the only moment shareholders can genuinely claim residuals is if the company goes bankrupt, which is rare. Thus, in the eyes of Stout, every claimant can be characterised as a residual claimant.

Hill further expands by challenging the idea that shareholders carry the greatest risk. She compares the risk of shareholders to that of other constituents and clearly states that shareholders can use exit options; that is, at any point shareholders deem the risk to be unacceptable, they can easily sell. This is unlike the situation of other stakeholders, such as employees who are at risk for unemployment and cannot withdraw their investments; therefore, shareholders have limited risk in comparison.[207] Shareholder primacy theorists have argued that shareholders do not have deserving protection in the corporation.[208] However, it is argued that shareholders have the autonomy to choose the form of investment and contract they are comfortable with in terms of risk and profit.[209] Additionally, shareholders have unique legal options in the form of derivative action and the ability to dissolve the company on fair grounds, options that are not available to other parties.[210] Moreover, shareholders can choose to exit a stock market with high liquidity.[211] Profit maximisation is an essential criticism of shareholder primacy, causing debates over the true meaning of corporate profit.[212]

Sheehy argues that shareholder gain is not synonymous with corporate profit. Therefore, shareholder primacy receives the same criticism as stakeholder primacy, as it requires

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[205] ibid.
[206] ibid.
[207] Jennifer Hill, 'Public Beginnings, Private Ends: Should Corporate Law Privilege the Interests of Shareholders?' (1998) 9 Aust J Corp L, 21,24.
[208] Benedict Sheehy, 'Scrooge-Rectant Stakeholder: Theoretical Problems in the Shareholder Debate' [2005] Rev 193.
[209] Kevin McGuiness, *The Law and Practice of Canadian Business Corporations* (Butterworth Publishers 1999).
[210] ibid.
[211] ibid.
[212] Mukwiri (n 29).

managers to focus on shareholder profit maximisation and short-termism.[213] Dine clearly states that shareholder primacy exists at the start of the organisation, and once functioning, the role of shareholders ceases to exist.[214] The question now is, can a company do well without caring for its various constituencies? The following discussion focuses on stakeholders and whether their interests in the company deserve recognition.

2.4.2 An Analysis of the Stakeholder Model

Freeman,[215] an influential supporter of the stakeholder theory, describes stakeholders as individuals who may be influenced by the organisation`s efforts to fulfil its mission. Therefore, a company should be run to benefit both shareholders' and stakeholders' interests affected by the company.[216] Freeman clearly states that profits are not the only important thing to a company, just as red blood cells are not the only essential component of life: one needs so much more. The stakeholder theory clearly rejects the view that shareholders hold a privileged position in business enterprises. From the stakeholders' point of view, corporations cannot maximise shareholder interests to disadvantage other stakeholders, because doing so is neither moral nor economically efficient.

For example, the rights of company employees are considered under s172 CA 2006, and the law acknowledges the importance of a company`s employees. Nevertheless, the provision suffers from criticism: it has a negligible influence on the employee's job since workers do not have the power to implement the duty of the director.[217] In other words, employees are in a disadvantageous position, if not worse because their interests must contend with the interests of shareholders. Accordingly, the theory developed to emphasise the importance of these connections. Considering this some commentators

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[213] ibid.
[214]Janet Dine, *The Governance of Corporate Groups* (Cambridge University Press 2004).
[215] Edward Freeman, *Stakeholder Theory: The State of the Art* (Cambridge University Press 2010).
[216] ibid.
[217] Elaine Lynch, 'Section 172: a Ground-Breaking Reform of Directors' Duties, or the Emperor's New Clothes?' (2012) 33 Co Law 196.

have argued the stakeholder and company relationship as a special one. [218] Furthermore, Dodd asserts that, since the organisation is one unit, directors must further the interests of stakeholders without giving priority to shareholders.[219]

This clearly indicates that directors, through their actions, should consider how their decisions affect a broad range of constituents. Dodd views the company as an independent individual and directors who act on behalf of a separate legal entity, rather than solely for the shareholders.[220] Blair and Stout, furthered on team production;[221] regarding company success, they suggested that the roles of directors should align with the needs of competing stakeholders.[222]

However, Sternberg has her own criticisms of stakeholder theory.[223] She argues that, due to its competing interests, the stakeholder approach is not practical nor workable. She further states that stakeholder theory is contrary to corporate governance beliefs.[224] The accountability of company directors to shareholders is paramount in corporate governance; in a stakeholder approach, however, the corporation is compelled to be accountable to everyone. Therefore, stakeholder theory is incompatible with corporate governance.[225] Sternberg concludes her argument by claiming that stakeholder theory offers no benefit, as it attracts those who want to reap the rewards of business while escaping responsibility and accountability.[226]

Sternberg concludes by claiming that the stakeholder principle effectively undermines corporate responsibility because a corporation responsible for everything is good for

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[218] Jorg Andriof and Sandra Waddok, *Unfolding Stakeholder Thinking* (Greenleaf Publishing 2002).
[219] Merrick Dodd, 'For Whom Are Corporate Managers Trustees?' (1932) 45(7) Harv L Rev.1145.
[220] ibid.
[221] Blair and Stout, 'A Team Production Theory' (n 205).
[222] ibid.
[223] Elaine Sternberg, 'The Defects of Stakeholder Theory' (1997) 5(1) Corporate Governance International Review Journal 3.
[224] ibid.
[225] ibid.
[226] ibid.

nobody.[227] Jensen[228] attacked the stakeholder approach, branding it as a principle in which executives enrich themselves by taking advantage of the modern corporation, leading directors to be self-interested.[229] Jensen explained that stakeholder theory encourages directors to serve many masters, something that is impossible for anyone to do. This creates a great deal of uncertainty and confuses directors when it comes to making decisions. However, Jensen also admitted that no stable company can pursue wealth for its shareholders without a strong relationship with customers, suppliers, bankers or the government.[230] This thesis did not consider other models like transaction cost theory and stewardship theory. Opportunism and limited rationality are the core behavioural assumptions of transaction cost theory,[231] whose objective is to reduce transaction costs using the previously outlined behavioural assumptions.

The transaction cost hypothesis ignores trust, even though it is one of the most crucial components of work ethics.[232] The transaction cost theory is theoretically against the idea that economic players are opportunists, but it does admit that some players are indeed opportunists and that it would be pricey to figure out who is and who is not.[233] As a result, transaction cost theory demonstrates that economic players are both untrustworthy and deceptive. Its biggest drawback is its failure to regard organisations as part and parcel of the social community. This thesis argues that business relationships are built on trust, which establishes positive reputations for the economic players in the long term.[234] When seen in this light, transaction cost theory has no regard for company success, as stated in section 172 (1).

Stewardship theory was also not included in this thesis. While it accepts concepts such as board trust and rejects the foundations of agency issues, board accountability is

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[227] ibid.
[228] Jensen (n 147).
[229] ibid.
[230] ibid.
[231] Rabia Arzu Kalemci, ‘Discussing the Role of Trust in Behavioural Assumption of Transaction Cost Theory’ (2013) 6(2) Turkish Journal of Business Ethics 72.
[232] ibid.
[233] ibid.
[234] Edward J Romar, ‘Globalisation, Ethics and Opportunism: A Confucian View of Business Relationships’ (2004) 14(4) Business Ethics Quarterly 663.

paramount in an organisation.[235] As with agency theory, stewardship theory accepts the existence of the agency problems within company structure. It holds that directors who act as company stewards do not possess an impulse to pursue their own interests; rather, they promote the success of the organisation. However, if the beliefs of stewardship theory concerning directors' behaviour in corporate settings were to be true, accountability provisions for boards would not be needed.[236] This thesis argues that there is too much trust in the board regarding directors' behaviour. Under stewardship theory, it is often assumed that directors' actions are naturally aligned.[237] This thesis argues that stewardship theory gives directors complete freedom when executing their discretion. To some extent, directors can be trusted, but this does not imply that they are competent in all areas. Honestly speaking, directors could simply be incompetent.

2.4.3 Entity Maximisation approach as a Replacement to Shareholder Primacy

(a) Advocating for the Entity maximisation approach

The two theories debated above have their inadequacies; noted by Macey,[238] neither model can be used to achieve corporate goals. Conceivably, shareholder value is not appealing pertaining to giving directives to directors in company management, although it could be considered realistic and achievable. Shareholder value does provide more validity than the stakeholder theory, but it is frequently overlooked because of its unpredictability, as previously mentioned. Though stakeholder theory appears attractive because of its justice principles, it is unfeasible in its application.

Therefore, it is necessary to consider a new approach. This thesis argues for an entity maximisation approach according to Keay`s entity maximisation model. [239] English law treats the company as an entity and not as a collection of shareholders.[240] Much research

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[235] Andrew Keay, Stewardship Theory: Is Board Accountability Necessary? (2017) 59(6) IJLMA, 1292, 1314.
[236] ibid.
[237] ibid.
[238] Jonathan Macey, 'Convergence in Corporate Governance' (1999) 84 Cornell LR, 1166,1172.
[239] Keay *The Corporate Objective* (n 4).
[240] Mukwiri (n 29).

has been done regarding the question of how directors should run companies.[241] The above discussion has shown that firms can be operated in a way that benefits either shareholders or stakeholders. This puts the emphasis on individuals or organisations, rather than on something objective. Focusing on groups or people gives way to partisan interests.[242] As much as we cannot deny the importance of such groups, we cannot centre on them because it then becomes impossible to create a model that is different to the ones already discussed. The company-centred approach attempts to maximise the entity and ensure that it is sustained – that is, it aims to prioritise its longevity as an ongoing concern.[243] The concept's most critical aspect is its emphasis on the company.

The reality of the concept is that the entity exists on its own, detached from its investors and independent even from new investors.[244] In simpler terms, the principle serves as an illustration of a business and a real person; as stated by Hoffmann, a business is a separate entity, similar to a person's birth and death.[245] Hoffmann's analogy is very useful here, as explained further by Keay, one body with many parts is a natural human, and all parts work together for the benefit of the body.[246]

The same applies to the company, which is comprised of shareholders and stakeholders that form parts of the corporate body and its various roles.[247] Therefore, when directors make decisions, they should abstain from favouring part of the corporation over another. To avoid confusion in the corporate body, no one part should take precedence over the others.[248] The entity as an association, including its members, is distinct from all those affiliated with it and has a legal status and personality.[249] Brown stated that the corporation cannot be characterised as unreal because it is a genuine being; one can

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[241] Ibid.
[242] Ibid.
[243] Berg (n 106).
[244] Waino Suojanen, Accounting Theory and the Legal Corporation (1954) 29, 391, 393.
[245] *Stanhope Pension Trust Ltd v Registrar of Companies* [1994] BCC 84,85.
[246] Myners (n 95).
[247] Keay *The Corporate Objective* (n 4).
[248] ibid.
[249] ibid.

simply acknowledge its empirical reality by acknowledging its presence.[250] It is therefore not contentious; as stated by Machen, no explanation is needed to understand that a corporation is an entity representing a human.[251]

Critics might say that only incorporations can give birth to a corporation. However, that is not true; one could argue that organisations can exist without incorporations.[252] In the past, unincorporated bodies have been considered individuals.[253] Moreover, in the past century, the legal definition of incorporation was traditionally explained in a corporate context to fit the terms of joint stock corporations.[254] Undoubtedly, the notion of the entity came in the modern era, as noted[255] when comparing the UK Companies Act 1862 with its predecessor of 1856. The law permitted a group of people to form a corporation; thus, a corporation was made up of those people and did not consider those people as individual actors.[256] This explains why corporations are distinct from their owners. In fact, academics have implied that this is the very reason why, to this very age, a corporation is addressed using the pronoun 'it,' thus confirming its distinctness.[257]

Moreover, the idea that entities are distinct legal personalities was settled in *Salomon*.[258] In *Regal*, McNaughton also supported the idea that the company is a legitimate business separate of those who formed it.[259] More recently, several cases have conceded to and supported the entity principle.

Fulham Football Club Ltd v Cobra Estate[260] confirmed that directors' responsibilities are to the corporation. The same views were echoed in *Peoples' Department Stores v*

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[250] William Brown, 'Personality of the Corporation and the State' (1905) 21 LQR 365,379.
[251] Arthur Machen, 'Corporate Personality' (1911) 24 Harv L Rev 253, 363.
[252] Keay *The Corporate Objective* (n 4).
[253] ibid.
[254] Paddy Ireland, 'Company Law and the Myth of Shareholder Ownership' (1999) 62 MLR 32, 43.
[255] Paddy Ireland, Ian Grigg-Spall and Dave Kelly, 'The Conceptual Foundations of Modern Company Law' (1987) 14 Journal of Law and Society 149,150.
[256] ibid.
[257] ibid.
[258] *Salomon* (n 32).
[259] *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134,157.
[260] [1994] 1 BCLC 363, 379.

Wise,[261] which affirmed that directors' obligations serve to improve the corporation. The company is entitled to those duties even in situations where proceedings of wrongdoing are brought in breaches.[262] Despite the shareholders power to sue the directors in derivative claims, the law considers the corporation to be the victim.[263] Moreover, any pecuniary taken resulting from the action goes to the company. This thesis establishes that derivative actions serve to confirm the approval of the entity theory.

(b) Pursuing Entity Maximisation and Sustainability

The company-centred approach promotes the company's overall maximisation, which allows managers to raise the company's stock value completely for a long period, generating assets for the organisation.[264] Optimising the resources of the organisation and concentrating on the sustainability of the company reduces the appetite for unwarranted risks. Pursuing maximisation with no care for the company's survival will harm it, and if the company fails to sustain itself, it will not profit any constituents. The purpose behind the organisation's overall maximisation and sustainability approach is to benefit its members and the corporation.[265] Unlike shareholder value, company maximisation does not abandon stakeholders' interests merely to benefit shareholders. Moreover, shareholders will benefit from supporting the company's interests as an entity, because the company itself will develop, survive and be successful.

The entity strategy does not necessarily imply a concentration on improved shareholder profitability, but it may include an emphasis on researching long-term benefits over short-term ones. The company will abstain from entering projects that look attractive in the short run but that would be detrimental to its reputation and future.[266] Over a long period, the organisation is bound to be successful at obtaining benefits through research and development, without damaging the image of the company.[267]

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[261] [2004] SCC 68.
[262] *Foss v Harbottle* (*Foss*) (1843) 2 Hare 461.
[263] See CA 2006 (n 18) para 11.
[264] Keay *The Corporate Objective* (n 4).
[265] ibid.
[266] ibid.
[267] ibid.

The more effective and productive the company is, the more shareholders will benefit. Along these lines, this thesis asserts that the most ideal approach to accomplishing shareholder value is by maximising the entity instead of always prioritising shareholders to the detriment of stakeholders. As confirmed by Goldberg, when directors balance the interests of all stakeholders, value is created for companies' and shareholders' benefit.[268] Entity maximisation is unique to stakeholder theory, yet (compared to competing approaches) it could benefit all company constituencies.[269] The stakeholder approach compels directors to consider all stakeholders; however, the entity approach compels directors to consider company interests, not just those of individual stakeholders. Similarly, like any other model, the company approach will not constantly profit stakeholders and the owners, and there will be cases when their interests come into conflict. Nevertheless, unlike stakeholder theory, the act of serving the organisation as a separate entity provides directors with a straightforward way to behave.

Directors are expected to set a precedent for whichever interest group will most likely support the organisation as an entity. Therefore, to an extent, the issue of balancing competing interests under the entity approach is limited**.** In situations where shareholders' interests and those of other impacted parties' conflict**.** The entity maximisation approach would encourage companies to think long term and recognise the importance of cooperative ties in developing competitive advantages.[270] For example, directors may recognise that paying greater salaries to staff or investing more in environmentally friendly technologies may result in reduced after-tax profits and dividends to shareholders.[271] The

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[268] Phillip Goldberg, 'Shareholders v Stakeholders: The Bogus Argument' (1998) 19(2) Co Law 34, 36.

[269] Xiuping Sun, 'Shareholding and Stakeholding: A Critical Review of Corporate Governance' (2004) 12 Corporate Governance An International Review Journal 242, 250.

[270] Luca Cerioni, The Success of The Company in s.172(1) An Enlightened Directors` Primacy, OLR (2008) vol 4 (1). p.1.

[271] Ibid.

directors would see continual wealth creation for company groupings as the optimum way for shareholders to profit from their investments on a regular basis.[272]

(c)The appropriateness of the entity maximisation Approach

According to Alex Edmans in his book titled "Grow the Pie,"[273] the concept of corporate purpose is defined as the fundamental rationale for a company's existence, underlying mission, and the societal function it fulfils. Significantly, according to this perspective, a company's primary objective should not be the accumulation of profits. Rather, profits are considered as a secondary outcome resulting from fulfilling a specific mission.

Several drawbacks commonly connected with the concept of shareholder value can be mitigated by adopting a perspective that regards the company as an independent legal entity. In this regard, directors should prioritise the maximisation of the firm's wealth. For instance, adopting a company-centred approach is expected to promote a more enduring perspective towards company decision-making, in contrast to a shareholder value approach where the emphasis on immediate profitability is anticipated to dominate.[274]

This perspective of the company centred approach is more proficient in elucidating many tenets of corporate law. This elucidates the rationale behind directors owing their duty primarily to the firm rather than to the shareholders. The company-centred approach effectively justifies the prominent authority of directors and the comparatively limited influence of shareholders in major corporations. Furthermore, it elucidates the possibility for shareholders to maintain membership within the company while pursuing legal action against it.[275] The adoption of a company centred approach can offer a

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[272] Ibid.

[273] Alex Edmans, Company purpose and profit need not be in conflict if we ‘grow the pie.’ Economic Affairs, (2020) 40 (2) 287,294.

[274] Margaret Blair, *Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century 34* (Brookings Institution Press 1995).

[275] John Quinn, The Sustainable Corporate Objective: Rethinking Directors’ Duties. *Sustainability* (2019) *11* (23), 6734.

rationale for the legal differentiation between corporate culpability and the individual actions of shareholders and directors, resulting in potential personal liability.[276] The perspective that regards a firm as a distinct entity stands as a more credible proposition compared to alternative theories concerning the nature of a company.

Considering the firm as a discrete entity offers a rationale for directors to prioritise the enhancement of the company's wealth as an independent entity, detached from the concept of shareholder value. When the company is perceived as a separate entity from its owners, it is not necessary for the firm's activities to align with the shareholders' interests. This recognition acknowledges the potential divergence between the interests of the company and those of its shareholders. In the situations, adopting a company centred approach would enable directors to make decisions that prioritise the well-being of the organisation, even if it comes at the expense of shareholders. Alternatively, directors may choose to act in the best interest of stakeholders if such actions would ultimately benefit the firm.

Furthermore, it is important to note that the mere fact that a company is established by its shareholders does not guarantee that the interests of the company and its shareholders will always align in the future. According to Blair and Stout,[277] after shareholders establish a company, they effectively establish a distinct and independent entity that possesses its own agency and may potentially act in a manner that is contrary to the shareholders' interests.[278] The rationale for advocating the company centred approach lies in its potential to effectively attain the normative target of enhanced benefits for all stakeholders of the organisation, including shareholders.

In fact, shareholders are more inclined to derive advantages by prioritising the advancement of the company's interests as a collective entity, rather than solely

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[276] Ibid.

[277] Margaret Blair and Lynn Stout, 'A Team Production Theory: Corporate Law' (1999) 85(2) Virginia Law Review 247.

[278] *Dawson International Plc v Coats Platon plc* [1989] BCLC 233.

chasing shareholder profit. This approach is more likely to result in the company's overall success, longevity, and growth.[279]

2.5The Benefits of the entity maximisation approach (EMA)

2.5.1 Long-Term Implications of Any Decision

The company-centred approach builds upon Keay's model of entity maximisation and sustainability.[280] When company directors became accountable and responsible of their conduct, it creates and increases the entity's value through market trust .[281] Success for a business enterprise usually entails a rise in value over time.[282] Making directors accountable to the entity not only will it benefit the firm but also its shareholders in the long run, which brings success to the company.[283] It was stated[284] that in essence, shares represent future revenue. Shareholders will not benefit unless the dividend payments continued in the future. Therefore, the success of the company and its benefit to its shareholders are determined by responsible directors, who pursue towards the organisation`s long-term objectives. In return, the company will be able to pay future dividends.

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[279] Andrew Keay, 'Ascertaining the Corporate Objective: An Entity Maximisation and Sustainability Model' (2008) 71(5) The Modern Law Review 663, 689.

[280] Keay *The Corporate Objective* (n 4).
[281] McCann and Wheeler (n 47).
[282] Lord Goldsmith, Lords Grand Committee, 6 February 2006, column 255.

[283] John Lowry, The Duty of Loyalty of Company Directors: Bridging
The Accountability Gap Thrugh Efficient Disclosure.The Cambridge Law Journal, vol 68.
Issue 03 (2009), 607,622.

[284] Paddy Ireland Property and contract in contemporary corporate theory. Legal Studies, (2003) 23 (3) 453,509.

2.5.2 Employees' interests in the company

This thesis considers all criteria stated in s.172 as assets.[285] For they contribute to the continued survival of the company as an entity directly or indirectly.[286] It was stated[287] that shareholders are unlikely to benefit from a firm that experiences frequent employee strikes, customer dissatisfaction with its products or suppliers who would favour its competitors. Directors who are accountable to the company create sound employee relations that promote long-lasting commitment to the firm. Therefore, when company directors are accountable to the firm, employees will perceive the firm beyond, as a way of making money but rather a place to which they belong and commit to improving, through the development of personal skills and constructive criticism.[288] This is a reward that a company gets when directors make decisions having regard to employees' interests. Perceiving employees as individuals with whom a shared mission must be developed.

2.5.3 Company Business Relationships

When shareholders promote accountability in their firms, it creates strong and productive commercial ties with other stakeholders. The company will maximise the value provided by stakeholder connections, corroborations, and reputation-building variables.[289] These assets (stakeholders) are an important part of the organisation`s wealth, that is, the potential of the firm to generate foreseeable longevity value through the maintenance of secure customer and supplier relationships.[290] Customer loyalty to brands and

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[285] Garth Saloner, Andrea Shephard, Joel Podolny, *Strategic Management* (1st edition, Wiley Publishing 2001).
[286] Luca Cerioni, The Success of The Company in s.172(1) An Enlightened Directors` Primacy, OLR (2008) vol 4 (1) 1.
[287] Ibid.
[288] Ibid.

[289] Jim Post, Lisa Preston and Sybille Sachs, Redefining The Corporation: *Stakeholders Management and Organizational Wealth* (Stanford University Press 2002).
[290] Cerioni (n 270).

businesses, according to some observers[291], lowers marketing expenses and stabilises production and sales volume.

2.5.4 Community and Environmental Impact of the Company's Operations

A company that has effective accountability measures reaps benefits from the community which increase the wealth of the firm. A company centred approach promotes and calls for a duty of care from directors. When company directors became accountable and responsible of their conduct and duties, it creates and increases the entity's value through market trust. Section 174 of the CA 2006 state that directors have a duty of care. That is to say, directors exhibit sensible and knowledgeable behaviour.[292] Directors are required to fulfil their duty of care by thoroughly examining all relevant information that is reasonably accessible to them prior to making decisions.[293]

This act portrays due care and promote the success of the company as an entity on its own. The definition of "care" is the degree of caution that a prudent individual of ordinary intelligence would exercise in the same scenario.[294]

According to section 174(1), it is required that a director of a corporation must demonstrate a reasonable level of care, skill, and diligence in their actions. The term "must" denote a sense of obligation in this context.[295] The overall responsibility to oversee their organisation is considered a component of the duty of care and can also be seen as an implicit consequence of the obligation to enhance the company's success, encompassing components of loyalty.[296]

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[291] Ibid.

[292] s174 (1) CA 2006.

[293] Arad Reisberg, Corporate Law in the UK After Recent Reforms: The Good, the Bad, and the Ugly, *Current Legal Problems*, (2010) Volume 63, Issue 1, 315,374.

[294] Ibid.

[295] Alastair Hudson, *Understanding Company Law* (2nd ed, Routledge Press 2017)

[296] Paul Davies et al, Gower and Davies *Principles of Modern Company Law* (9th ed, London 2012).

In Re Barings plc (No. 5),[297] Barings went bankrupt because of the general manager and senior derivatives trader of a Singaporean Barings subsidiary involved in unauthorised trading, causing the bank to suffer massive losses. The manager's unauthorised trading activities resulted in legal actions aimed at disqualifying three executive directors of Barings group firms on the grounds of being unsuitable to oversee a corporation. The court state that directors are obligated to consistently learn and retain an adequate level of knowledge and comprehension regarding the operations of the firm. This is necessary to effectively fulfil their responsibilities as directors.[298]

The case (*Re Barings*) pertained to the act of delegation carried out by all directors across the hierarchical structure of management. However, it is worth noting that this case might also be applicable to the supervision of individuals occupying positions higher than the non-executive directors within the hierarchical structure. This case is posited to be more efficacious in comprehending the contemporary anticipation of directors, specifically within the realm of private and public businesses.[299]

Investors anticipate that the board and management structure of the company will effectively oversee all business matters and possess a comprehensive awareness of any evolving market conditions in which the company works.[300] The contemporary business landscape has undergone significant transformations, characterised by the emergence of professional directors who bear the onus of ensuring the prosperity or downfall of a company. In the contemporary context, the corporate director is obligated to actively promote the welfare of the company, a responsibility that was not often recognised as customary around the time of the *City Equitable Fire Insurance Co* case in 1925.[301]

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[297] [1999] 1 BCLC 433.

[298] *Secretary of State for Trade and Industry v Baker (No.5)* [2000] 1 BCLC 523.

[299] Alastair Hudson (no 295).
[300] Ibid.
[301] Ibid.

Therefore, when company directors exercise a duty of care, the company will have a ‘social license to operate’[302] meaning that the commercial activity has public backing and does not generate public hostility. When directors are accountable the firm has positive community relations, which provide prospects for the company's long-term success. Any company that has a negative impact on the community or the environment is constantly under attack. Even if the company makes profits, the poor reputation will have an adverse effect on its operation and competitors will thrive in this environment. Therefore, a corporation should strive to have a positive reputation for ethical business practices. Maintaining strong ethical standards benefits the company's long-term credibility and trustworthiness. Therefore, when directors exercise and promote a duty of care in a company centred approach, the company is less likely to experience problems in achieving its objectives for it creates and increases the entity's value through market trust.

2.6 COVID-19 Rewriting the Purpose of a Corporation

The recent COVID-19 pandemic has highlighted why stakeholders matter. Stakeholder interests have become increasingly prominent because of the epidemic, but questions remain as to whether the change is just a reaction to the pandemic or if it will have long-term effects.[303] Shareholder theory is the hallmark of the UK CG Code, giving precedent to its members.[304] The other stakeholders come secondary, confirming the supremacy of the shareholders’ interests. The fact that s 172 does not offer stakeholder protection has drawn a great deal of criticism.[305] In the context of stakeholder protection, issues of sustainability arise as to whether directors have a legal obligation to weigh stakeholders’ interests equal with shareholders’.[306] In this case, the shareholder-centric model takes a backseat to the better governance model, which places the company's well-being and resilience at its centre. The pandemic has demonstrated that society depends on viable organisations to fulfil their objectives, rather than existing solely to maximise

[302] Ibid
[303] Irene-Marie Esser, ‘Does the Global Pandemic Signal a Paradigm Shift in Law and Economy’ Oxford Business Law Blog (2 July 2020).
[304] ibid.
[305] Blair and Stout, ‘A Team Production Theory’ (n 204).
[306] Walker (n 123).

shareholders' returns.[307] By law, boards are regulatory bodies that should cater not only to shareholder interests but also to the full spectrum of factors that allow the company to produce value over time.[308] This view, however, does not minimise the responsibility of boards to shareholders; rather, it suggests improvements to the essence and extent of that accountability.

The crisis confirmed Business Roundtable's agenda for corporate purposes.[309] Several executives signed and pledged their commitments to all the stakeholders, shifting away from the norm of supporting shareholder maximisation.[310] It was well established that companies that invest in their stakeholders tend to be successful over the long term.[311] Other industry leaders lent their support to Roundtable's objectives, citing the benefits they would have on building long-term value. The Business Roundtable stated that boards would concentrate on building long-term value, and better serving all clients, workers, societies, suppliers and consumers by having a wider and more complete view of corporate intent.[312] Whether this will have an impact is debatable, but at least it shows an engagement with to the topic and a move away from shareholder primacy.

These were the same issues addressed in the review of the UK CG Code 2019. The recent pandemic has put stakeholders' interests into perspective. Companies have been involved in a variety of events and projects not for profit, dealing with the devastating impact of the virus. For instance, MG Motor gave away 100 of its eco-friendly vehicles to help with the dwindling transport capacity of NHS trusts. Breas UK, the sole company that currently builds ventilators in the UK, saw it putting its staff on a seven-day working week to triple its capacity in dealing with the impact of the virus. Google invested vast sums of money in battling the virus by committing a total of £646 million to fund a project to

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[307] Lynn Paine, 'Covid-19 Is Rewriting the Rules of Corporate Governance,' Harvard Business Review (6 October 2020).
[308] ibid.
[309] ibid.
[310] Alan Murray, 'Business Roundtable Redefines the Purpose of a Corporation to Promote an Economy That Serves All Americans' (19 August 2019) https://fortune.com/longform/business-roundtable-ceos-corporations-purpose/ accessed 19 August 2019.
[311] ibid.
[312] ibid.

produce millions of face masks. Unilever, a British–Dutch consumer goods corporation and the world's biggest soap maker, increased its production by giving away some of its products valued £88 million.[313] The impact of all these activities defines the purpose of the corporation. The pandemic has seen a shift from the norm of shareholder value and profit maximisation, moving towards the perspective of stakeholders' interests and establishing an expectation for reputation of higher company behaviour standards.

In 2020, some companies listed on the stock exchange either postponed paying dividends to shareholders or even refused to pay them due to the impact of the pandemic.[314] This was in contrast to 2019 when British companies paid £110bn in dividends.[315] It could be argued that the motivation behind these actions is that companies realised that when the pandemic is over, they will be judged on how they have dealt with it.[316] In other words, their actions will have long-term effects on their reputations.

What remains to be discovered is whether this will be the normality for all companies, even after the crisis. The current legal system for stakeholders under s 172 is efficient; when the legislation was needed in a crisis, directors acted accordingly. The crisis has shown that directors will stand up to challenges if the situation is urgent and necessary to do so. When the situation demands it, directors focused on the firm's long-term viability. It could be argued, however, that the company's acts were not solely due to directors' decisions. The acts were backed by various government schemes. It also could be claimed that the responses of companies were a result of societal collective action, which was the driver that brought stakeholder interest into clear focus. It is therefore argued in this thesis that what can be learned from the COVID-19 pandemic crisis is that directors of companies can adopt a company-centred approach by focusing on companies' long-term sustainability.

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[313] Paine (n 307).
[314] Kalila Sangster, 'Coronavirus: 445 of UK's Biggest Firms have Cancelled, Cut or Suspended Dividend Payments' (11 August 2020). https://uk.style.yahoo.com/coronavirus-445-of-u-ks-biggest-firms-have-cancelledcutsuspended-dividend-payments-this-year-090107293.html accessed 11 August 2020.
[315] ibid.
[316] Walker (no 123).

2.7 The Corporate Board and Company Directors

The goal of this part is to emphasise the precise status of company directors in their firms, their responsibility to their day-to-day operations and their liabilities. This section seeks to demonstrate that, even though company directors are subject to directors' duties, it seems that the regulatory regime is ineffective at addressing undesirable conduct such as the directors' behaviour in the Libor cases. For instance, RBS directors were involved in Libor fixing scandal with other banks on several occasions, indicating problems with integrity.[317] Libor was used as a reference rate by banks when developing loans.

The regulator discovered that RBS traders were misleading in their dealings with their directors` information.[318] They repeatedly sought to profit from bets on derivatives, which was a clear violation of integrity-based trust.[319] It was serious misconduct, and the directors knew all about the Libor rigging and turned a blind eye.[320] The problem is a consequence of poor governance, which causes more serious misconduct. This section will attempt to clarify the inadequacy of the director's duties in addressing the public's interest in directorial conduct and propose extending the SMCR to non-financial organisations. In contrast to directors' duties, which seek private compensation, the regulatory regime acts as a deterrent against mismanagement and wrongdoing, which has a negative impact on the public interest.

2.8 The Requirement of Directors and their Duties

The literature review has shown that organisations are formed for explicit purposes and that this requires incorporating people into the company's administration to execute those obligations. A principal and central component of the corporate governance process is choosing and maintaining organisational executives who are responsible for guaranteeing corporate targets.[321] The board of directors oversees the firm's operations.

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[317] Ngozi (n 181).
[318] FSA, *The Failure of the Royal Bank of Scotland: Financial Services Authority Board Report* (Dec 2011).
[319] Ibid.
[320] Ibid.
[321] Ngozi (n 181).

Boards represent the corporation's undefined legal person, and managers are the persons to be held liable within companies.[322]

The CA 2006's s 155 recognises that a company does not have the features of a natural person; therefore, its actions are seen through its directors.[323] The preface of the 2018 UK Corporate Governance Code specifically defines directors` role in governing of corporations. Despite the evidence that managers are the people responsible for the management of corporations, they were called 'ornaments on a corporate tree.'[324] Leighton and Thain[325] likened boards of directors to passive actors. From this point of view, there has been a common misconception that boards normally do not function efficiently and are just rubber stamps or window displays at best.[326]

Nowadays, however, business directors are largely responsible for corporate success. Company directors are becoming increasingly involved in setting company objectives, hiring, firing and asking discerning questions.[327] The duties of the board involve complicated tasks, which include setting strategic priorities, managing company operations and reporting.[328] A part of their job as stewards is to maintain harmony among directors and investors. Their mission is to be the investors' lawful delegates and to screen, assess and remunerate the administrative performance.[329]

Following on from the previously mentioned thought, executives oversee not only the company if a crisis arises but also prevent any potential risks.[330] One of the most difficult tasks for directors these days is maintaining a strategic distance from clashes of interest. Any personal interest that clashes with their company obligations are an obstacle that

[322] Donald Nordberg and Terry McNulty, 'Creating Better Boards Through Codification: Possibilities and Limitations in UK Corporate Governance,' (2013) 3 Bus Hist 348.
[323] Jensen (n 51).
[324] ibid.
[325] David Leighton and Donald Thain, *Making Boards Work* (McGraw Ryerson Publishing 1997).
[326] ibid.
[327]Jay Lorsch, 'Empowering the Board' (1995) Harvard Business Review 73 (1) 107,117.
[328] ibid.
[329] ibid.
[330] ibid.

may discourage them from advancing the company's interests. This does not mean that a director does not have any connection with the company or the administration. Rather, this clearly means that every partnership should be understood and explained, because being a director creates plenty of chances for individual gains and benefits.

Therefore, when the quandaries are consistent, directors feel a huge compulsion to exploit these opportunities, which is why the job of a director is occasionally a difficult obligation. In general meetings, board decisions are subject to rules, legislation and shareholders. In addition, board members are strategists rather than controllers, and the board is regarded a highly respected commodity that can lead to sustainable competitive advantage.[331] UK company law includes and encourages firms to adopt model articles of association, noting that directors are responsible for managing companies.[332] Corporate boards play a pivotal role in business management.[333]

2.9 The Role of Boards in Influencing Corporate Decisions.

Empirical research, however, shows that boards of directors are ineffective.[334] Due to pluralistic indifference, some scholars point to the restricted rationality of boards.[335] When outside non-executive directors establish oversight, boards tend to be influential.[336] This comes from individual and collective acts, which both impede and inspire managers. Efficient behaviour demands for non-executives exercise their independence when executing their duties.[337]

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[331] Morton Huse, *Boards, Governance and Value Creation: The Human Side of Corporate Governance* (Cambridge Press 2005).
[332] CA 2006 s 20.
[333] Renee B Adams, Benjamin E Hermalin, and Michael S Welsbach, 'The Role of Boards of Directors in Corporate Governance: A Conceptual Framework and Survey.' (2010) 48(1) J Econ Lit, 58,107.
[334] Andrew Pettigrew and Terry McNuulty, 'Power and Influence in and Around the Boardroom' (1995) HR 845, 873.
[335] Rookmin Maharaj, 'Corporate Governance, Groupthink and Bullies in the Boardroom.' (2008) 5(1) Int J Discl Gov 69.
[336]John C Coffee, 'New Myths and Old Realities: The American Institute Faces the Derivative Action' (1993) 48 Bus Law 1407,1425.
[337] John Roberts, Terry McNulty and Philip Stiles, 'Beyond Agency Conceptions of the Work of the Non-Executive Director: Creating Accountability in the Boardroom' (2005) 16(1) British Journal of Management.

Daily and Dalton have reported that serving as a corporate director today is more overwhelming than doing so at any other time in the history of companies.[338] Shareholders face a daunting challenge in ensuring that directors perform in the shareholders' best interests and do not pursue their own goals. The basis of agency theory is the division of control and power in modern company.[339] According to agency theory, company directors use the basic experience and managerial skills of their company to gain an advantage over the company shareholders, who are absent from the running affairs of the company.[340]

According to Jensen and Meckling, a relationship arises because one hires another individual to provide certain services on their behalf.[341] Since directors preside over the company, there is a risk of self-interest, contrary to the interest of the shareholders.[342] As Smith pointed out, this principal–agent problem results in corporate governance problems; company directors who are tasked to manage other people's money are prone to act without a care in the same manner as they would with theirs.[343]

Agency theory describes company directors being the key internal control system that enables business leaders to track management behaviour.[344] According to this theory, one of the board's key duties is monitoring managers who misuse company assets primarily on behalf of shareholders. Additionally, the board takes part in the formulation of strategic decisions that have a direct effect on shareholder investment.[345] At the heart of the idea is that corporations balance the needs of management with those of shareholders and reduce agency costs using the right rewards and control mechanisms.[346] However, Blair and Stout claimed that directors are not the agent of

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[338] Catherine Daily and Dan Dalton, *The Sage Handbook of Corporate Governance* (Sage Publishing 2003).
[339] Stout (no 1).
[340] ibid.
[341] Hood (n 2).
[342] ibid.
[343] Keay (n 12).
[344] Michel Jensen and William Meckling, 'Theory of the Firm, Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3(4) J Financ Econ, 305,360.
[345] ibid.
[346] ibid.

anybody.[347] They also clarified that the commonly accepted norm that companies are owned by shareholders and exist to increase shareholder value is a damaging myth.[348]

Additionally, they asserted that businesses own themselves, and managers should follow lawful objectives when operating organisations.[349] Blair and Stout dismissed the concept of shareholders having precedence over company interests over other stakeholders.[350] They argued that shareholders have no priority over other corporate stakeholders in the company's interests, so shareholders' interests should not take precedence when determining what is best for the corporation.[351] However, despite different perceptions surrounding the status of the company, the management of the organisation rests on the shoulders of its directors.

2.10 The Enforcement of Directors' Liability

Company directors are subject to directors' duties, irrespective of the industry, but it seems that the regulatory regime has been ineffective in addressing the weaknesses at the senior level in banks such as in the Libor cases.[352] There are gaps in company law regarding the roles of directors in dealing with problems affecting financial service industries, such as risk-taking decisions and discussing actions in the financial sector.[353] This problem is a consequence of poor governance, which causes more serious misconduct.[354] Moreover, directors in financial institutions are encouraged to underestimate risks affecting other constituencies.[355] This leads to a failure to fully understand the connection between a low likelihood of risk and a high level of honesty.[356]

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[347] Margaret Blair and Lynn Stout, 'Corporate Accountability: Director Accountability and the Mediating Role of the Corporate Board' (2001) 79 Washington Law Rev, 403,448.
[348] ibid.
[349] ibid.
[350] ibid.
[351] ibid.
[352] John Gapper, 'Trading Floor Culture No Longer Acceptable' *Financial Times* (London, 5 July 2012).
[353] Chiu (n 6).
[354] ibid.
[355] ibid.
[356] Lucian Bebchuk, Alma Cohen and Holger Spamann, 'The Wages of Failure: Executive Settlement at Bear Stearns and Lehman 2000–2008' (2010) Yale Journal, 257,282.

This was reflected in the Northern Rock case,[357] where the competence of the chairman was questioned after the collapse of the bank.

However, no one was at the mercy of any individual obligation under the law, thus illustrating the lack of any strong and efficient legal structure that can address individual accountability. RBS nearly collapsed in 2009, and in its statement, the Financial Service Authority blamed senior managers for their weak risk decisions and poor governance practices.[358] However, once again, no one person was held liable for individual responsibility under the statute.

These cases demonstrate that the legal mechanisms in this field have not served as a deterrent or to boost the consciousness of senior executives so that they make sound decisions in the best public interest. To what degree should the management be held accountable for the decisions of banking organisations? The above cases show the inadequacy of law in terms of its ability to hold senior managers responsible for making risky decisions.

2.11 Bank Directors' Conduct

McWilliam described the lack of personal repercussions as the source of persistent bad conduct at institutions.[359] It could be argued that the regime of personal responsibility under the duties of directors was meant to be an incentive to deal with bad decision-making on boards; this, depending on the different approaches taken by banks, can be seen as ill-considered and improper conduct.[360] In response to the question of why the duties of directors are insufficient to keep bank directors accountable, this thesis argues

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[357] FSA Internal Audit Division, *The Supervision of Northern Rock: A Lessons Learned Review* (2008) https://www.fca.org.uk/publication/corporate/fsa-nr-report.pdf accessed March 2018.
[358] FSA, *The Inability of the Royal Lender of Scotland: Financial Companies Authority Board Report* (2011).
[359] Stuart McWilliam, 'UK's New Regime to Carry Senior Bankers Accountable for Helping the Corrupt is Actually a Game Changer' (2017).
[360] Jensen and Meckling (no 147).

that the duties of directors are usually incapable of coping with particular risk and fraudulent behaviour problems in the financial services sector.[361]

Finally, the enforcement system uses a poor method of compliance for directors' duties, and such flaws have only been revealed in the aftermath of the banking crisis. Unless directors' duties are changed in a way that increases individual liability in directors, there is no justification for practising sensible and desirable management.[362] Prominent banks failed during the financial crisis of 2007–2009. For instance, Northern Rock had a large market share in the mortgage -lending field. When the share price fell, blame was centred on Northern Rock's reckless growth, which was founded on unreliable business model with a catastrophically business plan that placed an undue reliance on retail markets for lending mortgage.[363]

Northern Rock's board was blamed for not rising to the corporate governance challenges. Non-executive directors were accused of failing to provide adequate oversight or to utilise their independence as a restraining power.[364] Regarding these results, the government reiterated the central duty of bank managers; namely, to minimise risks and avoid damage.[365] Further allegations against the board were made. First, the board chairman was seen as lacking sufficient experience and skills to manage a bank.[366] Second, on several occasions, the chief executive was blamed for his negligence; later, his NEDs struggled to employ sound checking mechanisms to restrain the daring chief executive.[367] In the *Observer*, Sunderland summed up the situation by describing Northern Rock's executive directors' appetite for danger as like putting a Ferrari engine in a Micra.[368]

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[361] ibid.
[362] Roy Smith and Ingo Walter, *Governing the Modern Corporation* (OUP 2006).
[363] House of Commons Treasury Committee, *The Run on the Rock: 5th Report of Session 2007-08*, (HC 56-1).
[364] Smith (n 28).
[365] ibid.
[366] ibid.
[367] ibid.
[368] Tomasic, Roman 'The failure of corporate governance and the limits of law: British banks and the global financial crisis.', in *Corporate governance and the global financial crisis: international perspectives.* Cambridge: (Cambridge University Press 2011), pp. 50-74.

Next was RBS. Prior to the 2008 financial crisis, it was on the brink of failure. It embarked on debt funding; the primary objective of the board was quick growth, which eventually brought the bank down. Given that profitability is a by-product of taking immense financial risks, the board accepted an unprofessional act of cutting costs within the bank, which was a dubious move.[369] Goodwin, RBS's chief executive officer, was too ambitious in acquiring Dutch bank ABN AMRO by bidding against its rival Barclays. The transaction was carried out without proper due diligence on the part of ABN AMRO.[370]

The purchase of ABN AMRO was mistimed and reckless. The FSA conceded that the deal did not make use of a due diligence assessment. The shortfall of the purchase would have been clearly seen if fair and accurate due diligence on ABN AMRO's portfolios had been used.[371] The effect of the transaction was further stressed by Sir Philip Hampton, then chairman, who said that it was the wrong deal at the wrong time.[372] However, regardless of the criticisms from the then FSA,[373] only few cases of personal liability for example, the case of Peter Cummings, the finance director of HBOS, who was fined £500,000 and barred from working in the financial services industry for life.[374] This thesis argues that there are regulatory gaps in company law regarding directors' duties when dealing with issues that concern risk taking, management decisions and market misconduct in the financial services sector.

2.12 Regulatory Gaps under Directors' Duties

Looking at the decisions made by some bank directors, it would be difficult to say that they would be held liable under directors' duties, even though risky choices made in the banking industry were in violation of directors' duties. The courts have established that it

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[369] FSA, *The Failure of the Royal Bank of Scotland: Financial Services Authority Board Report* (Dec 2011).
[370] ibid.
[371] Sheehy (n 208).
[372] Royal Bank of Scotland, 'Royal Bank of Scotland Group PLC Annual General Meeting/General Meeting' (Royal Bank of Scotland, 3 April 2009).
[373] FSA, *The Failure of the Royal Bank of Scotland* (n 370).
[374] Brooke Masters and Sharlene Goff, 'Life Ban and Fine for HBOS's Cummings' *Financial Times* (12 September 2012) https://www.ft.com/content/27905194-fceb-11e1-ba37-00144feabdc0 accessed 12 September 2012.

will generally not interfere with decisions made in good faith by directors, for they have the power and obligation to make their own decisions as per *Regentcrest.*[375]

What is required is for directors to explain their decisions and prove that they were for the company's good. It is true that s 172 obliges directors to be in a sound mental state when considering what is good for the company. If directors can act in subjective belief and such belief is held in good faith, then the courts cannot question the director's decisions. Concerning the directors of banks who were criticised in the regulators' reports, if the directors had honestly believed that the risk-related decisions they made were for the company`s good they would not be held liable. Looking at the high risks associated with dominant markets with the advantage of hindsight, it will be difficult to challenge and question the bank directors for breaching their directors' obligations.

It may also be difficult to impeach bank directors under s 174 for falling below the level of care required. It will have to be established that directors neglected to perform due diligence while performing their duties, thereby falling short of the level of care needed. The managers of failed banks could be held accountable for risk-related 'negligent decisions,' as in the cases of the managers of Northern Rock and HBOS, in which it was reported that the managers entertained and promoted weak underwriting standards and poor risk loans to present a rosy picture on their books.[376]

It is therefore uncertain whether the bank directors alluded to above would be judged as falling below a fair level of treatment. In addition, managing large banks is a difficult and dynamic job, as banks have become too complex to handle. Thus, directors must be judged on the standard merits of reasonableness relative to their contexts and positions. In addition, it will be very hard to believe that such non-financially qualified directors fell below a fair level of care in their decision making, as regulators have not defined the necessary standards of competence for board members.

Furthermore, it is questionable whether debatable questions relating to the roles of directors would be brought before the courts by banks through derivative lawsuits against

[375] [2001] 2 BCLC 319.
[376]Adolfo Paolini, 'Lending Subprime and Advising on Financial Investment from a D&O Insurance Perspective' (2012) J Bus Law, 432,448

directors overseeing banks during the crisis.[377] Furthermore, shareholders might be too reluctant to pursue derivative litigation against loyal directors who had served their interests.[378]

The overarching aim for directors' duties, as set out in s 172, gives precedent to the interests of members; this is contrary to what was desired in the awakening of the crisis, which brought changes to corporate governance.[379] The goal of policymakers is for bank managers to take responsibility for their risk-taking decisions and thus act in a way that brings financial stability.[380] However, that is not the main goal of directors' duties. This thesis argues that directors' duties have shortfalls when dealing with issues within the financial sector.

This is because of the purpose they serve, which is private and focuses on investors' interests, making it difficult to deal with the broader conceptions of public interests.[381] Moreover, the private enforcement of directors' duties deals with and focuses on capital providers' interests.

Private enforcement does not guarantee responsible firm behaviour, nor does it relate to the social dimension desired by bank directors. As far as malpractice and mis-selling are concerned, not only do they affect individual losses, but they also encompass social balances, which influence market confidence and integrity. This thesis argues that using shareholders' private litigation as a means of enforcement under directors' duties does not bring effective governance over directors for the public interests' objectives. Derivative litigations brought against directors by shareholders, concern conduct issues related to the shareholders' financial interests.

Davis[382] has shown his discontent with s 172, saying that although it compels directors to

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[377] Keay, 'The Public Enforcement of Directors' Duties' (n 88).
[378]Andrea Beltratti and Rene M Stultz, 'Why did some Banks Perform Better During the Credit Crisis? A Cross-Country Study of the Impact of Governance and Regulation' (2009) Working Article No 15180. National Bureau of Economic Research, Inc.
[379] Walker (n 123).
[380] ibid.
[381] Andriof and Waddock (no 218).
[382] Paul Davis, *Introduction to Company Law* (2nd edn, Oxford University Press 2010).

consider other constituents while executing their duties, shareholders' interests still take precedence over stakeholders' interests and cannot be directly implemented. Under such litigation, no consideration would be given to greater public interests in directorial actions. For that reason, directors' duties should be a mechanism for the interests of the public to deal with undesirable conduct in the financial sector.

2.13 Enforcement under the SMCR

The inadequacy of the directors` duties in dealing with directorial conduct is better tackled by the SMCR[383] which deals with issues concerning the conduct of directors of banks and financial institutions to change banking. The SMCR came with an enhanced regulatory liability for senior persons and employees who recklessly mismanage and harm financial institutions. Senior managers are governed by codes of behaviour and are liable for breach of any regulatory violation of any financial organisation concerned.[384] The senior person is also liable for oversight, whether they are personally involved in the regulatory contravention or not. The conduct rules imposed by the Prudential Regulation Authority (PRA) and FCA deal with behaviour and serve as a way for senior management to ensure that monitoring and oversight are effectively implemented.[385] Upon finding a breach, the senior persons involved will be fined or disqualified from working within the financial sector.[386] The Financial Services Act 2013 empowers the secretary of state, FCA and PRA to make criminal proceedings against directors who have knowingly caused business failures by not considering risks and whose behaviour has fallen below the level of a rational individual, leading them to make a decision that caused the financial institution to collapse.[387] The author will introduce and explain fully the effectiveness of the SMCR as a model in chapter 7, why it should be extended to non-financial

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[383] The Parliamentary Commission on Banking Standards (PCBS), *Changing Banking for Good* (First Report of Session 2013–14) HL 27-1.
[384] Financial Services and Markets Act (FSMA) 2000, amended by the Financial Services Act 2013, s 66(a), 66(b).
[385] ibid.
[386] ibid.
[387] FSMA 2000 (n 385).

organisations as a means of holding company directors to account and how it can be embedded.

2.14 Conclusion

This chapter discussed relevant theoretical foundation of the study by laying groundwork and developing an awareness of the problem of directors` liability. Recent literature was examined to address the persistent problem of directors` accountability. This chapter has reviewed relevant literature on what businesses are, how and why they act the way they do, and how they are perceived. The chapter has attempted to answer the issue of whose interest should company directors run organisations and to whom should they owe their duties. It has been argued that company success can only be achieved when the board is operating for the company interest, independent from its owners. Therefore, this thesis advocates for entity maximisation approach, Keay's model of entity maximisation and sustainability as a replacement to the enlightened shareholder approach. The company-centred approach attempts to maximise the entity and ensure that it is sustained in such a way that perpetuates its longevity. It was further argued that the SMCR could be used as an enforcement tool under the entity maximisation approach to improve the nature of accountability and responsibility of company directors.

Chapter Three

3 An Evaluation of the Key Issues within Directors' Duties

3.1 An Overview of Directors' Responsibilities Prior to the Company Act 2006

The author evaluated theories of directors' accountability. Theories tells us conceptually what directors should do. If we examine the duties in chapter three, they are like tangible duties that directors are bound by, not like the abstract philosophical theories we have looked at in chapter two. The main reason for the codification was to make it much easier for directors to be aware of and understand their responsibilities and hence improving standard of governance. This chapter will use section 172 under the CA 2006 as a platform to highlight the weaknesses of directors' duties. Section 174 frequently follows section 172; they are complementary duties. A director who does not observe s172 is more likely to be against s174. The reason being that a director who fails to promote the success of the company is more likely to break the duty to use reasonable care and skill. Therefore, this chapter will also demonstrate that s174 is not an effective substitute for s172.

This chapter seeks to bring clarity on director`s duty of good faith under the CA 2006. Directors have a duty to behave honestly in both ESV and shareholder primacy situations. In both cases, a subjective test is used, with the director's opinion set against the court's opinion to evaluate the directors` compliance with their fiduciary obligations. This chapter promotes the objective of this thesis by establishing that, although honesty is perceived subjectively, the law regarding dishonesty is an objective one as affirmed in the case of *Ivey v Genting Casinos.*[388] An analysis of this matter looks at the objective test as a standard measure to bring clarity to the duty of good faith under s172. This chapter will also examine the SMCR in relation to the limitations and challenges of the good faith approach to establish why it should be used to promote the objective test. It is a fundamental requirement that directors understand what their duties are under the law, as these duties serve to safeguard the company by holding directors accountable for its management.

[388] Ivey (n 65).

The format of this chapter will be as follows: Sections 3.2- 3.10 focuses on the development of the discussions that prompted the emergence of the ESV model as the cornerstone of corporate administration. Section 3.11 examines the historical approach of The Good faith Responsibility before the enactment of the CA 2006. Section 3.12 assesses the duty of good faith as a standard for behaviour as interpreted under s172 and its advantage in aiding company directors to evade justice. Section 3.13 will demonstrate and expose the weaknesses of the standard of the subjective test imposed on directors under s172 as low and set a proposed approach of an objective approach instead. The section furthers on how the SMCR can address the limitations of the good faith approach to directors` duties. Section 3.14 will make a critical analysis of s 174. Section 3.15 and 3.16 argues for a proposed approach and recommend the case of *Ivey v Genting Casinos* as a solution to the problems surrounding the issue of dishonesty, which states that dishonesty is an objective test. Section 3.17 will conclude by stating that the subjective test under s172 does not fairly hold directors accountable to their actions instead an objective test is proposed.

3.2 The Reform of Company Legislation Post-1997

This part focuses on the development of the discussions that prompted the emergence of the ESV model as the cornerstone of corporate administration. To enhance management decision making, the ESV model was implemented, requiring company directors to enhance members' interests and consider the needs of different stakeholders.[389] The goal of this strategy was to produce ESV. However, this thesis raises a lot of unanswered questions concerning the way this requirement was drafted, especially regarding its enforceability.[390]

After the Labour government was elected in 1998, it started reviewing company law, aiming to modernise it.[391] An independent board was set up on behalf of the CLRSG.[392] The mandate of this group was to adjudicate legal principles and come up with a way to

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[389] Nicholas Grier, 'Enlightened Shareholder Value: Did Directors Deliver?' (2014) 2 Jud Rev 95.
[390] ibid.
[391] CLRSG, *Modern Company Law* 'Foreword' DTI file 23283. March 1998.
[392] ibid.

modernise company law for the 21st century.[393] The CLRSG issued some significant documents, such as guidelines for the questions and answers raised. [394] Following public feedback, Parliament passed the Business Law Reform Bill in 2005.[395] After extensive discussion in the Houses of Parliament, the bill was eventually passed and converted into the CA 2006.[396]

Following, the CLRSG noted in its strategic framework document that the present law reflects the purpose of corporations; that is, to serve their members and other stakeholders.[397] The CLRSG brought forth reasons supporting the need for reform; for example, the existing legislation did not properly acknowledge that corporations produce wealth when teams peacefully operate and managers account for the community's larger interests in their operations.[398] The CLRSG's primary objective was to establish a legal framework that encouraged businesses and promoted openness,[399] hence the introduction of the ESV approach.

The CLRSG was of the view that the only way shareholders' profit maximisation can be achieved is when the interests of other stakeholders are considered. Adeyeye commented that the ESV model looks at long-term shareholder return, while also considering moral, sensible, and sustainable frameworks. [400] It seems that the CLRSG addressed the question of the corporate objective by highlighting two broad forms of arguments in business: the enlightened relevance of shareholders and the pluralist method.[401] The CLRSG opted for the latter; it believed that corporations should be shareholder-centric and that the members' interests should take precedence over the interests of others. However, the CLRSG was also aware of the fact that companies will

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[393] ibid.
[394] ibid.
[395] DTI, *Modernising Company Law* (White Paper, Cm 5553-1, 2002).
[396] ibid.
[397] The White Paper on *Modernising Company Law: The Strategic Framework*, para 5.1.4.
[398] *Re Smith v Fawcett* (n 52).
[399] CLRSG (n 391).
[400] Adefolake Adeyeye, 'The Limitations of Corporate Governance in the CSR Agenda' (2010) 31(4) Co Law 114,118.
[401] The White Paper on *Modernising Company Law:* (n 397).

not achieve maximum value for shareholders if they do not build long-term relationships; as stated in this instance, the law failed to achieve the requisite inclusive approach.[402]

3.3 The 2002 White Paper: The Idle Objective Standard

In 2002, the government published a White Paper report; this was presented to the CLRSG[403] with the intention of simplifying and modernising company law. Recommendations from the CLRSG were accepted, with clause 19 implementing schedule 2.[404] The purpose of the clause was to formalise the law by defining the requirement to support a company's performance. This duty of bona fide was within the parameters of ESV; that is, to facilitate the company's performance for shareholders` benefit, a director must behave honestly, considering all relevant factors using the standards of a careful and skilled person.

The basic principles of ESV are illustrated in clause 2(b), in which a director is supposed to account for different issues. It is striking to note that an effort to incorporate an objective test into law was made under clause 2(b) of schedule 2. In determining a company's interest, a director must consider all material factors such as the expected consequences of directors' acts that would be deemed significant by a careful and skilled person. This thesis argues that s 174 was an attempt to implement an objective test to determine the norms of a careful and able person. This thesis will further argue how the development of an objective test would be a breakthrough in holding directors accountable in sections 3.13- 3.14.

3.4 The Pluralist Approach

The CLRSG's major goal was to develop a model that would bring wealth and benefits to all members of a company.[405] Two models were considered: pluralism and the ESV model. The pluralist approach is fundamentally the stakeholder value model; it reflects

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[402] CLRSG, *Modern Company Law* (n 391).
[403] ibid.
[404] Steven Cairns, *Changing the Culture of Financial Regulation: A Corporate Governance Approach* (2014).
[405] *Stanhope* (no 46).

the prospect of substantial change.[406] In the pluralist model, directors are compelled to shift their focus of interest to a broad range of internal and external constituencies; they do not just focus on their shareholders. This model considers the interests of those stakeholders connected to the company to be relevant as the interests of shareholders and has much regard for the moral and just aspects of the law.[407]

Dodd highlighted the importance of the business in social terms, commenting that the business plays a pivotal role in both social activity and profit.[408] The approach seeks to encourage directors to execute their duties, considering and balancing any possible conflicting interests without prioritising shareholders. However, the CLRSG noted that implementing the pluralist approach would entail a restructuring of directors' duties if it were to enable directors to consider other constituencies without sacrificing shareholders.

In its consultation paper, the CLRSG sought to find answers to the effect of pluralism by questioning whether it should be enforceable for directors to balance the interests of all constituencies. The argument put forward for supporting pluralism against the shareholder approach was that the latter does not acknowledge that corporations accumulate capital better when working towards one goal, and for that reason, directors must acknowledge stakeholder interests when discharging their duties.[409] The CLRSG also believed that shareholders shouldn't be the only ones to benefit from the company's interests and that the economic right granting shareholders total control of the company is not authentic.

However, pluralism was not seen as the only solution to the issue of companies building a strong relationship with non-shareholders. The CLRSG had great confidence in the ESV model, believing that it would deliver and meet the same objectives as well as (or even better than) pluralism.[410] The CLRSG had reservations about pluralism as a possible workable approach. This thesis argues that changing the existing legal framework to allow

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[406] ibid.
[407] Shuangge Wen, 'Revisiting the Corporate Objective Through the Economic Lens: The UK Perspective' (2013) 24(8) ICCLR 32, 302,317.
[408] Dodd (n 220).
[409] *Stanhope* (n 46).
[410] ibid.

other stakeholders (other than the shareholders) to have priority of interest would create a complex situation that would require a revamp of the whole legal framework, wherein shareholders would end up as the ultimate losers, without any power or control over the company's affairs.[411] Therefore, the CLRSG would not allow nor accept any institutional modifications that put shareholders in an inferior position and with less company control.[412] The ESV model came with no institutional changes that would require shareholders to select and remove directors; moreover, directors would be required to consider the interest of stakeholders above all.

The CLRSG moved away from implementing the pluralist approach for fear that it would make the law deviate from its main objective of serving shareholders' interests.[413] Other objections were put forward, such as that, by adopting pluralism, directors' duties would require amendments. This would make the duties difficult to enforce, considering that there would be several stakeholders, and balancing conflicting interests would lead to poor judgments. For the reasons above, the CLRSG took the view that the reality of implementing pluralism made it neither workable nor desirable. As a matter of fact, the CLRSG proposed that the way forward was the ESV model, which according to them would see companies run in a way that would bring competitiveness and wealth to all constituents.[414]

3.5 The ESV Approach

Although directors played a significant role in companies, their role was not prescribed in legislation until the CA 2006. However, the shareholder primacy and stakeholder theories shared different beliefs on how companies should be run. As pointed out in the previous two chapters, both theories have their drawbacks. The CLRSG opted for a more balanced approach in form of the ESV model, hoping that the ESV approach would clear the confusion about the company`s obligations to directors and create an understanding as to whom the interests are owed.[415]

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[411] CLRSG, *Modern Company Law* (n 391).
[412] ibid para 3.29.
[413] ibid para 5.1.13.
[414] ibid para 2.21.
[415] Lord Goldsmith, Lords Grand Committee, 6 February 2006, col 255.

The bill was seen as the new approach to directors' duties – 'the heart' of the new legislation.[416] Furthermore, the ESV approach would create an understanding that when businesses give attention to a broader variety of concerns for the benefit of shareholders, managers would be more likely to produce a sustainable long-term performance, as defined under s 172(1). Directors are to consider the prescribed list of content in sub-s 1 when executing their duty to use the ESV approach.[417] The CLRSG stressed that doing so would promote long-term success for the company.[418] The CLRSG went on to state that the ESV approach's main objective was to generate the maximum value for shareholders.[419] The biggest difficulty encountered by the CLRSG was the emphasis on the short term rather than on the shareholder value itself. The CLRSG was very much aware of the directors' obligations that compel them to act for the company's benefit, but instead, they interpreted them as benefitting shareholders in theory.[420]

There was no reference to how the committee had come to that conclusion nor case law to prove that the common law represented the shareholder value.[421] This thesis highlights that this act has generated uncertainty. There is no adequate verification method to point out case law that interpreted the statutory obligation to regard of the company`s interests into an obligation to support the organisation's performance for its members' benefits.[422] Bavoso further stated that the CLRSG's assumption that company interests should be linked to those of shareholders was not in line with the court's rulings.[423] The legislation implemented a specific ESV goal (shareholder value) by compelling directors to support the company's performance for the good of its members.[424] Alcock asserts that judging a

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[416] Alistair Darling, Commons Second Reading, 6 June 2006, col 125.
[417] Ibid.
[418] CLRSG, *Modern Company Law* (n 391). para 2.21.
[419] ibid para 5.1.12.
[420] CLRSG, *Modern Company Law* (n 391).
[421] *Ivey* (n 65) 67.
[422] ibid.
[423] Vincenzo Bavoso, 'The Global Financial Crisis, the Pervasive of Shareholder Value and the Unfulfilled Promise of Anglo-American Corporate Law' (2014) ICCLR 213, 220.
[424] Grief (n 81).

company's performance based on shareholders' benefits implies that the entity is of no significance.[425]

The CLRSG clearly explained the question regarding for whom the corporation should be run. It acknowledged that the issue was centred on shareholder value, which gave precedent to shareholders.

It has been argued that the ESV approach is structured in a disguised manner; it gives the impression that it caters to the interests of other stakeholders, which could be interpreted as a less-friendly approach to short-term wealth creation.[426] However, this thesis argues that the CLRSG made it more likely for directors' obligations to be executed based on shareholder interests. Before the CLRSG, directors were expected to act for the company, but the implementation of s 172 made their decisions more shareholder centred. Essentially, directors are not doing anything different after the enactment of the CA 2006.

3.6 An Assessment of the ESV

Several academics have shared mixed emotions about the current definition of the ESV. Some view it as a blueprint for a modern corporate governance framework,[427] while others see it as nothing more than a continuation of the current shareholder value ideology.[428] Keay points out that s 172 (1) can be classified as a 'shareholder first interpretation' since the only enlightened element is the recognition of shareholders` interests and directors enhance the company's performance by prioritising its members.[429]

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[425] Alcock (n 25).

[426] David Collison et al, Shareholder Primacy in UK Corporate Law: An Exploration of the Rationale and Evidence, ‖ Research Report 125, Certified Accountants Educational Trust (London), 2011, 34, 39, 44.

[427] Osama Mustafa Mudawi, 'Does the Concept of Enlightened Shareholder Value Succeed in Bridging the Gap between the Shareholders and Stakeholders Value Theories?' (2018) 8(2) BER. https://www.macrothink.org/journal/index.php/ber/article/view/11271 accessed 2018.

[428] Andrew Keay, 'Tackling the Issue of the Corporate Objective: An Analysis of the United Kingdom's Enlightened Shareholder Value Approach.' Sydney Law Review (2007) (29) 577.

[429] ibid.

Keay presented his criticisms of the prescribed factors in s 172 (1), calling them 'a lame duck'. He stressed that directors should follow a meticulous approach when making long-term decisions. He makes it clear that the word 'long term' is not specified, which leads to ambiguity and debate. In the performance of their functions, directors have a duty towards employees, as they did under s 309 of the CA 1985. Section 172 replaced the old provision while maintaining the same spirit of considering employees' interests. However, employees still have no standing to enforce that obligation, and therefore, the new provision is most likely ineffective. As far as the directors are concerned regarding the community and environment, Keay points out that, like the problem with the phrase 'long term,' this is a complicated concept, as it is very difficult to precisely define the idea of 'community,' and it is not easy to understand what encompasses the term 'environment'. Keay also points out that the repeal of the OFR was a significant disappointment for those who campaigned for stakeholder interests.[430] The fact that the OFR concept never lived to see the day raises the question as to whether the provision is committed to considering stakeholder interests.

The provision provides a legal action that directors face when breaching their duties under s 172, in which the shareholders are the only stakeholders permitted to bring a case under s 260 through a derivative proceeding for the company. Even if derivative proceedings are launched, Keay contends that directors may well argue that they behaved in good faith considering the matters listed under s 172(1) and that the actions were for the company's success, in line with its members' interests.[431] Because of this, it is very challenging for a member to show that the directors were unconcerned about the related issues. Since shareholders alone are allowed to bring a claim, directors may compromise with their shareholders at the expense of other stakeholders.[432] The provision, s172 act in favour of the shareholder without regard to other respected parties who add value to the company.

[430] ibid.
[431] Keay ''Section 172 (1) of the Companies Act 2006' (n 428).
[432] ibid.

However, despite the criticisms of the ESV approach, Keay points out that it has also brought a new direction to the corporate landscape. Directors are now expected to concentrate on their companies' long-term purposes, as opposed to the short-term interests that triggered the financial crisis in 2007. The ESV approach also avoids opportunism on the part of the manager, and as per Keay, it does not need directors to balance the needs of a diverse community of stakeholders.[433] If it were mandatory for directors to do so, they would use it to their advantage when making decisions. No one would doubt the directors' decisions if they claimed that they were made because of balancing interests.

3.7 The Operational and Financial Review

In the context of ESV, the CLRSG suggested two accountable methods for companies: for directors to effectively consider their goals in both the short and long term, in order to achieve a company performance that would benefit shareholders as a whole; and operational and financial reviews (OFR).[434] The OFR was designed to promote good reporting in companies by compelling them to publish financial reviews that explained their strategies and relationships with other stakeholders.[435]

When the CLRSG reformed company law, its aim was to expand transparency, so that it would extend beyond a company's investors. Regarding the lack of enforcement of the pluralist approach, the OFR was intended to supplement a more extensive ESV approach as a reporting tool for monitoring directors.[436] Access to such details was seen as helping stakeholders promote their interests.[437]

The OFR was intended to ensure that companies would be operated in a way that fulfilled their proper purpose. By implementing the OFR, the CLRSG argued that corporate disclosures would fulfil their obligation to regard stakeholder interests. The danger of a lawsuit would improve reporting and accountability, unlike private mechanisms such as

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[433] ibid.
[434] CLRSG, *Modern Company Law* (n 391).
[435] Ibid.
[436] Collison (n 426).
[437] Nicholas Rowbottom and Marek Schroeder, 'The Rise and Fall of the UK Operating and Financial Review' (2014) 27(4) AAAJ 655-685.

derivative actions intended to bring compliance under s 172(1).[438] The government ministry responsible for corporate reporting expressed the need for the OFR, saying that it was a significant step in enhancing business reporting and accountability and encouraging efficient dialogue as the main drivers of long-term business success.[439] The OFR added appropriate reporting requirements to disclosures of required regulations, and it included substantial explanations for any deviation from the standards.[440] These standards were laid down by the then Accounting Standards Board with detailed reporting statements to which the directors were to adhere.[441] These two components made OFR distinct from its successors, the business review for it wasn't subject to any mandatory disclosures nor compliance with reporting standards.

However, the OFR had its critics in other accounting bodies, who were against the auditing requirements and the litigation part that called for the prosecution of auditors who act recklessly and knowingly give misleading information. It was argued that the OFR would compel auditors to reduce disclosures to avoid criminal responsibility.[442]

3.8 The Repeal of the OFR and the Reaction to the Repeal

Despite its wide acceptance and importance from a stakeholder point of view, the OFR was repealed just after its passing. It was criticised for placing unnecessary burdens on companies.[443] In 2005, Gordon Brown unexpectedly called for the requirement for a mandatory OFR to be abolished, describing the standards imposed on companies as excessive and a hindrance to progress.[444] The repeal decision was considered controversial and caused widespread discontent among many organisations, resulting in

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[438] John Lowry, 'The Duty of Loyalty of Company Directors; Bridging the Accountability Gap Through Efficient Disclosure' (2009) 68 Camb Law J 607, 622.
[439] DTI (2005) para 10.
[440] Ibid.
[441] Accounting Standards Board, *Reporting Statement: Operating and Financial Review* (January 2006).
[442] Rowbottom and Schroeder (n 437).
[443] Explanatory Memorandum to The UK Companies Act 1985 (Operating and Financial Review) (Repeal) Regulations 2005 Statutory Instrument No 3442.
[444] Gordon Brown 'Speech Title' (Speech to the Confederation of British Industry Conference, 28 November 2005). https://www.ft.com/content/9073a120-600d-11da-a3a6-0000779e2340 accessed 28th November 2005.

Friends of the Earth taking legal action against the government;[445] the organisation requested a judicial review basing the repeal unjust and illogical. [446]

The same concern was shared by the Institute of Accountants, which expressed its concern with the decision, given the work that had been put into the establishment and execution of the legislative framework.[447] The Chartered Institute of Management Accountants expressed its dissatisfaction by further stating that it believed in the values of the OFR, saying that interfering with the system puts stakeholders at a disadvantage. The move was regarded as a wrong step and a risky one.[448] Additionally, the Association of Certified Chartered Accountants expressed the idea that the OFR had gained wide support from the business community as a channel that could deliver an effective reporting mechanism, stating that ruling it out before its efficacy left a lot to be desired.[449]

The repeal of the OFR affected advocates of the stakeholder approach who supported pluralism by recommending the ESV model.[450] However, questions could be asked as to whether the OFR would have met its intended purpose. The likelihood of corporate transparency and growing stakeholder consideration was hampered by the introduction of the business review, as a model of reporting.[451] The striking distinction lies in the disclosure of information related to stakeholders.[452] The OFR stood to benefit stakeholders by achieving the very essence of ESV, while the business review's focus was on promoting stakeholder benefits and causes.[453]

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[445] Friends of the Earth, 'Brown Faces Legal Challenge after Scrapping OFR' (8 December 2005).
[446] ibid.
[447] Macey (no 77).
[448] ibid.
[449] ibid.
[450] John Quinn, The Corporate Objective: Reinterpreting Directors' Duties (2016) 231,260.
[451] ibid.
[452] ibid.
[453] ibid.

3.9 The Effects of ESV on Employees

In the past, the common law was against the recognition of employee interests for example, see *Hutton v West Cork Rly Co.*[454] Regardless of the considerable subsequent changes in the social environment, the traditional position has shown resilience, despite the introduction of two legislation. S 309 CA 1985, compelled directors to consider employees` interests when discharging their obligations, a provision that was not often litigated. The explanation for this is that corporations had control in s 309, so the workers of the company could not directly enforce it. Therefore, there was a need to expand the old structure through the inclusion of stakeholder category, as was done when the CA 2006 was introduced.[455]

The rights of business employees are considered under this s309; it acknowledges the importance of a company's employees. Subsequently, this has empowered directors to deliver for all stakeholders. The CA 2006's s 172 is as different from the shareholder-centric approach[456] in that that stakeholder interests are more likely to be achieved under the section. Nevertheless, the provision suffers from criticism: it has a negligible influence on the employee's job since workers do not have the power to implement the duty of the director.[457] Throughout the drafting of the 2006 Act, there was an inclination that employee interests would be prioritised more than in the 1985 Act by requiring directors to deal with other stakeholders more seriously.[458] Keay notes that s 172 neither explicitly nor indirectly encourages stakeholders to take action against deceptive directors.[459]

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[454] *Hutton v West Cork Rly Co* (*Hutton*) (1882) 23 Ch D 654.
[455] CA 2006 (n 18) s 172.
[456] Cynthia Williams and John Conley, 'An Emerging Third Way? The Erosion of the Anglo-American Shareholder Value Construct' (2005) 38(2) Cornell Int Law J. Article 5. https://scholarship.law.cornell.edu/cilj/vol38/iss2/5.
[457] Elaine Lynch, 'Section 172: a Ground-Breaking Reform of Directors' Duties, or the Emperor's New Clothes?' (2012) 33 Co Law. 196,203.
[458] Charles Wynn-Evans, 'The Companies Act 2006 and the Interests of Employees' (2007) 36 Ind Law J 188,193.
[459] Andrew Keay, *Enlightened Shareholder Value: The Reform of the Duties of Company Directors and the Corporate Objective* (2006) Lloyds Maritime and Commercial Law Quarterly 335,345.

As a consequence, many scholars condemn this subsection because it does not strengthen the status of workers; rather, it worsens it and has a deleterious effect on employee rights.[460] In other words, employees are still in a disadvantageous position, if not a worse one, because their interests have to contend with the interests of other stakeholders on the same forum.[461] Fischer argued that numerous employee laws provide workers with security;[462] however, s 172 does not offer any improvements – just as with its predecessor, employees are still disadvantaged.[463]

3.10 The Position of Creditors

A growing number of corporations are encountering the possibility or experiencing the condition of insolvency. The current economic situation characterised by a significant increase in the cost of living is exerting substantial negative effects on firms operating in the United Kingdom. [464] The financial strain caused by escalating utility expenses is not limited to households, as small enterprises in particular encounter difficulties in sustaining their operations.[465] In such circumstances, it is imperative for the management to promptly and decisively make strategic choices in order to rectify the deteriorating trajectory that the company is currently experiencing.[466] Nevertheless, conducting business operations while teetering on the brink of insolvency might be likened to navigating a precarious situation, akin to treading on fragile eggshells[467]. Decisions made by the board of directors during this period may face potential challenges due to their alleged failure to adequately consider the interests of various parties, such as the

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[460] Paul Davies and Sarah Worthington, *Principles of Modern Company Law* (10th edn, Sweet & Maxwell Press 2003).
[461] Collins Ajibo, 'A Critique of Enlightened Shareholder Value: Revisiting the Shareholder Primacy Theory' (2014) 2 BL Rev, Vol 2.
[462] Deryn Fisher, 'The Enlightened Shareholder–Leaving Stakeholders in the Dark: Will s172 (1) of the Companies Act 2006 Make Directors Consider the Impact of Their Decisions on Third Parties?' (2009) 20(1) ICCLR 11.
[463] ibid.
[464] Office for National Statistics- Rising Business Insolvencies and High Energy Prices, 7 October (2022).
[465] Ibid.
[466] Andrew Keay, Peter Walton and Joseph Curl, Corporate Governance and Insolvency: Accountability and Transparency (1st edn, *Edward Elgar Publishing* 2022).
[467] Ibid.

company's creditors and significant stakeholders[468]. The needs of creditors are paramount in an organisation. However, those needs are not listed in s 172(1)(a-f), in short, it is an odd omission.[469] Ajibo points out that the 'others' referred to in sub-section (1) often include creditors, as they fall under the same group as other stakeholders.[470] Furthermore, the omission of creditors in sub-s (1)(a-f) was a calculated one, because their interests are catered for protection under sub-section(3), which means that directors are obligated to give little consideration to creditors' interests under s 172.[471]

The most striking feature of sub-sections (3) is that it is only applicable during insolvency when managers are presumed guilty of wrongful trading.[472] This means that directors should regard creditors' interest during insolvency.[473] Hicks and Goo[474] noted that s 172(3) has been demonstrated in cases such as *West Mercia Safetywear Ltd v Dodd,*[475] in which directors were compelled to consider creditors' interest while in danger of insolvency, although they did not owe creditors any such obligation.[476] In the recent legal matter of *BTI 2014 LLC v Sequana SA & Ors*[477], the focus pertains to the degree to which company directors are obligated to take into account the concerns of creditors in relation to their duties under common law and statutory duties. The board of AWA, a firm, disbursed a dividend amounting to €135 million to its sole shareholder, Sequana SA. Now of dividend distribution, AWA exhibited solvency. The distribution of the dividend adhered to the legal obligations outlined in the CA 2006 and conformed to the statutory principles governing the preservation of capital.

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[468] Ibid.
[469] Davies and Sarah Worthington (n 460).
[470] Walker (n 123).
[471] ibid.
[472] Insolvency Act 1986, s 214 or Misfeasance Insolvency Act 1986, s 212.
[473] Derek French, Stephen Mayson and Christopher Ryan, *Company Law* (26th edn, Oxford University Press 2010).
[474] Andrew Hicks and Say H Goo, *Cases and Materials on Company Law* (6th edn, OUP 2008).
[475] *West Mercia Safetywear Ltd v Dodd* (1988) BCLC 250.
[476] *Yukong Line Ltd v Rendsburg Investment Corporation (No 2)* (1998) 1 WLR 294.
[477] [2022] UKSC 25.

Nevertheless, AWA was burdened with enduring pollution-induced contingent liabilities, which were prospective future obligations, of an indeterminate magnitude associated with the necessity to remediate a contaminated river. This circumstance resulted in a tangible possibility that AWA could face insolvency in the future, although insolvency was not deemed to be likely. This eventually happened in 2018, resulting in the administration of AWA. The claimant, BT1 2014 LLC, initiated a legal action asserting that the directors' decision to disburse the dividend violated their obligation to consider the interests of the creditors, as there existed a genuine possibility of the firm facing insolvency in the forthcoming period.

According to the Supreme Court's ruling in the decision, directors are obligated to fulfil their obligation of acting in good faith in the best interests of the company. This duty also includes the consideration of the interests of creditors, as stipulated in section 172(3) of the Companies Act 2006. Nevertheless, it was unanimously determined that while the obligation does indeed exist, it cannot be activated only based on a tangible possibility of insolvency. Hence, during the period of dividend distribution, the directors were not obligated to prioritise the concerns of the company's creditors due to the absence of actual or impending insolvency of AWA, nor was insolvency deemed likely.

The judgement provides guidance regarding the obligation to consider the interests of creditors, which arises when directors possess knowledge or should possess knowledge that the firm is insolvent, on the verge of insolvency, or when insolvency is likely. Directors have a fiduciary duty to duly assess and prioritise the interests of creditors, considering the specific conditions of the company at the given moment. The need for balance arises when considering the possibly divergent interests of various stakeholders, including the members. Nevertheless, in cases where insolvency is unavoidable, the interests of creditors take precedence. Therefore, as a rule, directors must consider creditors' interests. In the case of *NZ*, it was explicitly mentioned that any action that endangers solvency should be considered a position for directors to consider creditors' interests.[478] Moreover, in cases of doubtful solvency, directors are persuaded to regard creditors' interests, despite the company not yet being bankrupt. Company directors are tasked by

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[478] *Nicholson v Permakraft* (*NZ*) Ltd (1985) 1 NZLR 242.

the court to regard creditors` interests;[479] however, the purpose of s 172 under creditors' interests remains unclear. However, without a meaningful good faith requirement, the core duty of loyalty is subject to abuse and does not contain a suitable standard of liability. As will be shown in the subsections below.

3.11 The Good Faith Responsibility

In common law, the fiduciary obligations are divided into five classes. Before explaining the various fiduciary duties that apply to directors, the origins of fiduciary duties must be addressed. The word 'fiduciary' comes from a Latin word 'fiducia', which meant 'trust' in Roman law.[480] Thus, in essence, a fiduciary obligation is a relationship that requires faith and trust.[481] If one decides to act for the good of another in relation to their interests, then a fiduciary relationship is said to have been formed. His Lordship Browne-Wilkinson commented[482] that a fiduciary relationship arises because an actor has agreed to oversee another actor's possessions. *Bristol & West Building Society v Mothew*[483] confirmed that trust and confidence between the two actors are created because of the surrounding circumstances. The relationship involves commitment and for an individual to be responsible of their duty.[484] As a result, responsibility arises, since the circumstances demonstrate that duty is due. The trustee relationship shows that an individual has agreed to responsibility over another's property, putting one in an advantageous position to gain from a vulnerable fiduciary.[485]

The first part of directors' fiduciary duty is their good faith responsibility to the company.[486] In this context, good faith is interpreted to mean fair conduct.[487] As a result, directors must

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[479] *Brady v Brady* (1998) BCLC 20.
[480] Charles Sherman, *Roman Law in the Modern World* (Baker Voorhis & Company 1937).
[481] ibid.
[482] *Henderson v Merrett Syndicates Ltd*
[483] *Bristol & West Building Society v Mothew* [1998] Ch 1, 18.
[484] ibid.
[485] Robert Flannigan, 'The Boundaries of Fiduciary Accountability; (2004) 83 Can Bar Rev. 35, 36,54.
[486] Paul Davies and Sarah Worthington, *Principles of Modern Company Law* (10th edn Sweet & Maxwell Press 2003).
[487] ibid.

execute their duties and authority for the intended purpose – the company. As seen in *Re Smith & Fawcett Ltd,* the subjective test is used to establish the perception of the director's judgment over the company.[488] Per the *Howard Smith Ltd* case, the court will refrain from interfering with directors' judgments over company decisions made in honesty.[489] However, when it is unconvincing to the court, it will interfere.[490] When working for the firm`s benefit , directors must take into account both current and future members interests, as per *Item Software Ltd v Fassihi.*[491]

However, directors should also consider the needs of other stakeholders for example employees, suppliers, creditors, a community who benefit the company beyond the normal stakeholders. And directors should refrain from giving precedence to the interest of shareholders alone.[492] This thesis will concentrate on the director's responsibility to prioritise the organisation`s interest. The duty shall be discussed in the following paragraphs when dealing with the CA 2006 in addressing the controversy surrounding stakeholders. The second part of directors' obligations applies to the responsibility to use their authority properly. Directors are expected to act in agreement with the organisation's constitution.[493] This means that the director must operate as per the terms of the constitution to avoid causing the corporation to go against its own terms.[494]

Under case law, there have been situations in which directors have used their power, not for their proper purpose; for instance, situations in which directors used their powers to offer shares meant for the business to raise money without the approval of the shareholders to avoid a takeover proposal.[495] In such situations, a power meant exclusively for one purpose was abused for unsuitable reasons. *Re Smith & Fawcett Ltd* claimed that directors should exercise integrity and honesty when considering the

[488] *Re Smith & Fawcett Ltd* (1942) Ch 304, 306.
[489] *Howard Smith Ltd v Ampol Petrolium Ltd* (1974) AC 821.
[490] *Charterbridge* (n 63) Ch 62.
[491] *Item Software Ltd v Fassihi* (*Item Software*) (2004) EWCA Civ 1244.
[492] Andrew Boyle and John Birds, *Company Law* (Jordan Publishing Ltd 2009).
[493] Alastair Hudson, *Company Law* (18th edn, Sweet & Maxwell, 2010).
[494] ibid.
[495] ibid.

company's interests.[496] In the same vein, in *Punt v Symons & Co Ltd,*[497] directors abused their powers by obstructing a takeover. Bryne J established that directors ought not to operate above the law.[498] In *Hogg v Cramphorn Ltd case,*[499] the defendant company's directors were unsettled by a takeover bid, and their fear of being ousted from their positions led to them distributing shares to connections who had supported them in the workplace.

While they claimed that it was in the company's common good to protect their roles on the board, even though the actions were made in good faith, the court overruled and considered them to have acted for an inappropriate purpose.[500] Third, as trustees of the company's property, directors are liable for any misapplication thereof. Any misapplication of the property of the company that places directors in a conflict of interest against their beneficiaries, to whom they owe obligations, is forbidden.[501] The concern is that the trustee will take advantage of their position to advance their own personal agenda, rather than that of the company. Even those who do not purposely favour their own interest may do so. Kershaw noted that opposing people, particularly those who think they have behaved sincerely and in good faith,[502] do not trust themselves to offer unbiased guidance. Flannigan stated that the reason for imposing that duty of trust on a director is to safeguard against any self-interest.[503]

Therefore, directors are not permitted to enter any engagement that may put their personal interests that might conflict with the company`s interests. An organisation cannot enter a contract in which it has a financial interest against its directors, as the deal would be regarded as the corporation's right and would be deemed invalid.[504] A director can

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[496] Hudson, *Company Law* (n 493).
[497] *Punt v Symons & Co Ltd* (1903) 2 Ch 506.
[498] ibid.
[499] *Hogg v Cramphorn Ltd* (1967) Ch 254.
[500] ibid.
[501] Hudson, *Company Law* (n 493).
[502] David Kershaw, 'Does it Matter How the Law Thinks about Corporate Opportunities?' (2005) 25 (4) LS 533, 554.
[503] Robert Flannigan, 'Access or Expectation: The Test for Fiduciary Accountability' (2010) 89 (1) Can Bar Rev 1,38.
[504] *Gray v New Augarita Porcupine Mines Ltd* (1952) 3 DLR 1.

only profit from interest through a general resolution, provided that all the relevant information has been reported. Any conflict of interest must be disclosed to the firm. This thesis has established in this chapter that there would be a competing interest if evidence and rationale show that there is a potential conflict arising on a director against the company's interest.[505] In *Aberdeen Rail Co v Blaikie Brothers,*[506] a deal was signed with the director's own company, provides a clear example of a conflict of interest.

A director cannot engage in any deals with conflicts of interest while holding the office of director. In *Island Export Finance Ltd v Umunna,* Lord Herschell stated that a director must not present themself in a situation that conflicts with their duty.[507] Lord Millet spoke similarly in *Bray v Ford*, saying a fiduciary needs to exercise his good faith by avoiding clashing with company's interests.[508] It was claimed in *Bristol v Mothew* that there is to be a rule of no conflict,[509] while in *Keech v Sandford,* it was noted that the reason behind the ruling was to make certain that a fiduciary is not moved to act for their own personal interest at any particular time.[510] This rule is justified on two grounds. First, it acts as a deterrent against directors positioning themselves for the opportunity. Second, it prevents directors from profiteering from opportunities.[511]

Conaglen contemplated the idea that the court does not have to show that a breach occurred, only that there is a possible risk.[512] The court only seeks to establish the potential risk if the fiduciary prefers so. The court is not concerned as to whether the trustee behaved honestly or whether the opportunity was of no significance. In the case, *Regal v Gulliver,*[513] the organisation could not buy a cinema, so directors paid from their

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[505] Irene-Marie Esser, 'Recognition of Various Stakeholders Interest in Company Management' (2008) 23 (3) 317,375 South African Mercantile Law Journal.
[506] *Aberdeen Rail Co v Blaikie Brothers* (1854) 1 Macq 461.
[507] *Island Export Finance Ltd v Umunna* (1986) BCLC 460.
[508] *Bray v Ford* (1896) AC 44 (HL).
[509] *Bristol v Mothew* (1998) Ch 1.
[510] *Keech v Sandford* (1726) EWHC J76.
[511] Andrew Keay, 'The Authorising of Directors' Conflicts of Interest: Getting a Balance?' (2012) J Corp Law Stud 129,169.
[512] Matthew Conaglen, 'The Nature and Function of Fiduciary Loyalty' (2005) 126 LQR 452,480.
[513] *Regal (Hastings) Ltd v Gulliver* (1967) 2 AC 134.

own pockets to aid the organisation. After the sale of the firm, the directors were found liable for gains made on those shares. Directors' good behaviour in seeking to help the company was of lesser concern since benefits were made because of their own initiative and judgment.

This may seem harsh: there was no wrongdoing since *Rega*l could not profit from the opportunity in the first place. Although the court acknowledged these points, it also said that if it were not for the directorship of *Regal*, the company would not have had the opportunity to purchase the cinemas. Therefore, *Gulliver* needed to be held accountable for his actions, even though the incentive had been rejected by *Regal*. Therefore, the case illustrates the difficulty that comes from conflicts of interest, regardless of the different perspectives regarding the situation.

3.12 The Duty of Good Faith: A Standard for Behaviour

Good faith is not easily defined. The case, *Interfoto Picture Library Ltd*, good faith is said to be accurately represented by colloquialisms such as fair play and openness.[514] Under s. 172, directors must carry out their responsibilities in a trustworthy manner. it was affirmed that the important factor to consider is the director's perception of good faith, then the court`s interpretation regarding the company`s interest.[515] The requirement of the director's state of mind is a subjective test.[516]

It was explained later in *Regentcrest Plc* that the bona fide duty of directors supersedes what the court thinks.[517] It does not look at the second thoughts of the court's objective element but rather rests on honestly believing the directors' decisions regarding the company.[518] In essence, the focus is on the director's mind. However, in situations that bring harm to the company, the actions of directors need to be proven to have been honestly for the company good.[519] Keay[520] states clearly that the duty focuses a great

[514] *Interfoto Picture Library Ltd v Stiletto Visual Programmes Ltd* (1989) QB 433.
[515] *Re Smith and Fawcett Ltd* (n 488) Ch 304.
[516] ibid.
[517] *Regentcrest* (n 15) 2 BCLC 494.
[518] ibid.
[519] ibid.
[520] Keay, 'The Duty to Promote the Success of the Company' (n 18).

deal on what the director's mind considers. The courts cannot force their own opinions when judging whether directors' actions reflect the company's best interest.[521] Moreover, no reasonable test is applied.[522] Margaret Hodge, the then MP, clearly explained that regardless of the decisions directors make, much weight rests on their good faith judgment[523] However, Keay clearly states that the courts will not accept statements of directors' good faith when their actions led to the detriment of the company.[524] The judge might simply not take into account the evidence given by directors, as consistently affirmed by Harman J in *Re Company.[525]* Therefore, a contention by a director is unlikely to succeed, and judges will by no means accept it.

However, there tend to be cases in which the court has taken into account objective considerations, such as the *Charterbridge* case.[526] In *Charterbridge* it is stated that in situations where it can be shown that a director failed the interest of the company through their actions, the court can use an objective test to find the director liable for their actions.[527] The objective test is preferred to the subjective and has proven to be effective in UK law when dealing with directors' duties of loyalty, as demonstrated in *Madoff Securities International Ltd v Raven.[528]* In conclusion, the requirement in para 1 of s 172 is a norm of duty of honesty that deals with the state of mind, and the requirement is to be exercised when directors are discharging their duties.[529] However, without a meaningful good faith requirement, the core duty of loyalty is subject to abuse and does not contain a suitable standard of liability.

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[521] ibid.
[522] ibid.
[523] Hodge (n 59).
[524] Walker (no 123).
[525] *Re Company* (1988) BCLC 570.
[526] *Charterbridge* (n 63) Ch 62.
[527] ibid.
[528] *Madoff Securities International Ltd v Raven* (2011) EWHC 3102.
[529] Walker (n 123).

3.13 The Duty of Good Faith as a Measure of Accountability for Directors

Section 172(1) compels a director in good faith to execute their duties in their company's shareholders' interest.[530] Though there is a difference in its wording, the courts interpret s 172 as its common law duty predecessor; as stated in *Hellard & Ors v Carvalho,* s 172 'codifies the pre-existing common law'.[531] A requirement of the director's state of mind is a subjective test.[532] Warren J explained that so long as it can be established that a director's action was honestly for company good, it suffices the court.[533]

Therefore, good faith test measures whether the director sincerely believed their conduct was to benefit the firm.[534] The argument rests on the directors and whatever they perceive to be best for the firm, while the presumption of evidence lies on those who ask the directors to show that the decision was not for the company's good.[535] Moreover, deciding whether the director was acting for the common good and in good faith is a daunting task. As stated in *Regentcrest*,[536] the court will not disregard decisions made in good faith simply to suit its judgment.[537]

The court will take a stance on violation of duty only in grievous situations and were doing so is an opportunity for a complainant to bring a claim.[538] An example is *Item Software v Fassihi,*[539] in which a director was involved in a conflict of interest, resulting in the business failing and was found not to be acting in the company's interest. Arden further clarified that a director is expected to report their own wrongdoing against the duty of good faith, as stated in s 172.[540]

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[530] CA 2006 s 172.
[531] *Hellard & Ors v Carvalho* (*Hellard*) (2013) EWHC 2876.
[532] Demsetz (n 148).
[533] *Cobden Investments v RWM Langport Ltd* (2008) EWHC 2810.
[534] John Quinn, 'The Duty of Good Faith in Light of The Business Judgement Rule' (2016) 27 (4) ICCLR 7.
[535] ibid.
[536] *Regentcrest* (n 15).
[537] ibid.
[538] Hudson, *Company Law* (n 493).
[539] *Item Software* [2004] EWCA Civ 1244.
[540] Ibid.

Understanding how to deal with an argument of good faith is not straightforward.[541] Bowen's issue with the subjective test is that a director can escape liability for their wrongdoing by using good faith to compensate for their actions at the company's expense.[542] It is, therefore, not surprising that, due to certain incidents, courts have introduced some objective elements into the duty.[543] The inclusion of the duty of good faith has provided directors with a defence in situations where there is a significant amount of culpability. The SMCR can address the limitations of the good faith approach to directors` duties.

3.14 Examining the application of Directors` Duties under s174 of the Companies Act 2006

Section 174 frequently follows section 172; they are complementary duties. A director who does not observe s172 is more likely to be against s174. The reason being that a director who fails to promote the success of the company is more likely to breach the duty to use reasonable care and skill. Therefore, this chapter will also demonstrate that s174 is not an effective substitute for s172.

If the codification of common law fails to prioritise the principles of section 172 of the Companies Act 2006 over financial gains, it is difficult to effectively encourage directors to act in a more sustainable manner. The director is obligated to promote the company's best interests by exercising independent judgement and employing the authorities granted to them within the company's constitution. The standard that is required is specified in section 174 of the Companies Act 2006. The initial requirement is outlined in section 174(1) of the Companies Act 2006, which states that "a director of a company must demonstrate reasonable care, skill, and diligence." This quality highlights the duty associated with advocating for the company's best interests, requiring the utilisation of a high level of expertise. Section 174(2) of the Companies Act further explains the definition of reasonable care, skill, and diligence by stating that:

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[541] Hudson, *Company Law* (n 493).
[542] *Hutton* (n 454).
[543] *Charterbridge* (n 63) Ch 62.

This refers to the level of care, expertise, and thoroughness that would be expected from a reasonably diligent individual who is performing the duties of a director for the company. This includes both the general knowledge, skills, and experience that are typically required for someone in this role, as well as the specific knowledge, skills, and experience possessed by the director.

Section 174(2) of the Companies Act 2006 establishes that there are both objective and subjective standards in place. This is logical because a director should have greater responsibilities based on their level of expertise and competence. Under common law, directors have the authority to assign their tasks, if it is done in a reasonable manner. The precedent has been established in the case of *Re City Equitable Fire Insurance Co. Ltd*,[544] where a minimal need must be met. This suggests that if the director is consistently behaving in a rational manner with the objective of advancing the company's best interests, there will not be a violation of directors' obligations. However, it is important to note that each case will be evaluated based on its own circumstances, but the standard established in the case of *Re City case* is still considered the recognised duty due by directors. The application of reasonableness as the standard for determining liability suggests that the business judgement rule may exist in English law, but it must be violated for liability to be established. Consequently, proving a breach of directors' duties will be exceedingly challenging unless the director's actions are blatantly irrational.

The *Re City* case has received criticism for putting lax obligations on directors that fail to align with the contemporary nature of companies. Fisher[545], has contended that the duty of care, as outlined by Romer J, is objectively defined, while the duty of skill is subjectively determined. However, the combination of these components into a comprehensive responsibility has resulted in the subjective level of competence overshadowing the objective duty of care. Boyle[546], asserts that the classical statement of *Re City* is inadequate and unsuitable for the requirements of the contemporary business

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[544] [1925] Ch 407.

[545] Sam Fisher, Reform of the Duty of Care and Diligence of Directors in Australia (1993) 14 The Company Lawyer 145-146.

[546] Alan Boyle, Draft Fifth Directive: Implications for Directors` Duties, Board Structure and Employee Participation (1992) 13 The Company Lawyer 6.

environment. Therefore, there is uncertainty over whether risk decisions made under section 174 could potentially violate directors' obligations. In jurisdictions where the business judgement rule is in effect, directors are shielded from being challenged for decisions that are related to commercial or business matters. In this context, risk appetite and management decisions, unless they are neglected, are considered as business judgements that cannot be questioned by shareholders in civil proceedings.[547]

To determine whether directors have breached the standard of care outlined in section 174 of the Companies Act 2006, it must be argued that they either delegated risk management excessively and neglected its significance, thereby failing to meet the expected standard of care, or that their decisions were negligent and did not meet the standard that a reasonable person in their position would have followed. An American case *Re Citigroup Inc. Shareholder Derivative Litigation*[548], saw its shareholders' lawsuit dismissed due to their failure to demonstrate how, despite the implementation of systems and procedures for board monitoring, directors have not effectively held senior managers accountable for their actions, thus leading to excessive delegation and lack of monitoring.[549]

The UK banks that experienced failure had implemented risk management systems, although not all of them were sufficient in retrospect. Directors are rarely impeached for lack of care and diligence because of delegation, unless the situation is extremely obvious and severe, as per the Barings scandal in the 1990s. Impeachment may be more likely. The preceding section has illustrated that s174 of the Companies Act 2006 is insufficient to effectively support s172, which is likely to face difficulties. One could contend that this is attributable to deficiencies in directors' duties. Regarding

[547] Iris H-Y, Chiu Regulatory Duties for Directors in the Financial Services Sector and Directors duties in Company Law, (2016) Journal of Business Law

[548] (2009) 07 Civ. 9841.

[549] Iris H-Y, Chiu Regulatory Duties for Directors in the Financial Services Sector and Directors duties in Company Law, (2016) Journal of Business Law.

if directors delegate decisions to other levels, they are unlikely to be considered to have violated their duty of care, if they have implemented reasonable systems of oversight. The establishment of a care threshold may potentially lead to a decrease in the level of responsibility among directors, if specific processes are implemented.[550] This could result in the promotion of a culture focused on simply fulfilling requirements rather than actively overseeing and engaging with the responsibilities at hand. This section has demonstrated that s172 has its weakness, but its weakness is partially mitigated by s174. Thus, section s174 does not effectively serve as a support for s 172.

3.15 Proposed Approach

The standard of the subjective test imposed on directors under s 172 is low. As explained in the *Hutton* case,[551] by interpretation, a director could escape responsibility if they can demonstrate to have acted in good faith. However, it is very difficult to measure intention. Indeed, it was stated in *Re A Company,* that it is inconceivable for directors, ex parte, to simply justify their actions as being honestly for the company's interest.[552] Additionally, Hannigan stated that the lack of reasonableness is the downfall of the subjective test under s 172.[553] This is very much the opposite of the common-law approach, which is objective centred.

The case, *Charterbridge*[554] is a good example of the court introducing an objective element. It has been stated that, in situations where it can be shown that a director failed the interest of the company through their actions, the court can use an objective test to find the director liable for their actions. The proposed solution aims to demonstrate that, although honesty is perceived subjectively, the law regarding dishonesty is an objective one.

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[550] Ibid.
[551] *Hutton* (1883) 23 Ch D 654.
[552] *Re A Company* [1987] 1 BCLC 82.
[553] Brenda Hannigan, *Company Law* (4th edn, Oxford University Press 2016).
[554] *Charterbridge* (n 63) Ch 62.

An analysis of this issue looks at the objective test as a standard measure to bring clarity to the duty of good faith under s 172. The definition of dishonesty is clarified in the sense of an accessory's responsibility for a breach of confidence.[555] The law on trust cases, though difficult in its application, does possess clarity regarding the test used for honesty.[556] The explanatory notes of s 172(1) specifically state that the laws of trusts are intended to bring an understanding to directors' responsibilities.[557]

In *Royal Brunei Airlines Sdn Bhd v Tan*,[558] it was noted that a third-party defendant would not escape any damage incurred by a trustee's breach of trust of the beneficiaries if the defendant participated in a such breach of trust dishonestly or fraudulently.[559] The trustee's own state of mind is not important.[560] Lord Nicholls explained the essence of the *Tan* case as any act contrary to how a moral person should behave in each situation.[561]

Honesty is an objective element.[562] Therefore, the test does not look at what the defendant perceived but rather what the defendant would have done as an honest person.[563] So, by failing to satisfy the test of an honest man in those circumstances one is perceived as dishonest. This subjective conviction was inadequate for fulfilling the test of integrity, even though *Tan* had made a gesture of willingness by paying the airline.

In support of this objective test, Lord Nicholls stated that honesty is distinct from the objectivity of incompetence and has an awareness of subjectivity. In relation to what an individual understands, it describes a situation compared with what a normal person might have understood the situation. However, this does not imply that people are free to define honesty as they wish; subjective honesty is not measured using a subjective element. If

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[555] Cadbury (n 38).
[556] Ibid.
[557] DTI (n 39).
[558] *Royal Brunei Airlines Sdn Bhd v Tan* (*Tan*) (1995) 2 AC 378.
[559] Connor Griffith, 'Ivey Getting Casino II: The Debate of Defining Dishonesty' (*Keep Calm Talk Law Journals*, 24 November 2017) http://www.keepcalmtalklaw.co.uk/ivey-v-genting-casinos-pt-ii-the-debate-on-defining-dishonesty/ accessed 24 November 2017.
[560] Ibid.
[561] Hudson, *Company Law* (n 493).
[562] Ibid.
[563] Ibid.

a person intentionally appropriates the property of another, they will be guilty of dishonesty, regardless of their perceptions.[564]

Lord Nicholls gave clarity to cases relating to bona fide duty and explained that confusion comes from courts that misinterpret objective tests as subjective ones, misleading directors.[565] Much of this is demonstrated in *Twinsectra Ltd v Yardley*,[566] in which Lord Hutton took a different view from Lord Nicholls in *Tan* as to what dishonesty entails. Lord Hutton stated that dishonesty cannot be judged by a person not acting objectively; instead, one should subjectively know that their actions would be deemed to be dishonest.[567]

In the test for honesty, Lord Hutton adds a subjective aspect to make it a mixed test that equally involves objectivity and subjectivity.[568] From the statement of Lord Nicholls, honesty is defined as an action measured in relation to the understanding of an individual at a given time.[569] Lord Hutton believed that the third-party claimant had to decide for himself that what they were doing was deceptive.[570] Lord Nicholls' test was meant to regard the information of the third-party defendant to examine whether a rational person might have recognised that they were being deceptive in the defendant's position.[571] Therefore, it is immaterial to try to perceive the defendant's awareness of dishonesty.

The Lord Hutton test added a second subjective aspect to the dishonesty test. As a result of this combined test, a defendant can avoid responsibility simply by showing that they did not realise that their conduct would be deemed unethical by an objectively honest

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564 *Tan* (n 558).
565 Ibid.
566 *Twinsectra Ltd v Yardley* (2002) 2 All ER 377.
567 Ibid.
568 *Twinsectra (*2002) 2 All ER 377.
569 *Tan* (n 558).
570 Friedman (n 197)
571 Velasco (n 199).

individual.[572] The judgment in *Barlow Clowes International Ltd*, on the other hand, plainly confirmed that the honesty test is objective.[573]

3.16 Resolution of the Issues

The *Ivey* Test

The problems surrounding the issue of dishonesty were resolved and affirmed in the case of *Ivey v Genting Casinos,*[574] which this thesis submits as the leading case for determining the duty of good faith. It is a criminal law case and states that dishonesty is not limited to criminal cases. Mr. Ivey was a professional gambler who enjoyed playing casino games such as Punto Banco. He confessed to using 'edge sorting' throughout the game, a tactic that helped him beat the casino.[575] He won a total of £7.7m, but the casino refused to pay him, saying that he tampered with the game and cheated. As a result, Mr. Ivey filed a civil lawsuit, alleging that he was owed his winnings.

The Court of Appeal affirmed in its decision that dishonesty is not a required component of cheating and if it were, proving dishonesty would be difficult.[576] The ruling established a two-limbed test for deciding dishonesty, based on the test set in *R v Ghosh*:[577]

a) Was the defendant's behaviour deceptive by fair and decent people's standards (the objective limb)? If so,

b) Was he/she aware of his/her actions to be immoral by these standards? (the subjective limb)[578]

If these two tests cannot be established, then there is no evidence of dishonesty.[579] Ivey had claimed that cheating necessitates a deceptive mental condition, which he lacked.

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[572] Alastair Hudson, *Equity and Trusts* (5th edn, Routledge Cavendish Publishing 2007).
[573] *Barlow Clowes International Ltd v Eurotrust International Ltd* (*Barlow Clowes*) (2005) UKPC 37.
[574] *Ivey* (n 65).
[575] Ibid.
[576] Matt Hall and Tom Smith, 'The Disappearing Ghost Test' (2017) (2) CL&J, 181.
[577] *R v Ghosh* (1982) QB 1053.
[578] Blair and Stout (n 204).
[579] Ibid.

For that reason, he was genuinely convinced that his actions were not dishonest and was entitled to his winnings. Three issues were put forth for the Supreme Court consideration: (a) the concept of cheating, (b) importance of dishonesty, and (c) the correct test for dishonesty.[580]

<u>The Decision in *Ivey*</u>

When it comes to cheating, Lord Hughes stated that there is no truthful cheating, for it means that any cheating is acceptable rather than illegal.[581] In other words, truthful cheating would be against the definition of the term. Lord Hughes ends his unanimous decision by claiming that cheating does not have to mean deceit in everyday language and that cheating does not necessarily mean doing anything that might be deemed unethical by the average citizen.[582] Accordingly, cheating does not necessarily require dishonesty as one of its legal elements.[583]

When it comes to dishonesty, Lord Hughes makes it clear that it is not a fixed term when it is used as part of a criminal charge.[584] On the contrary, dishonesty, like an elephant, is characterised by its ability to be noticed whenever it is encountered.[585] Dishonesty is a jury decision based on evidence and principles and not a legal issue.[586] In other terms, even though it cannot be described, dishonesty is recognisable. Lord Hughes concluded by claiming that the dishonesty test is applicable to civil and criminal law.

To establish dishonesty, a tribunal subjectively assesses subjectively an individual's real state of awareness or belief about the evidence.[587] The fact that an individual's conviction is rational is not an additional prerequisite; the question is whether it is held in good

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[580] Hall and Smith (n 576).
[581] *Ivey* (n 65).
[582] Rudi Fortson, 'Making Dishonesty Fit the Crime' (2018) Queen Mary School of Law Legal Studies Research Paper No 292. SSRN: https://ssrn.com/abstract=3299369 accessed 11 December 2018.
[583] Ibid.
[584] McGuiness (n 209).
[585] Ibid.
[586] Ibid.
[587] Cerian Griffiths, 'The Honest Cheat: A Timely History of Cheating and Fraud Following *Ivey v Genting Casinos (UK) Ltd t/a Crockfords* [2017] UKSC 67' (2020) 40(2) Leg Stud 252, 268.

faith.[588] The factfinder can assess the individual's actual reasoning of knowledge or belief by applying the objective criteria of ordinary decent citizens.[589] The offender is not expected to acknowledge their standards to be unethical.

Following the unanimous Supreme Court decision in *Ivey*, the objective test defined in *Barlow Clowes* is used to assess if someone is acting dishonesty.[590] As a consequence, the jury considers the guidelines provided in para 74 of the *Ivey* test, which defines the subjective and objective elements.[591] The subjective question is not whether the defendant believed their actions were truthful but rather what the defendant understood in the circumstances under which that behaviour occurred.[592]

The decision in *Ivey* goes some way to improve by abandoning the subjective test. Bowen described the issue with a subjective test, saying that a director can escape liability for their wrongdoing by using good faith to compensate for their actions at the expense of the company.[593] Similar to the *Ivey* test, the good faith test uses an objective requirement to improve adherence to the obligation to behave for the company's good.[594]

Furthermore, the shareholder principle argues that directors can be trusted to fulfil their fiduciary obligations.[595] Since most violations are of vague statements of law, creating a consistent presumption of good faith may have a declaratory impact on directors' conduct.[596]

To accomplish this aim, directors should be held accountable if they fail to behave and regard the company's interests as a legal body, and the objective test for good faith is the

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588 Ibid.
589 Griffiths (n 587).
590 *Barlow Clowes* (n 573).
591 Maddison Ormerod and Tonking Wait, 'The Crown Court Compendium Part 1: Jury and Trial Management and Summing Up' (Judiciary College, June 2018). https://www.judiciary.uk/wp-content/uploads/2018/06/crown-court-compendium-pt1-jury-and-trial-management-and-summing-up-june-2018-1.pdf accessed June 2018
592 Ibid.
593 *Hutton* (1883) 23 Ch D 654.
594 Keay *The Corporate Objective* (n 4).
595 Ibid.
596 Ibid.

best way to do so.[597] The test objectively measures good faith and can be used in cases in which directors have neglected to support the company's interests.[598] Furthermore, recognising the guilt of not behaving in good faith in pursuing the company's performance is a challenge. As stated in *Regentcrest*,[599] the court cannot go against a decision made in good conscience by the directors.[600] Only in the most serious circumstances can the court challenge directors' decisions and allow a complainant to bring a suit.[601]

In the *Item Software* case,[602] a director of *Item Software* decided to deal with the distributor company Isograph directly to make the terms less stringent.[603] As a result of the director's involvement, the organisation failed during negotiations. The director was obviously working against, rather than for, the company's best interests.[604] Therefore, a specific objective standard of good faith increases directors' knowledge of their obligation to behave in the company's interest for fear of being held accountable.[605]

This thesis argues that, by introducing an objective test, s 172 can be used to litigate breaches. If s 172 cannot be used in litigation, it will follow the case of its predecessor, the old CA 1985, which failed to oversee any case law. The thesis contends that in the absence of thorough litigation to provide judicial clarification (such as a swaying clause) makes s 172 redundant and reinforces the notion that the ESV is merely an illusion. Adopting an objective test will open the section to judicial review and step away from the existing position, which is inconsistent with s 172's modest goals.[606] Therefore, the introduction of an objective test could be the only possible way to litigate breaches under the CA 2006.

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[597] Keay *The Corporate Objective* (n 4).
[598] Ibid.
[599] *Regentcrest* (n 15).
[600] Hudson, *Equity and Trusts* (n 493).
[601] Ibid.
[602] *Item Software* (n 539).
[603] Kalemci (n 231).
[604] Ibid.
[605] Jensen (n 147).
[606] Andrew Keay, 'Section 172 (1) of the Companies Act 2006: An Interpretation and Assessment' (2007) 28 Co Law 106,110.

In support to the *Ivy* test the SMCR strengthens the objective test by promoting accountability in financial institutions as will be explained in depth under chapter 7. The SMCR identified accountability as one of the problems in the financial sector and implemented personal accountability. Personal accountability is emphasised for all employees, senior managers now have a legal obligation under SMCR to take great concern to prevent rule violations. Individual responsibilities are described separately in the task descriptions.[607] The conduct rules under the SMCR brought total individual responsibility and accountability to the position of office.[608] It is now mandatory for anyone in the position of senior management to be fit and proper under the SMCR.[609] Honesty, integrity, and reputation are used to determine whether someone is fit and proper. The SMCR can address the limitations of the good faith approach to directors` duties.

3.17 Conclusion

This chapter critically used section 172 under the CA 2006 as a platform to highlight the weaknesses of directors' duties. Section 174 frequently follows section 172 they are complementary duties. A director who does not observe s172 is more likely to contravene s174.Therefore, this chapter also demonstrates that s174 is not an effective substitute for s 172. This chapter has provided a better understanding and clarity of the director`s duty of good faith under CA 2006. This chapter has promoted the objective of this thesis by establishing that, although honesty is perceived subjectively, the law regarding dishonesty is an objective one as affirmed in the case of *Ivy v Genting Casinos.* A standard measure to bring clarity to issues concerning good faith under s172. This chapter contends that the standard to which directors are held is exceedingly low, allowing directors to avoid accountability provided they can demonstrate that their actions were justified. Therefore, the clarification of the duty of good faith in its

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[607] FCA, FIT Handbook (FCA 2020).
[608] FCA, FIT Handbook (FCA 2020) 1.3.1B.
[609] Walker Morris, 'Fitness and Propriety of Senior Managers and Certified Person' (14 November 2019) https://www.walkermorris.co.uk/publications/extension-of-the-senior-managers-and-certification-regime-part-1/fitness-and-propriety-of-senior-managers-and-certified-persons/ accessed 14 November 2019.

interpretation under s172 will make it obvious when a director has breached their duties and bring a deterrent.

Chapter Four

4 An Examination of Directors' Liability under the Companies Act 2006

4.1 Introduction

This chapter critically reviews two case studies RBS and Carillion against s172 and s174 of the Companies Act 2006, and the bad choices their management made. These case studies are used to demonstrate the inadequacies of the directors` duties to deal with undesired conduct of company directors. These responsibilities were developed with the expectations that directors should act in the best interest of the company. Therefore, this chapter will also evaluate what could have looked different on Carillion and RBS under the entity maximisation approach. This will be done by addressing the pertinent questions, If the directors had used the company-centric strategy, would it have had an impact in the present circumstances? How may the implementation of the entity approach have prevented the failure of both companies?

RBS was selected because it was the world's largest bank and the financial sector's most powerful player.[610] Carillion was chosen because it is a recent case and moreover had a local impact in Liverpool. The lives of countless people in Merseyside were supposed to be changed for the better through the creation of a new flagship hospital, which never lived up to expectations. The case studies aim to analyse in detail the various factors that cumulatively resulted in the fall of RBS and Carillion. The case studies will expose the judgment errors and the adverse actions of the management that led to the collapse of both RBS and Carillion.

Accusations are levelled on several factors for the downfall of RBS and Carillion: 'multiple poor' decisions, which include the failure to spot the risks attached and inadequate due diligence analysis.[611] Finally, the decisions undertaken by the Carillion and RBS boards

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[610] Treasury Committee, *The FSA's Report into the Failure of RBS* (HC 2012–13). HC 640. vol 5.

[611] Jill Treanor and Simon Bowers, 'RBS Failure Caused by "Multiple Poor Decisions"' *The Guardian* (London, 12 December 2011) https://www.theguardian.com/global/2011/dec/12/royal-bank-of-scotland-fsa-report accessed 12 December 2011.

are critically examined against the legislation, s 172(1) and s 174 of the CA 2006, to expose its weaknesses in dealing with the directors' conduct. Therefore, the effect of s 172 is questioned in response to its application. This chapter will have the following structure: sections 4.2, 4.3, and 4.4, will give a detailed background of RBS as a European giant in the financial service sector. The sections will demonstrate how RBS established itself to be a mega bank through its acquisition strategy which eventually led to its downfall. Section 4.5, will critically review s172 (1), considering the RBS scandal. The clause will seek to establish whether s172 of CA 2006 is effective enough to hold RBS directors liable for their actions for the failure of RBS. Sections 4.6 and 4.7, examine a case study of the background and collapse of Carillion. Sections 4.8 and 4.9, examine the behaviours of Carillion`s board of directors and key characters that led to its collapse.

Section 4.10 critically reviews s172 (1) of the CA 2006, considering the Carillion scandal, and whether the provision is effective enough to hold Carillion`s board liable for its actions. Section 4.11 critically reviews s174 of the CA 2006 considering the Carillion and RBS scandals and sections 4.12 and 4.13 evaluate what could have looked different on Carillion and RBS under the entity maximisation approach. How the implementation of the entity approach could have prevented the failure of both organisations.

Section 4.14 concludes by highlighting that applying certain provisions under s 172 and s174 of the CA 2006 fails to deliver justice when dealing with directors' conduct and holding them to account. Though the legislative framework is well designed, it is prone to be exploited by company directors in evading justice because of loopholes.

4.2 *The Royal Bank of Scotland as a Case Study:*

Brief Background

RBS Group was a major European financial services conglomerate with a track record of successful acquisitions and integration.[612] RBS was established in Edinburgh, Scotland,

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[612] Saud Taj, *The Royal Bank of Scotland and Its Decline* (2015) 3(2) Business and Management Horizons Journal 13,23.

in 1727 as a Scottish-based bank that catered to the needs of local businesses.[613] However, in the mid-1980s and early 1990s, deregulation of financial services in the UK made RBS a desirable acquisition target for other banks.[614] To avoid this, RBS implemented a growth-by-acquisition strategy, recruiting more entrepreneurial managers with a desire to expand the bank in the UK and beyond.[615] RBS began to expand steadily in the 1990s, eventually becoming a leading bank with 15 million customers and over 2,200 branches in the UK alone.[616]

This was the result of some major activities undertaken by the bank in order to boost its efficiency.[617] In March 2000, RBS made a major change by acquiring NatWest (National Westminster Bank), a much larger bank.[618] Since NatWest's performance was low at the time of RBS' acquisition, effective integration was a major challenge.[619] However, the merger was deemed effective and the financial community applauded it.[620] It was the biggest takeover deal in British banking history and would make RBS one of the world's largest financial service groups.[621] This led to the then Chief Executive of the bank, Fred Goodwin, receiving awards for Global Business of the Year.[622]

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[613] Sabina Siebert, Graeme Martin and Branko Bozic, 'Organizational Recidivism and Trust Repair: A Story of Failed Detectives' (2018) 5(4) Journal of Organizational Effectiveness: People and Performance 328, 345.
[614] Ngozi (n 182).
[615] Ibid.
[616] Kennedy and Others, 'Managing the Aftermath: Lessons from the Royal Bank of Scotland`s Acquisition of NatWest' (2006) 24(5) European Management Journal 368,379.
[617] Munshi Samaduzzaman, *Literature Review on Corporate Governance Structure and Performance in Non-Financial Firms in Bangladesh* vol 7, no 1 (Macrothink Institute 2015).
[618] Ibid.
[619] Ibid.
[620] Lianna Brinded, 'The Sorry History of the Near Destruction of Investment Banking at RBS' *Business Insider* (London, 6 March 2015) https://www.businessinsider.com/why-rbs-failed-as-an-investment-bank-2015-3?r=US&IR=T accessed 6 March 2015
[621] Ibid.
[622] Nitin Nohria and James Weber, 'The Royal Bank of Scotland: Masters of Integration' (2005) 9 Harv Bus Rev 404.

4.3 The Successful Acquisition of NatWest

NatWest Bank was purchased by RBS in 2000. NatWest was a big bank with a much larger market capitalisation than RBS.[623] NatWest was a national behemoth, with spiralling costs and a failed foray into investment banking.[624] With its cost-to-income ratio skyrocketing, the bank was continually losing ground in the marketplace.[625] RBS' offer took a lot of time and effort to put together; public records were generated to support the contract.[626] Compared to RBS, NatWest was much larger therefore, it had to be established that RBS had all the resources to see the deal through. In March 2000, RBS triumphed. The acquisition deal was worth £21 billion and was regarded as the greatest in the history of UK deal making.[627]

During this time, the effectiveness of RBS's acquisition integration was demonstrated not only by NatWest but also by other RBS units, such as Direct Line.[628] The greatest turnaround of RBS during this period was its ability to earn the confidence of the market and to develop trust with customers, which led it to raise a lot of capital.[629]

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[623] Ibid.
[624] Harry Wilson, Phillip Aldrick and Kamal Ahmed, 'Royal Bank of Scotland Investigation: The Full Story of How the "World's Biggest Bank" Went Bust' (London, 5 March 2011) https://www.telegraph.co.uk/finance/newsbysector/banksandfinance/8363417/Royal-Bank-of-Scotland-investigation-the-full-story-of-how-the-worlds-biggest-bank-went-bust.html accessed 5 March 2011.
[625] Brinded (n 619).
[626] Harry Wilson and others (n 624).
[627] Ibid.
[628] Ibid.
[629] Taj Saud, 'The Royal Bank of Scotland and Its Reputational Decline: A Case Study' (2015) 3 Business and Management Horizons 13,23.

4.4 ABN Amro: The Poisoned Chalice

4.4.1 (a) *Background to the RBS Consortium acquisition of ABN Amro*

In 2007 the Dutch bank ABN Amro was ripe for takeover[630] and received a $66 billion bid from Barclays Bank.[631] Two days after that, a group headed by RBS and including Fortis Bank and Banco Santander made a counter-offer of $72 billion, of which $50 billion would be cash and the balance made up of shares in RBS.[632] The deal itself was of much significance in the history of takeovers in Europe. It was the world's biggest banking acquisition and the first cross-border takeover of a European bank.[633] ABN Amro commanded a significant presence in the European banking market, and there were no underlying signs of any financial difficulties.[634] Usually, takeovers are characterised by the weakness of the target but not with ABN Amro, which had a healthy organisation boasting offices in around 53 countries and an outstanding reputation.[635]

(b) *Royal Bank of Scotland and Acquisition of ABN Amro*

Following RBS' purchase of NatWest in 2006, shareholders were dissatisfied with Goodwin's risky growth plan, and he was accused of 'megalomania', following which he ruled out any further advancements.[636] Barclays, on the other hand, was attempting to acquire ABN Amro Bank. Its success would put it above RBS into second place in the UK

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630 Harry Wilson and others, 'RBS Investigating the ABN Amro Takeover' *The Telegraph*, (London, 11 Dec 2011) https://www.telegraph.co.uk/finance/newsbysector/banksandfinance/8947530/RBS-investigation-Chapter-2-the-ABN-Amro-takeover.html accessed 11 December 2011.

631 Colin McClelland, 'RBS Offer for ABN Beats Barclays on Price and Synergies' (29 May 2007).

632 ibid.

633 Patrick Hosking and Miles Costello, 'RBS Consortium Muscles in on Barclays Bid to Woo ABN Amro.' *The Times* (London, 14 April 2007) https://www.thetimes.co.uk/article/rbs-consortium-muscles-in-on-barclays-bid-to-woo-abn-amro-tmgshgb707d accessed 14 April 2007.

634 Treasury Committee, *The FSA's Report into the Failure of RBS,* HC 640.

635 Stout (n 1).

636 John Kollewe, 'RBS Chief Sir Fred Rejects Change of "Megalomania"' *The Independent* (London,5 August 2005).

banking field.[637] There was also the need to position RBS in the transnational field, particularly within Europe.[638] RBS went into a bidding war with Barclays Bank to acquire ABN Amro, which had branches around countries. ABN Amro had a sound investment banking strategy and a takeover would decrease its synergy costs.[639] RBS pursued a radical approach to acquire ABN Amro after seeing the acquisition as an opportunity too good to pass up.[640] It was an acquisition that RBS was prepared to venture into as necessary, which eventually led to its downfall.[641] ABN Amro was successfully bought for £80 billion, a price which financial analysts termed aggressive and overpriced.[642] However, the move was perceived to be a productive one considering the size of ABN Amro and its international reputation, which could be an incentive for RBS.[643] RBS's confidence was boosted by its prior ability to acquire NatWest.[644]

RBS went on to acquire ABN Amro using a hostile takeover approach via a short-term debt strategy because RBS had substantial credit risk and leverage problems.[645] RBS acquired ABN using two lever arch folders and a CD.[646] This was the biggest blunder RBS made in the acquisition, a decision that required a level of risk-taking that could be defined as a game of chance. Its previous experiences with the NatWest takeover led it to believe that it could ignore the necessary due diligence undertaking. In its report of

[637] Ron Kerr and Sarah Robson, 'Leadership as an Elite Field: Scottish Banking Leaders and the Crisis of 2007–2009' (2011) 7(2) Sage Journal 151.
[638] Ibid.
[639] Treasury Committee, *The FSA's Report into the Failure of RBS* (n 634).
[640] Ibid.
[641] Harry Wilson, 'Royal Bank of Scotland': the full story of how the world`s biggest bank went bust (London, 5 March 2011) https://www.telegraph.co.uk/finance/newsbysector/banksandfinance/8363417/Royal-Bank-of-Scotland-investigation-the-full-story-of-how-the-worlds-biggest-bank-went-bust.html accessed 5 March 2011.
[642] Ibid.
[643] Treasury Committee, *The FSA's Report into the Failure of RBS* (n 634).
[644] Ibid.
[645] Stout (n 1).
[646] Jayanth Varma, 'RBS "Gamble" on ABN Amro Deal' *Financial Services Authority* (FSA, 12 December 2011).

what went wrong at RBS, the FSA acknowledged the board's limited due diligence regarding the acquisition.[647]

The takeover of ABN Amro was a huge error according to Sir Philip Hampton, the company's then chairman.[648] RBS took a hostile approach towards ABN, which has not always proven to be a successful route; as explained by Edward Grabianowski,[649] it slows growth due to the nature of hostile takeover operations. To make matters worse, the ABN acquisition was through debt rather than equity.[650] This had a negative impact on RBS` liquidity and stretched its core capital position.[651] RBS's capital ratio was sufficient in early 2007 to meet the Basel II minimum requirement of 8 percent.[652] However, by the end of 2007, everything had changed, as RBS had a poor capital ratio, which was exacerbated by ABN's debt purchase.[653] RBS was unable to retain the necessary 9.5 percent equity Tier 1 capital, and by the end of 2007, its capital ratio had fallen to 2 percent.[654]

Lack of due diligence, ignoring all the risks involved, was not the right approach to such a large acquisition.[655] In its report, the FSA stated that RBS was overconfident and content in its ability to execute acquisitions because of its past triumphant deal with NatWest.[656] RBS was accused of moving forward with the ABN acquisition without adequately assessing the risks.[657]

It was explained further that the RBS board did not give enough time to meetings regarding the ABN Amro acquisition.[658] As reported in the board meeting minutes, the

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647 Treasury Committee, *The FSA's Report into the Failure of RBS,* HC 640 (n 634).
648 Ibid.
649 Edward Grabianowski, *How Hostile Takeovers Work* (HowStuffWorks 2016).
650 *Re Smith v Fawcett* (n 52).
651 *Extrasure Travel Insurance Ltd* (n 42).
652 Alison Lui, 'Greed, Recklessness and Dishonesty? An Investigation into the Micro-regulation and Culture of Five UK Banks between 2004–2009' (2015) 16 J B R 106, 129.
653 Ibid.
654 Ibid.
655 FSA, *The Failure of the Royal Bank of Scotland* (n 634).
656 Ibid.
657 Ibid.
658 *Howard Smith Ltd* (n 489) 821.

board failed to conduct a crucial review of risks.[659] RBS did not consider the impact it would have upon its stakeholders before it went on to acquire ABN Amro. Due diligence helps to evaluate options that benefit the company; RBS should have abstained from investing in ABN without proper diligence, for without it, sound decisions are impaired.[660]

Leading the consortium was a bad decision, as RBS already had high leverage. Between May and August of 2008, it raised about £20 billion of funding, which became an issue as the funding started to dry up.[661] In contrast to its peers, it relied heavily on short-term financing.[662] It accumulated nearly 65 percent of overnight support, while the average was 35 percent.[663] The failure of RBS was not solely due to the ABN Amro contract, however. The FSA listed three weaknesses of the board: insufficient time to deal with risks, lack of relevant discussion on markets, and insufficient team members capable of strategic thinking.[664] RBS had a lot of people who could execute policy but just a handful who could lead and figure out what strategy was best.[665] RBS was accused of pursuing a profit maximisation approach. However, growth and profit maximisation accompanied by a clear strategic risk review is beneficial to a company.[666] RBS was contrary; it pursued a radical approach towards acquisitions without thorough due diligence, an approach which proved very costly in the end.[667]

Other RBS's weaknesses were its leadership, bad board decisions, and a culture that promoted unnecessary risk taking.[668] According to Lui, the chief executive officer's dominant personality made it impossible for board members to exercise independent judgment and be critical of board decisions.[669] As a result of this toxic environment, the board could not function effectively.

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[659] FSA, *The Failure of the Royal Bank of Scotland,* HC 640 (n 634).
[660] Bowers and Treanor (n 611).
[661] *Ivey* (n 53) 67.
[662] *Howard Smith Ltd* (n 489) 821.
[663] Ibid.
[664] FSA, *The Failure of the Royal Bank of Scotland* (n 634).
[665] FSA, `Reforming Remuneration Practices` (n 62).
[666] Kerr and Robson (n 637).
[667] Treasury Committee, *The FSA's Report into the Failure of RBS,* HC 640 (n 634).
[668] Lui (n 625).
[669] Ibid.

(c) ***The RBS Board`s Unmanageable Culture***

The RBS board was engulfed by new controversy over its decision to pay large bonuses to its directors and maintain their lavish annuities. The growing distrust in RBS led some to question the underpinning paradigms that govern the economic system and caused social discontent among groups such as the Occupy London movement that protested high bonus payments.[670] It was asserted that directors profited from exorbitant incentives and ascribed the bank's accomplishment to these liberal bonuses,[671] and yet the bank was underperforming and on the verge of collapse. Such exceptional payments caused the disparity in justifying the underperforming directors and brought about the issue of distributional justice. It is argued whether executive compensation should be linked to company performance. For example, in the USA, pay and performance have a close link, contrary to the UK and Germany, while in Japan it has no effect at all.[672] RBS' directors were rewarded with bonuses regardless of performance. The huge amounts of executive pay sent a message that boards of directors were immune to any supervision or restriction. Additionally, senior RBS financiers admitted that the reward culture may have added to the emergency of 2007 of 2008, and Goodwin himself conceded that the reward framework was 'something that ought to be taken a gander at`. Thus, there was dissent amongst RBS stakeholders, who protested in anger against the bonus culture, which was a 'reward for failure.'[673]

The board was also accused of being narrow minded and incompetent by failing to foresee or deal with future risks. The Group Chief Risk Officer had no access to the Group

[670] Kevin Roe, *Leadership Practice and Perspective* (3rd edn, OUP 2020).

[671] John Plender, 'Capitalism in Crisis: The Code that Forms a Bar to Harmony' *Financial Times* (London, 8 July 2012) https://www.ft.com/content/fb95b4fe-3863-11e1-9d07-00144feabdc0 accessed 8 January 2012.

[672] Filatotchev Igor and Deborah Allcock, 'Corporate Governance and Executive Remuneration: A Contingency Framework' (2010) 24(1) The Academy of Management Perspectives 20.

[673] Mark Field, 'Sir Fred Goodwin`s Knighthood is an Irrelevant Bauble. The Rewards for Failure are the Real Issue' *The Telegraph* (London, 23rd January 2012). https://www.telegraph.co.uk/finance/financialcrisis/9033649/Sir-Fred-Goodwins-knighthood-is-an-irrelevant-bauble.-The-rewards-for-failure-are-the-real-issue.html accessed 23 January 2012.

Executive Committee meetings; for that reason, he had no relevant information about potential risks and policies he could share with other members.[674] Furthermore, according to the RBS report on 2008, the Risk Committee did not meet very often, the board met nine times and there were 20 ad hoc board meetings[675] in the whole of 2007, at which meetings issues such as future risks and solutions were supposed to have been discussed. Instead, representatives looked over previous data and endorsed measures that were ineffective.[676] Furthermore, there was no indication that members alerted the Group Management Committee to any possible danger.[677]

RBS' mission statement is 'Make it Happen,' a good illustration of a convincing bank. However, its poor management of risk assessment was exposed, which led to the hostile acquisition of ABN Amro.[678] Diversity was a major weakness and problem. Since 2004, only one woman and no ethnic-minority directors served on the board.[679] RBS lacked a structure that could ensure that its boards inspired the best talent while preventing prejudice from restricting their ability. In its study, the FSA also raised concerns about the board's size and effectiveness.[680] RBS' problems continued with the LIBOR fixing scandal after investigations by the financial regulator discovered it had exploited the LIBOR in collaboration with other banks on several occasions, indicating problems with integrity.[681]

LIBOR was used as a reference rate by banks when developing loans. It is linked to corporate debt, and financial analysts use it to get a sense of what the consumer is expecting.[682] Far from that, however, the regulator discovered that RBS traders were misleading in their dealings with their directors' information. They repeatedly sought to profit from bets on derivatives, which was a clear violation of integrity-based trust.[683] Reports further highlighted that RBS was too exposed to conceal its manipulative

[674] Granthan (n 36).
[675] Manne (n 76).
[676] Ibid.
[677] FSA, *The Failure of the Royal Bank of Scotland,* HC 640 (n 634).
[678] *Bligh v Brent* (n 34).
[679] Lui (n 625).
[680] Ibid.
[681] Ngozi (n 181).
[682] Ibid.
[683] Ibid.

dealings.[684] It was pure misconduct; the senior managers knew all about the LIBOR rigging and turned a blind eye.[685] Arguably, they were also reckless in their behaviour.

Over the years, RBS endured episodes of trust-related reputational issues. The bank utilised a variety of tactics to restore the harm done that included structural constraints on future conduct; in addition, changes in legislation were implemented and internal investigations were conducted.[686] Moreover, the bank took an apologetic approach, apologising during a Parliamentary Select Committee hearing.[687] However, in trying to regain consumer trust, the bank continued to transgress, harming trust amongst the public and stakeholders. Thus, in this case, RBS and its directors were the constant guilty parties causing reputational embarrassments, which brought about open dissatisfaction from the public.[688]

4.5 *Considering the RBS Scandal, An analysis of Section 172 (1) of the CA of 2006*

This section examines Fred Goodwin's and his board's actions when they oversaw RBS. It seeks to establish whether s 172 of the CA 2006 can hold them liable for their actions for the failure of RBS. The discussion is centred on the decisions made by the board and how they relate to s 172(1). To hold the RBS board liable under s 172, it must be established that the board did not act morally to support the organisation`s performance for shareholders' interest and to consider the factors mentioned.[689] The prescribed list of content in sub-s (1) is to be considered by directors when executing their duties to bring out the concept of 'enlightened shareholder value'.[690]

What is considered important is a subjective element that will involve the director's mental state.[691] What is needed is a good-faith judgment by directors, not a court order relating

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[684] Treasury Select Committee, *The FSA's Report into the Failure of RBS,* HC 640 (n 634).
[685] Treasury Committee, *The FSA's Report into the Failure of RBS,* HC 640 (n 634).
[686] Ibid.
[687] Ibid.
[688] G30 Working Group, *Banking Conduct and Culture: A Call for Sustained and Comprehensive Reform* (Washington D.C, July 2015).

[690] Alistair Darling, Commons Second Reading, 6 June 2006, col 125.
[691] Alcock (n 25).

of what`s good for the company.[692] It was stated that a court would not serve as authoritative over decisions that the managers took in good faith.[693] The question is whether RBS directors had a sincere conviction that the ABN Amro offer was for the company good. RBS directors will argue that they acted honestly and believing that the acquisition would benefit the organisation. No evidence can be drawn to suggest that the acquisition was meant to harm the company.

The requirement of directors to act in good faith cannot be dismissed, judging by the transaction made. The problem lies in the lack of clarity in the standard for assessing directors' actions.[694] Ibid. Though it is unequivocally stated that paying lip service to the variables would not suffice,[695] it may be hard to demonstrate that RBS directors simply offered lip service to the requirements in s 172.[696] It was established in *Extrasure Travel Insurance Ltd v Scattergood*[697] that this duty is almost impossible to breach. If RBS directors can prove that the transaction was meant to benefit the company, though the belief might be deemed unreasonable, they will still escape liability under s 172.

Pennycuick's objective consideration in *Charterbridge*[698] deals with the shortfalls that come with the subjective test. It was stated that, in situations where it can be shown that a director failed the interest of the company through their actions, the court can use an objective test to find the director liable for their actions. Keay strongly stressed the need for the judiciary to consider and adopt an objective element in s 172(1), commenting that a director can still evade liability by claiming to have acted in accordance with the law.[699] In other words, a subjective judgment may be regarded as one of many factors to consider when determining whether RBS' directors, behaved in good faith.[700] Therefore, it has to be proven that RBS directors' conduct was unacceptable while executing their duties

[692] *Re Smith & Fawcett Ltd* (n 488).
[693] *Howard Smith Ltd* (n 489) 832.
[694]
[695] David Chivers, 'The Companies Act 2006: Directors' Duties Guidance' (*The Corporate Responsibility Coalition*, October 2007)1.
[696] Keay ''Section 172 (1) of the Companies Act 2006' (n 606).
[697] *Extrasure Travel Insurance Ltd* (n 53).
[698] [1970] Ch 74.
[699] Keay ''Section 172 (1) of the Companies Act 2006' (n 606).
[700] Keay, 'The Duty to Promote the Success of the Company' (n 18).

contrary to the company's interest. The court must distance itself and beware of hindsight when assessing the directors' actions.[701]

The FSA's report showed that the RBS board was aware of its insufficient risk assessment before the transaction for ABN Amro was made.[702] The due diligence was inadequate, and RBS directors tried to justify their actions by explaining that the merger was hostile.[703] In its report, the FSA stated that the RBS board used its past experiences of success in acquisitions and neglected to act in accordance with due diligence.[704]

Considering all this, the RBS board proceeded with the transaction without due care. The costly acquisition of ABN Amro was described as the biggest mistake in the company`s history that later had severe effects related to the downfall of the company. [705] Directors of a company cannot be penalised for bad business by law, yet, when considering the level of risk taken by the RBS board members, it is possible that imposing liability on them is fair to deter other directors of financial institutions from such practices. By failing to adopt an objective interpretation, it will be very difficult to establish that RBS directors acted in dishonest belief while executing the ABN Amro deal. It will be very daunting to establish whether the company's success was promoted by RBS' directors. Keay stated that the phrase 'success of the company is far from clear, along with its interpretation,[706] since the directors' good faith judgement determines the meaning.[707]

The case *Item Software (UK) Ltd,* [708] though established that a director cannot claim to have acted in company's benefit when his/her judgement is at the expense of the company. The ABN Amro investment was meant to bring a considerable financial profit;

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[701] *Secretary of State for Trade and Industry v Goldberg* (*Goldberg*) [2004] 1 BCLC 597.
[702] Hodge (n 59).
[703] ibid.
[704] Granthan (n 36).
[705] Royal Bank of Scotland Group plc, 'Annual General Meeting' (Press Release, 3 April 2009) https://investors.natwestgroup.com/~/media/Files/R/RBS-IR-V2/shareholder-meetings/rbsnews-2009-4-3agm3.pdf accessed 3 April 2009.
[706] Keay, 'The Duty to Promote the Success of the Company' (n 18).
[707] Explanatory notes to CA 2006 (n 18) para 327.
[708] Hudson (n 493).

however, it was crippled by the idea of short-term gains. Hubris and recklessness were only part of the motive to pursue the acquisition.[709]

It was an opportunity too good to let pass. It was an acquisition that RBS was prepared to venture as necessary, which eventually led to its downfall. It would be extremely difficult to find RBS directors in violation of s 172 in any of the potential avenues of action. Furthermore, the Act's overreliance on a subjective evaluation makes it very difficult to call into question the director's own judgment.[710] Objectively, it cannot be disputed that the costly takeover of ABN Amro was not good for the company. The company directors of RBS were unquestionably incompetent, and no one has been held accountable for their behaviour. The current statutory framework is therefore exposed as inadequate for bringing accountability to company directors.

4.6 A Case Study of Carillion

The directors' responsibilities to the corporation are outlined under ss 170–181 of the CA 2006.[711] These responsibilities were developed to reduce any uncertainty in the statute's wording and bring clarification.[712] It is, therefore, proper in the circumstances to evaluate a case study pertaining to the collapse of Carillion. Carillion was picked as a case study because it is a current example that has affected Liverpool locally. Numerous individuals` lifestyles in Merseyside were supposed to be changed for the better through the creation of a new flagship hospital, which never lived up to expectations. The impact was summed up by then Liverpool mayor, Joe Anderson, who stated that 'it is very difficult to encapsulate the anger and frustration'.[713] A detailed examination of the decisions taken by Carillion shows that the directors clearly were at fault of their obligations to support the

[709] Alex Massie, 'Barclays v RBS: A Tale of Luck and Greed.' *The Spectator* (5 April 2009) https://www.spectator.co.uk/article/barclays-vs-rbs-a-tale-of-luck-and-greed accessed 5 April 2009.
[710] Explanatory notes to CA 2006 para 327.
[711] CA 2006 s170.
[712] David Cabrelli, *The Reform of the Law of Directors Duties in UK Company Law* (University of Edinburgh, 2008).
[713] Rob Davies and Joanna Patridge, 'How Carillion Collapsed Stymied Two State-of-the-art Hospitals, *The Guardian* (16 January 2020).

success of the corporation by demonstrating care, expertise, and diligence.[714] However, the case study will demonstrate that directors' duties do not go far enough to protect companies and regulate conduct.[715]

Carillion was a major contractor in the UK until 2017,[716] boasting of its large ventures overseas and a market of £2 billion.[717] However, this case study discovered weaknesses in its business model.[718] Carillion pursued an 'unsustainable dash for cash' driven by acquisitions.[719] Intentionally, Carillion embarked on aggressive accounting policies that misrepresented the reality of the business and presented a positive picture to the markets.[720] Regardless of the company's results, directors painted a rosy picture by raising dividend payments every year.[721]

Dividends were paid out in greater amounts than the company's cash flow.[722] Despite the company's challenges, the board of directors kept a positive attitude. The corporation lost £7 billion in revenue but only had £29 million in hand; its demise was a tale of folly, arrogance, and greed.[723] The demise of Carillion was caused by and was attributable to the board. The case study investigates the conduct of the directors of Carillion and the breaches of duties under the CA 2006, s 172, and exposes its inability to deal with directors' conduct. Once again, s 172 is questioned in response to its effectiveness in promoting corporate accountability.

4.7 *Background*

Carillion demerged from Tarmac in 1999 and became an independent public company focusing on support services and construction services while Tarmac concentrated on

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[714] CA 2006 s 172.
[715] Chiu (n 135).
[716] Neil Hodge, 'Learning from Corporate Collapse, Risk Management' (1 February 2019) 66(1) New York 30.
[717] Joseph Smith, 'Carillion plc: A Governance Case Study from the UK' (Duke University School, 18 July 2018).
[718] BEIS and Work and Pensions Committees (HC 16 May 2018) HC 769.
[719] ibid.
[720] ibid.
[721] ibid.
[722] ibid.
[723] ibid.

building materials.[724] The problems for Carillion began when it took on multiple projects.[725] Government projects accounted for a substantial portion of Carillion's company.[726] The collapse of Carillion was portrayed as an accident waiting to happen with repercussions for other stakeholders.[727] This led to a call for thorough investigations into the actions of Carillion's directors and its corporate governance framework.[728]

The collapse attracted much coverage and several inquiries. It was a shock to the parliamentary committee how it survived long before its collapse.[729] Carillion's investors were worried about the company's growing debt and its inability to deal with it, and they started to sell their stock in 2015 in fear of running loss.[730] Until it went bankrupt, Carillion was the UK's leading building construction company.[731] Insolvency, however, left it with a £2.6 billion deficit[732] and 30,000 unpaid suppliers at risk of losing out.[733] Carillion owed £2 billion to its other stakeholders as of June 2017.[734]

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724 Commission `Green-paper` (n 100).

725 Jonathan Freedland, 'After Carillion We Have the Chance to Build a Better Country' *The Guardian* (London, 19 January 2018).

726 Robert Chapman, 'Ineffective Risk Management and the Collapse of Carillion' (2018) 7(12) PM World Journal 1.

727 HC Deb 12 July 2018, vol 644- Sixth Series.

728 Institute of Directors, 'Good Governance: "Carillion Bonus Rule Change Sign of Ineffective Governance"' (Press Release, 15 January 2018). https://www.iod.com/news/news/articles/Carillion-bonus-rule-change-sign-of-ineffective-governance accessed 15 January 2018.

729 BEIS and Work and Pensions Committees, *Carillion, 2nd Joint Report Session* (HC 2017–19). HC 769.

730 Ibid.

731 Ibid.

732 Commons Select Committee, 'Pension Scheme Trustees Questioned on Carillion' (30 January, 2018) https://committees.parliament.uk/committee/164/work-and-pensions-committee/news/97881/pension-scheme-trustees-questioned-on-carillion/ accessed 30 January 2018.

733 BBC, 'Carillion Collapse: Insurers Pay Out £30m to Suppliers' (25 January 2018) https://www.bbc.co.uk/news/business-42811707 accessed 25 January 2018.

734 Lizzy Buchan, 'Government Faces Questions over Carillion Contracts as Crisis Go Down to the Wire', *The Independent* (London, 15 January 2018) https://www.independent.co.uk/news/business/carillion-crisis-latest-administration-government-talks-construction-company-schools-prisons-a8158576.html accessed 15 January 2018.

4.8 The Behaviours of Carillion`s board of directors

A scathing report on Carillion's board of directors was published by the House of Commons.[735] The report accused the board of being ignorant and tolerant of a toxic culture.[736] Despite their apparent responsibility, Carillion directors acted as victims of the company`s failure before Parliament.[737] These behaviours had an element of risk with serious effects. The fall of Carillion was a result of sheer greed without any due care for its stakeholders.[738]

The House of Commons Select Committee branded the Carillion board members as 'fantasists' having no regard for its financial difficulties,[739] not taking drastic measures to deal with the issues facing the company and pretending that everything was well.[740] Their actions portrayed incompetence, particularly as they were looking after themselves and causing financial hardship to suppliers, and harming employees' pension funds. The Carillion board members' behaviour was summed up in front of the select committee after they declined to return their bonuses willingly and were labelled 'delusional characters' who preferred to lay responsibility for Carillion's demise on everyone but themselves.[741]

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[735] BEIS and Work and Pensions Committees, *Carillion* (n 718).
[736] ibid.
[737] Work and Pensions ad BEIS Committees publish report on Carillion*, News Article* (London, 16 May 2018) https://committees.parliament.uk/committee/164/work-and-pensions-committee/news/97606/work-and-pensions-and-beis-committees-publish-report-on-carillion/ accessed 16 May 2018.

[738] ibid.
[739] Simon Goodley, 'Carillion Bosses Were Fantasists Chasing Pot of Gold, MPs Say' *The Guardian* (London, 28 February 2018) https://www.theguardian.com/business/2018/feb/28/carillion-bosses-fantasists-chasing-pot-gold-mps-say accessed 28 February 2018.
[740] Rob Davies, 'Carillion Was in Trouble by Mid-2016, Says Whistle-blower' *The Guardian* (London, 22 February 2018) https://www.theguardian.com/business/2018/feb/21/carillion-was-in-trouble-by-mid-2016-says-whistleblower accessed 22 February 2018.
[741] Rob Davies, 'Former Carillion Directors Branded "Delusional" at MPs Q&A' *The Guardian* (London, 6 February 2018) https://www.theguardian.com/business/2018/feb/06/carillion-director-mp-executives-collapse accessed 6 February 2018.

(a) *Acquisitions*

Carillion`s growth was a result of its acquisitions and paid £1.57 billion for goodwill.[742] Goodwill is an accounting term, describing the discrepancy between net value assets and the value paid-in capital.[743] Goodwill accounts for non-physical resources, such as the workforce, business name, trademarks, and patents, then physical assets like buildings and equipment. Carillion acquired its rivals, for instance, Mowlem, Alfred McAlpine, and Eaga, and the prices paid were considerably higher than the value of assets.[744] For instance, Eaga was purchased for £330 million of goodwill in 2011[745] and accumulated a profit of £31 million, but it made a loss of £260 million in the following five years.[746] Carillion's acquisition strategy was a cash grab that could not be sustained.[747]

Carillion’s acquisitions were criticised for lacking strategy, though it was effective in outplaying its competitors in the market.[748] It used an aggressive bidding strategy to generate the cash necessary to win its bids,[749] and its acquisitions were financed by rising debt, raising potential pension concerns.[750] Regrettably, its decision to venture into overseas markets was disastrous. It was driven by optimism instead of strategic expertise,[751] the most notable example being the 2011 contract with Sherie Properties in Qatar for construction, which never came to completion. Carillion’s directors attempted to

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[742] Adam Deller, ‘ACCA: Think Ahead, Carillion Collapse Increases Scrutiny of Goodwill Impairment Rules of Goodwill’ (1 April 2018) Accounting and Business, Think Ahead file:///C:/Users/User/Downloads/AB-UK-April-2018.pdf accessed 1 April 2018.
[743] Focus Economics: ‘Unwinding Carillion`s Collapse and its Wider Implications’ *Focus Economics* (Barcelona Spain, 28 May 2018) https://www.focus-economics.com/blog/unwinding-carillion-collapse-and-its-wider-implications accessed 28 May 2018.
[744] ibid.
[745] Carillion plc, *Annual Report and Accounts* (2011).
[746] Carillion Energy Services Ltd, Annual Report and Financial Statements (2016).
[747] BEIS and Work and Pensions Committees, *Carillion* (n 717).
[748] The Construction Index, ‘Carillion Report: Conclusions and Recommendations’ (16 May 2018) https://www.theconstructionindex.co.uk/news/view/carillion-report-conclusions-and-recommendations accessed 16 May 2018.
[749] BEIS and Work and Pensions Committees (n 717).
[750] Carillion plc, *Annual Report and Accounts* (2006).
[751] Alchian and Demsetz (n 148).

put the blame for the firm's collapse on a few rogue contracts in foreign business environments.[752]

The reality was that Carillion's directors were rash in their strategy for expansion. They did not consider the long-term prospects of the company, or the consequences expansion would have on its stakeholders. Carillion backed its spending spree through debt instead of injecting equity into the growing company.[753] The board did not prioritise investing in the company's pension scheme but instead pursued their cash-chasing acquisitions policy and accrued deficits in the scheme. Making good on pension commitments to their stakeholders was low on their priority list.[754] This attitude was exemplified by former Finance Director Richard Adam, who called pension financing money wasted.[755]

(b) *Accounting Errors*

Carillion concealed its financial difficulties until 2017 when its £845 million loss was exposed.[756] Carillion used a term known as 'aggressive accounting', a method of presenting sales and income using optimistic projections before the profits are announced [757] This strategy depends on reliable projections for long-term business survival. Carillion overestimated the viability of its ventures, used questionable unsigned capital as revenue, and concealed its debt to portray a false picture.[758]

MPs discovered that Carillion regularly reported large quantities of 'traded not certified' construction income[759] that had not yet been approved by customers, such as claims and variance payments.[760] As a result, it was unclear if payment would be made. In 2016, Carillion recorded £294 million of traded not certified revenue but never disclosed it as

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752 ibid.
753 Carillion plc (n 745).
754 OECD, `Principles of Corporate Governance` 1999.
755 ibid.
756 Rob Sweet, '"Accounting tricks": How Carillion Duped the Market' *Global Construction Review* (Atom, London, 16 May 2018).
757 ibid.
758 Alchian and Demsetz (n 148).
759 ibid.
760 Sweet (n 756).

such in public financial statements,[761] yet this was not raised by the audit committee. Carillion used also 'reverse factoring' to conceal debt to portray having a stronger capital than was the case.[762]

Reverse factoring entails a firm arranging payment of stakeholders by a bank; the bank would then demand payment at a later stage.[763] Carillion had a reputation for reverse factoring, which resulted in it accumulating debts against its supply chain without reporting it.[764] The report states that Carillion showed absolute disdain for its suppliers, who were the lifeblood of the UK economy.[765]

Carillion's payment scheme exploited its suppliers, pressuring them to reduce their credit, which was a brazen effort by its directors to save their struggling business model.[766]

(c) *Dividend Payments*

Carillion's directors were determined to portray a healthy and successful company through increasing dividends paid each year. Despite unsteady profits, Carillion's executives issued growing dividends to shareholders to avoid bad publicity. For instance, Carillion paid a catalogue of dividends of £77 million in 2014, £80 million in 2015, and £83 million in 2016 while generating only £159 million in cash. In the same year, 2016, Carillion lost £38 million in cash and yet paid its highest ever level of dividends.[767] In other

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[761] Gill Plimmer, 'Carillion Probe Pulls no Punches on Individuals or Institutions, *The Financial Times* (London, 16 May 2018) https://www.ft.com/content/aad5cb88-5820-11e8-b8b2-d6ceb45fa9d0 accessed 16 May 2018.
[762] David Gustin, 'Carillion, Moody's and Accounting Transparency with Supply Chain Finance' (Chicago, 1 May 2018) https://spendmatters.com/tfmatters/carillion-moodys-and-accounting-transparency-with-supply-chain-finance/ accessed 1 May 2018.
[763] ibid.
[764] Ibid.
[765] BEIS and Work and Pensions Committees (n 718).
[766] The Construction Index, 'Carillion Hid Debt Implications of Reverse Factoring' The Construction Index (14 May 2018) https://www.theconstructionindex.co.uk/news/view/carillion-hid-debt-burden-of-its-reverse-factoring accessed 14 May 2018.
[767] Federico Mor, House of Commons Library: 'Carillion Collapse: What Went Wrong' (House of Commons, 19 January 2018) https://commonslibrary.parliament.uk/carillion-collapse-what-went-wrong/ 19 January 2018.

words, the company was successfully using debt to pay dividends.[768] This dividend strategy was meant to attract investors and cover bad publicity. With dividend payments increasing year by year, investors failed to notice that the company was encountering severe financial hardship.[769]

It was a disguise for the company's situation. The problem of cash flow at Carillion did not prevent the directors from giving out dividends and handsome pay-outs for those at the top.[770] For instance, Mr. Richard Hawson, the chief executive, received an increase in his salary of 8 percent in 2015 and 9 percent in 2016, with a bonus of £245,000, despite failing to meet his financial performance targets. On the other hand, Mr. Phillip Green, the chairman, received an increase in his basic salary of 10 percent in 2016, in contrast to the 2 percent pay rise received by employees that year. The board would have been better able to manage the financial pressure if it had agreed to stop paying dividends.[771]

Richard Adam, the then finance director, was adamant when questioned by the select committee concerning dividends that the payments were meant for the wellbeing of the organisation as a whole,[772] but this was contrary regarding the loss to the pensioners. Between 2011 and 2016, a large sum of £441 million in dividends was paid out, in contrast to £246 million in pension fund shortfall recovery payments over a six-year span.[773] Carillion's board of directors was accused of ignoring concerns about its pensions for at least six years.[774] Keith Cochrane, former Carillion chief executive officer, denied that the company's board was prioritising the payment of dividends over making pension contributions despite dividends being near twice the value of pension payments.[775] After

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[768] ibid.

[769] Federico Mor et al*, The Collapse of Carillion* (HC Library Briefing Paper 8206,14 March 2018) https://researchbriefings.files.parliament.uk/documents/CBP-8206/CBP-8206.pdf accessed 14 March 2018.

[770] Work and Pensions Committee, *Carillion 'Trying to Wriggle Out of Pension Obligations for Last 10 Years'* (HC 2018).

[771] BEIS and Work and Pensions Committees (n 718).

[772] Carillion plc, *Annual Report and Accounts Cashflow Statements* (2011–2016).

[773] ibid.

[774] Maria Espadinha, 'Carillion Directors Ignored Pension Concerns for Years' *Financial Times* (London, 6 February 2018).

[775] ibid.

being presented with an illustration of a mother with two kids giving one child more money than the other, he simply looked bewildered.[776] Carillion's directors rewarded themselves, having no regard for the company's stakeholders.

(d) *Clawback of Bonuses*

Performance-linked remuneration plans for executive directors must contain clawback clauses according to Clause 37 of the UK Corporate Governance Code 2018,[777] which makes it possible to reclaim bonuses. The Carillion Remuneration Committee (RemCo) implemented a programme that required clawback in the event that a director was found to have engaged in gross misconduct.[778] Carillion claimed to have put in place specific conditions in which directors' salaries could be clawed back with help from legal and remuneration advisors Deloitte, which denied it ever provided such advice.[779] The RemCo pursued clawing back incentives in February 2015 but decided against going beyond a small group of directors, which would have an effect on the company's potential success.[780]

The poor clawback provisions at Carillion were confirmed by Deloitte in September 2017 as impossible incentives to claw back.[781] Carillion had its first profit warning in September 2017, and the RemCo revisited its clawback conditions, making some adjustments to include severe reputational harm and risk failures.[782] Despite the company's grave financial situation, the committees found no evidence that RemCo attempted to enforce

[776] Denzin and Lincolin (n 115).
[777] Bank of England, 'Bank of England Tightens Bonus Rules' *Financial Times* (London, 13 January 2016).
[778] BEIS and Work and Pensions Committees (n 718).
[779] Letter from Michael Jones to the Chairs of the Work and Pensions and BEIS Committees (13 March 2018).
[780] UK Parliament, 'Carillion Board's "Greed on Stilts"' *News from Parliament* (UK Parliament, 26 March 2018).
[781] Deloite, *Carillion plc, Remuneration Committee Report* (7 September 2017).
[782] Carillion plc, 'Minutes of A Meeting of the Remuneration Committee of the Board of Directors' (7 September 2017).

these. Its poor clawback system made it difficult for directors to be penalised.[783] Rachel Reeves, then chairperson of the BEIS Committee, commented that the structure was problematic.[784]

(e) *Corporate Governance*

The UK parliamentary inquiry attributed the fall of Carillion to corporate governance concerns.[785] The inquiry placed responsibility for the collapse firmly at the board`s feet. The UK Code states clearly that accountability, openness, and an emphasis on an entity's long-term sustainability are the basic principles of good governance.[786] Phillip Green, the then Chairman, claimed that Carillion's board upheld these very attributes.[787] However, the Carillion report contradicted the statement of Phillip Green during the accounting review that the board lacked a cultural audit and values.[788]

Minutes from a Carillion board meeting identified a culture of non-compliance, falsifying figures, and wilful blindness.[789] Even the Institute of Directors' report affirmed the demise of Carillion, pointing to the ineffectiveness of its corporate governance procedures.[790] Poor standards of corporate governance were reflected when the board continued paying out dividends to shareholders when it was unwise to do so. The period of 2012 to 2017 saw Carillion's board of directors paying over £330 million in dividends, which is more than the company earned in cash, and from 2009 to 2018, Carillion`s debt skyrocketed from £242 million to almost £1.3 billion.[791]

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[783] Neil Gerrard, 'Carillion Bosses` Concern Was "Fat Pay and Bonuses"' Construction' *Manager Magazine* (Atom, London, 26 March 2018) https://constructionmanagement.co.uk/carillion-bosses-more-concerned-fat-pay-and-bonuse/ accessed 26 March 2018.
[784] UK Parliament, 'Carillion Board's "Greed on Stilts"' (n 780).
[785] BEIS and Work and Pensions Committees (n 718).
[786] The UK Corporate Governance Code, 2018.
[787] Harold Demsetz (n 148).
[788] Carillion plc, 'Lessons Learned Board Pack' (June 2017).
[789] Carillion plc, 'Minutes of a Meeting of the Board of Directors' (22 August 2017).
[790] Institute of Directors (n 728).
[791] Maria Espadinha (n 774).

Though the company was underperforming, the board went on paying themselves unreasonable bonuses. This was even criticised by its own shareholders.[792] To appease its wrongdoing, Carillion's board paid large sums of money to shareholders while accumulating enormous debts. Considering this, one wonders what role the non-executive directors played. It falls under the purview of the NEDs to maintain effective oversight and ensure integrity is practised right across the board.[793] The NEDs were adamant during the parliamentary inquiry committee that they challenged management consistently on debt issues when debt rocketed to £961 million over a year.[794] Doubts were cast over whether the NEDs exercised any effective check on the executive management team. The concluding remarks judged that they were hoodwinked as much as anybody else.[795]

(f) *Auditors*

The board of directors has the duty of preparing and producing sound financial statements according to the CA 2006.[796] Thus, the auditors are assured of financial statements free from any inconsistencies and material misstatements.[797] KPMG's auditors were alleged to be members of 'cosy club' in the collapse of Carillion.[798] After acting as auditors for Carillion for 19 years, KPMG was accused of involvement in accounting irregularities and approval of Carillion's directors' breath taking figures.[799] The long tenure is poor corporate governance for a firm to maintain independence. However, Michelle Hinchliffe, KPMG's head of audit, was adamant that independence was a state of mind.[800] The need for

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[792] Aaron Morby, 'Carillion Boss Offered Senior Staff Bonuses to Stop Exodus' *The Construction Enquirer* (London, 3 April 2018).
[793] The UK Corporate Governance Code 2016, para-A 4.
[794] Maria Espadinha (n 774).
[795] Coase (n 154).
[796] CA 2006 ss 394 and 414.
[797] *Financial Reporting, International Standard on Auditing (UK and Ireland) 200* (June 2016) https://www.frc.org.uk/getattachment/aa24dd60-5ca4-4cec-8c67-ac470b82f931/ISA-(UK)-200_Revised-June-2016.pdf accessed June 2016.
[798] Kalyeena Makortoff, 'KPMG Partners Receive Bumper Pay-outs Despite Carillion' (5 December 2018) https://www.theguardian.com/business/2018/dec/05/kpmg-partners-receive-bumper-payouts-despite-carillion-fallout accessed 5 December 2018.
[799] ibid.
[800] Coase (n 154).

'mandatory rotation' has been in place since 2008 to ensure objectivity within the audit industry. [801] It was created to eliminate the risk of a conflict of interest between an accounting firm and the business being audited.[802] This was contrary to Carillion's auditors, who did not possess the very essence of independence.

Despite knowing that Carillion was involved in accounting irregularities, KPMG was not able to provide a competent audit expert for 19 years.[803] Moreover, they charged Carillion a large amount of £29 million in audit fees, and MPs accused KPMG of destroying a company that was crying for help.[804] When responding to questions from the joint committee, Peter Meehan, audit partner at KPMG, dismissed claims that his company was negligent and incompetent. He was very apologetic about the inconvenience caused but was not willing to take the blame.[805]

4.9 Key Characters

MPs held the board of directors accountable for Carillion's loss and collapse. They singled out several individuals whose behaviour ultimately pushed the company over the edge and to the demise of Carillion, which put 20,000 jobs at risk. The key characters were:

(a) *Richard Adam*

Adam was an influential figure in Carillion`s finance department. He held the office of the director of finance for a 10-year period. He came under fire from MPs, who branded him as the architect of the collapse of Carillion.[806] He was accused of having tight control over

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[801] Financial Reporting Council, *Audit Tender Notes on Best Practice* (February 2017) https://www.frc.org.uk/getattachment/53c85956-d712-47d2-989f-2f8eff42be29/Audit-Tenders_notes-on-best-practice-Feb-2017.pdf accessed February 2017

[802] ibid.

[803] Work and Pension Committee (n 718).

[804] ibid.

[805] Ben Chapman, 'I Wouldn`t Trust You to Audit the Contents of My Fridge, MP Tells KPMG' *The Independent* (London, 22 February 2018) https://www.independent.co.uk/news/business/news/carillion-collapse-kpmg-deloitte-mps-worthless-accounts-business-committee-rachel-reeves-a8223626.html accessed 22 February 2018.

[806] Caitlin Morrison, 'Carillion Collapse: Who was Behind the "Recklessness, Hubris and Greed" that Led to the Demise of the Government Contractor? *The Independent* (London, 16 May 2018).

the entire finance department being and very defensive at challenges during board meetings.[807] His strong stance and approach to the issue of pension schemes portrayed someone with too much control, power, and uncompromising spirit. It is hard to accept that any accounting policy decision would be passed without his authority. His true character came to light in 2016. Adam retired and sold the entire shareholding he had worked for years, for £776,000 in May 2017. His decision to leave was voluntary in 2016, perfectly timed before the true financial picture of Carillion was exposed and its value plunged. MPs summed it up that, it was a calculated way of evading liability.[808]

(b) *Richard Howson*

Howson was the chief executive officer of Carillion from 2012 to 2017. He received £1.5 million in 2016, £231,000 in pension payments, plus a bonus of £122,612. Carillion's leadership was criticized by the Committee for irresponsible behaviour.[809] When the company went bankrupt, Howson splashed money on luxury houses.[810] He also owned a £1 million-chalet in the French Alps while Carillion collapsed, leaving 43, 000 jobs at risk and taxpayers with a £600 million bill [811] The Committee reported that Carillion`s directors were busy chasing gold instead of taking care of the well-being of their employees and pensioners.[812] Howson was self-centred, improving his own living

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[807] Letter from Andrew Dougal to the Chairs of The Work and Pension Committee (5 April 2018).
[808] Jensen and Meckling (n 147).
[809] Berle and Means (n 146).
[810] Allan Selby, 'Millionaire Bosses at Collapsed Carillion Spent Thousands on Homes while Company Went to Ruin' *The Mirror* (London, 2 June 2018) https://www.mirror.co.uk/news/uk-news/millionaire-bosses-collapsed-carillion-spent-12636843 accessed 2 June 2018.
[811] ibid.
[812] Rob Davies, 'Recklessness, Hubris and Greed – Carillion Slammed by MPs' *The Guardian* (London, 15 May 2018). https://www.theguardian.com/business/2018/may/16/recklessness-hubris-and-greed-carillion-slammed-by-mps accessed 15 May 2018.

conditions at the expense of the company. The Committee report stated, Howson was out of control and lacked governance leadership.[813]

(c) *Alison Horner*

Ms Horner oversaw the remuneration committee from 2014 to 2017 receiving a salary of £61, 000. Through her leadership bonuses and wage, increments were implemented while Carillion was in financial trouble. [814] She was accused of promoting a "rotten corporate culture" and promoting salaries and bonuses when the company was under performing.[815] The report states that she acknowledged no responsibility or regret her actions apart from being sorry, for the way things had gone.

(d) *Zafar Khan*

Khan was the finance director for Carillion between August 2016 and September 2017 when he was fired and walk out with a £ 425,000 payoff. During that time, he was accused of failing to take control of Carillion`s unprincipled accounting practices.[816] He asserted to MPs that he was relieved of his duties after he "spooked" the rest of the board with a presentation warning that the company`s finance had worsened.[817] However, Phillip Green, then Chairman of Carillion claimed that he was not good with his numbers.[818] In her evidence to MPs, Emma Mercer, who succeeded Khan, claimed that those who had been in the post before her had taken an "aggressive tone" in their valuation of contracts

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[813] ibid.

[814] Hannah Uttley, 'Reward for Failure: Pay chief who Dished Out Huge Bonuses to Carillion Bosses is Given Promotion' (London, 21 May 2018) https://www.thisismoney.co.uk/money/markets/article-5754637/Reward-failure-Pay-chief-dished-huge-bonuses-Carillion-bosses-given-promotion.html accessed 21 May 2018.

[815] ibid.

[816] Engineering News Record, 'When Carillion`s Leaders Missed the Biggest Risk of All' Engineering News Record (28 February 2018) https://www.enr.com/gdpr-policy?url=https%3A%2F%2Fwww.enr.com%2Farticles%2F44058-when-carillions-leaders-missed-the-biggest-risk-of-all accessed 28 February 2018.

[817] Letter from Zafar Khan to the Chairs (21 February 2018).

[818] Letter from Phillip Green to the Chairs (20 February 2018).

that later underperformed.[819] Khan was deemed an accountant who couldn't count after failing to differentiate between reducing a company's debt and increasing it.[820] His incompetence was further exposed after admitting in the board minutes concerning accounting irregularities that, incompetence and laziness played a big part.[821] Though the committee accepted that he took the reins during the company`s difficult time he could not be spared for his irresponsibility in approving accounts that had a negative image of the company. The following section will now review Carillion critically under CA 2006, s 172.

4.10 *Considering the Carillion Scandal, A Critical Analysis of Section 172 (1) of the CA of 2006*

Directors are required under s 172 (1) to execute their duties in honesty respecting the company`s best interest, prioritising its members.[822] Lord Greene, pronounced that it's the directors` judgment in good faith and not the court`s perception.[823] It's all about the director`s state of mind.

It was well documented in *Regentcrest plc v Cohen* that it is a duty that requires a subjective test, which does not require an objective element. It only looks at whether directors` actions and decisions were out of honest for the company`s success.[824] Much is placed on directors` state of mind and the duty to look on what the directors themselves considered. [825]

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[819] Daniel Boffey and Rob Davies, 'Former Carillion Finance Directors Expected to Face Investigation; *The Guardian* (London, 17 March 2018) https://www.theguardian.com/business/2018/mar/17/former-carillion-finance-directors-investigation-frc accessed 17 March 2018.

[820] John Crace, 'Listening to Carillion's Bosses, You Are Surprised It Survived So Long' *The Guardian* (London, 6 February 2018) https://www.theguardian.com/business/2018/feb/06/listening-to-carillions-bosses-youre-surprised-it-survived-so-long accessed 6 February 2018.

[821] Carillion Plc, Minutes from a meeting of the Board of Directors, 9 May 2017.

[822] CA 2006 s 172.

[823] *Re Smith & Fawcett Ltd* (n 488).

[824] *Regentcrest* (n 15).

[825] Keay, 'The Duty to Promote the Success of the Company' (n 18).

It cannot be refuted that; it was the directors` actions that led to the collapse of Carillion which had an impact on stakeholders. The judgment of Pennycuick[826] exposed the shortfalls of a subjective test. The court must determine if an individual intelligently as a director reasonably accepts that Carillion directors' actions were for company interest. Keay emphasized the importance of the judiciary considering and adopting an impartial element in section 172 (1).[827]

In other words, a subjective judgment may be one of the factors used to determine whether Carillion's directors behaved in good faith, as the judge is only required to accept the directors' word.[828] It must be proven that Carillion's directors' conduct was unacceptable and not for the company's good. The law must distance itself and beware of hindsight when assessing a director's actions.[829] It will have to be proven whether Carillion's directors were acting for the company's success regarding other stakeholders, for instance, its employees. Carillion had a £587 million pension shortfall before its demise.[830] Richard Adam, who had then been finance director for 10 years, was questioned by the committee about the deficit and the culture of aggressive accounting, which was deemed an unsustainable company approach. Adam was remembered for his steadfast refusal to contribute to the company's pension plans, regarding it a money wasting endeavour.[831] In a subjective test, it would be difficult for Richard Adam to prove that he was promoting the success of the company when he disregarded injecting funds into the employees' pension scheme.

Carillion's board was accused by MPs of showing 'greed on stilts' in terms of their incentive plans and remuneration policies.[832] The directors were accused of failing to

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[826] *Charterbridge* (n 63) Ch 74.
[827] Keay ''Section 172 (1) of the Companies Act 2006' (n 606).
[828] Keay, 'The Duty to Promote the Success of the Company' (n 18).
[829] Goldberg (n 268).
[830] Josephine Cumbo, 'UK Government Pressed Over Carillion Pension Deficit' *Financial Times* (London, 18 January 2018) https://www.ft.com/content/2d3a5f24-fc3e-11e7-a492-2c9be7f3120a accessed 18 January 2018.
[831] Morrison (n 806).
[832] Jess Clark, 'Carillion Bosses "Greed on Stilts," Inquiry Claims' (26 March 2018) *New Civil Engineer*. https://www.newcivilengineer.com/author/jess-clark/page/22/?cmd=gotopage&val=4 accessed 26 March 2018.

have regard for the company's interest.[833] Experiencing its worst financial performance, directors chose to reward each other with dividends when the firm was bankrupt.[834] Carillion's directors were determined to portray a healthy and successful company by increasing the dividends paid each year. Despite unsteady profits, Carillion`s executives issued growing dividends to shareholders to avoid bad publicity. The problem of cash flow at Carillion did not prevent the directors from distributing dividends and handsome pay-outs for those at the top.[835]

Directors' incentives were impossible to claw back under these measures.[836] Carillion's board behaviour was summed up before the committee after directors refused to pay back their bonuses voluntarily, and they were termed 'delusional characters.'[837] These were not the decisions made in the corporation`s best interest as required under s 172. Carillion executives would escape liability for the company's demise because of using an objective measure rather than a subjective one. The company was liquidated with a staggering £7 billion in liabilities.[838]

4.11 *Considering the Carillion and RBS Scandals, A Critical Analysis of Section 174 of the CA of 2006*

Section 174 is a duty associated with advocating for the company's best interests, requiring the utilisation of a high level of expertise. In order to determine whether directors have breached the standard of care outlined in section 174 of the Companies Act 2006, it must be argued that they either delegated risk management excessively and neglected its significance, thereby failing to meet the expected standard of care, or that their decisions were negligent and did not meet the standard that a reasonable person in their position would have followed about the question of whether directors in the unsuccessful companies of Carillion and RBS may be held accountable for 'negligent decisions' about

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[833] ibid.
[834] Work and Pension Committee, *Carillion 'Trying to Wriggle Out of Pension Obligations* (n 770).
[835] ibid.
[836] Work and Pension Committee *Carillion 'Trying to Wriggle Out of Pension Obligations*, (n 770).
[837] ibid.
[838] Work and Pension Committee (n 770).

risk, it is possible to argue that the directors allowed for sub-par levels of care. One could claim that RBS's failure to conduct sufficient due diligence in relation to the acquisition of ABN-AMRO was negligent. The RBS's weaknesses were a result of bad board decisions, and a culture that promoted unnecessary risk taking. On the Carillion case, its acquisitions were criticised for lacking strategy, though it was effective in outplaying its competitors in the market. Carillion was accused of using an aggressive bidding strategy to generate the cash necessary to win its bids, and its acquisitions were financed by rising debt, raising potential pension concerns. The reality was that Carillion's directors were rash in their strategy for expansion. They did not consider the long-term prospects of the company, or the consequences expansion would have on its stakeholders. [839]

Paolini contends that bankers possessed a clear understanding of the significant potential consequences and were teetering on the brink of imprudent behaviour in their pursuit of risk-taking.[840] Nevertheless, it is important to evaluate these limitations within the framework of the intricate nature of transactions and the need for streamlined decision-making in highly competitive global markets for banks and financial institutions.[841]
One could claim that significant risks were taken based on trust in advanced, although new, risk management procedures.

Therefore, it is unclear whether directors at the companies would be deemed to have failed to meet a reasonable level of care.[842] Moreover, overseeing the operations of extensive multinational institutions is inherently difficult and intricate. As a result, directors must be evaluated based on a criterion of rationality that considers their specific circumstances and roles. In addition, since regulators have not mandated specific specialised criteria for Board members, it would be challenging to argue that certain directors, particularly those without financial training, have failed to meet a reasonable

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[839]Morrison (n 806).

[840] Adolfo Paolini, 'Lending Sub-prime and Advising on Financial Investments from a D&O Insurance Perspective' (2012) Journal of Business Law 432.
[841]Iris H-Y, Chiu Regulatory Duties for Directors in the Financial Services Sector and Directors duties in Company Law, (2016) Journal of Business Law.

[842] Ibid.

standard of care in their decision-making.[843] Khan was the finance director for Carillion before its collapse, he was accused of failing to take control of Carillion`s unprincipled accounting practices, that he was not good with his numbers. Khan was deemed an accountant who couldn't count after failing to differentiate between reducing a company's debt and increasing it.[844]

Specifically questioning his qualifications as an accountant. The parliamentary committee pointed out that the RBS board lacked relevant knowledge of the markets, and insufficient team members capable of strategic thinking. RBS had a lot of people who could execute policy but just a handful who could lead and figure out what strategy was best.[845] Nevertheless, there is a benefit to having a diverse range of abilities on the Board. However, it would be challenging to argue that Board members without financial training would automatically lack the necessary expertise and dedication for the role.

Moreover, there is uncertainty over the feasibility of holding directors individually accountable when their actions are the result of collective discussions and shared accountability.[846] The Court has expressed the view that in larger businesses, choices such as risk appetite and business strategy are typically taken collectively by the Board. In such cases, it is less probable for individuals to be held responsible for these decisions. The ruling in the *Arch Cru* case[847] appears to validate the notion that smaller organisations with well-defined roles may face greater ease in holding individuals accountable for culpability.

One could argue that personal liability systems, such as directors' obligations under sections 172 and 174, were specifically designed to discourage boards from making bad decisions that lead to reckless and improper behaviour in different parts of the company. Why do the directors' duties seem to have little relevance in holding directors

[843] Ibid.
[844] Work and Pension Committee, *Carillion 'Trying to Wriggle Out of Pension Obligations* (n 770).
[845] Ibid.
[846] Ibid.
[847] *Arch Financial Products LLP & Ors v The Financial Conduct Authority* [2015] UKUT 13.

accountable? Firstly, one could contend that the obligations of directors in the realm of corporate law are feeble and unable to tackle the specific challenges related to risk and wrongdoing in the financial services industry. Furthermore, one could contend that the enforcement of directors' obligations in company is a feeble form of enforcement, and these inadequacies have only become apparent considering the RBS and Carillion examples mentioned above.

4.12 Carillion under the Entity Maximisation approach (EM)

This section evaluates what could have been different in Carillion under the entity maximisation approach. Had the directors applied the entity maximisation approach would that have made a difference in given circumstances? The directors' responsibilities to the corporation are outlined under ss 170–181 of the CA 2006.[848] These responsibilities were developed with the expectations that directors should act in the best interest of the company.

It is, therefore, proper in the circumstances to evaluate what could have been different on Carillion under the entity maximisation approach. A detailed examination of the decisions taken by Carillion shows that the directors clearly were at fault of their obligations to support the success of the corporation by demonstrating care, expertise, and diligence.[849] For example, Carillion's acquisitions were criticised for lacking strategy, though it was effective in outplaying its competitors in the market.[850] It used an aggressive bidding strategy to generate the cash necessary to win its bids,[851] and its acquisitions were financed by rising debt, raising potential pension concerns.[852] Regrettably, its decision to venture into overseas markets was disastrous. It was driven by optimism

[848] CA 2006 s170.
[849] CA 2006 s 172.
[850] The Construction Index, 'Carillion Report: Conclusions and Recommendations' (16 May 2018) https://www.theconstructionindex.co.uk/news/view/carillion-report-conclusions-and-recommendations accessed 16 May 2018.
[851] BEIS and Work and Pensions Committees (n 717).
[852] Carillion plc, *Annual Report and Accounts* (2006).

instead of strategic expertise,[853] the most notable example being the 2011 contract with Sherie Properties in Qatar for construction, which never came to completion. Thus, engaging in relentless maximisation without considering the company's existence will have detrimental effects, as the company's failure to sustain itself will result in no benefits for its stakeholders.[854]

The entity maximisation approach compels Carillion directors to enhance the wealth of the organisation with care. This comprises directors making efforts to raise the long-term market worth of the organisation, considering the investments made by different individuals and groups. For instance, Richard Adam, the then finance director, was adamant when questioned by the select committee concerning dividends that the payments were meant for the wellbeing of the organisation as a whole,[855] but this was contrary regarding the loss to the pensioners. Between 2011 and 2016, a large sum of £441 million in dividends was paid out, in contrast to £246 million in pension fund shortfall recovery payments over a six-year span.[856] Carillion's board of directors was accused of ignoring concerns about its pensions for at least six years.[857] Carillion`s board prioritised the payment of dividends over making pension contributions despite dividends being near twice the value of pension payments.

Put simply, directors should prioritise actions that maximise the worth of the company, resulting in an increase in both the net present value and strategic significance of the organisation. The Carillion directors should have prioritised the well-being of the organisation when carrying out their responsibilities. Consequently, the primary objective is to cultivate the shared interest of all stakeholders who have made financial contributions to the organisation. The Entity maximisation encompasses more than just the pursuit of maximum profitability.

[853] Alchian and Demsetz (n 148).
[854] Ibid.
[855] Carillion plc, *Annual Report and Accounts Cashflow Statements* (2011–2016).
[856] ibid.
[857] Maria Espadinha, 'Carillion Directors Ignored Pension Concerns for Years' *Financial Times* (London, 6 February 2018).

The long-term vision and goal of maximising entity wealth will involve the directors of Carillion avoiding acts such as delaying payment to creditors and embracing hazardous enterprises that may lead to future credit issues, all in the pursuit of increasing revenue growth. For instance, MPs discovered that Carillion regularly reported large quantities of 'traded not certified'[858] construction income that had not yet been approved by customers, such as claims and variance payments.[859] As a result, it was unclear if payment would be made. In 2016, Carillion recorded £294 million of traded not certified revenue but never disclosed it as such in public financial statements,[860] yet this was not raised by the audit committee. Carillion used also 'reverse factoring' to conceal debt to portray having a stronger capital than was the case.[861] Minutes from a Carillion board meeting identified a culture of non-compliance, falsifying figures, and wilful blindness.[862] By invoking the EMS, Carillion directors will be prevented from acting to artificially inflate the share price or engage in fraudulent accounting practices.

Maximising the potential of an entity contributes to the promotion of sustainability. Sustainability refers to the ability of a firm to maintain its financial stability and avoid insolvency, which is a situation when the company is unable to recover from its financial difficulties. For example, The House of Commons Select Committee branded the Carillion board members as 'fantasists' having no regard for its financial difficulties,[863] not taking drastic measures to deal with the issues facing the company and pretending that

[858] Alchian and Demsetz (n 148).
[859] Sweet (n 756).
[860] Gill Plimmer, 'Carillion Probe Pulls no Punches on Individuals or Institutions, *The Financial Times* (London, 16 May 2018) https://www.ft.com/content/aad5cb88-5820-11e8-b8b2-d6ceb45fa9d0 accessed 16 May 2018.
[861] David Gustin, 'Carillion, Moody's and Accounting Transparency with Supply Chain Finance' (Chicago, 1 May 2018) https://spendmatters.com/tfmatters/carillion-moodys-and-accounting-transparency-with-supply-chain-finance/ accessed 1 May 2018.
[862] Carillion plc, 'Minutes of a Meeting of the Board of Directors' (22 August 2017).
[863] Simon Goodley, 'Carillion Bosses Were Fantasists Chasing Pot of Gold, MPs Say' *The Guardian* (London, 28 February 2018) https://www.theguardian.com/business/2018/feb/28/carillion-bosses-fantasists-chasing-pot-gold-mps-say accessed 28 February 2018.

everything was well.[864] Their actions portrayed incompetence, particularly as they were looking after themselves and causing financial hardship to suppliers, and harming employees' pension funds. Thus, by optimising the resources of the business and focussing on the sustainability of the company, the desire for unjustified risks is diminished. Engaging in relentless maximisation without considering the company's existence will have detrimental effects, as the company's failure to sustain itself will result in no benefits for its stakeholders. Thus, Carillion`s seeking of profit maximisation without considering the survival of the company was misguided, as the company went into insolvency.

The EM approach could have seen the maximisation of profits for Carillion resulting in various benefits, such as timely repayment and reduced risk for creditors, improved working conditions, enhanced job security and bonuses for employees, and a positive impact on the company's operating environment. Instead of prioritising the investors and their interests. For example, despite unsteady profits, Carillion's executives issued growing dividends to shareholders to avoid bad publicity. For instance, Carillion paid a catalogue of dividends of £77 million in 2014, £80 million in 2015, and £83 million in 2016 while generating only £159 million in cash. In the same year, 2016, Carillion lost £38 million in cash and yet paid its highest ever level of dividends.[865] In other words, the company was successfully using debt to pay dividends.[866] This dividend strategy was meant to attract investors and cover bad publicity. With dividend payments increasing year by year, investors failed to notice that the company was encountering severe financial hardship.[867] The board would have been better able to manage the financial

[864] Rob Davies, 'Carillion Was in Trouble by Mid-2016, Says Whistle-blower' *The Guardian* (London, 22 February 2018) https://www.theguardian.com/business/2018/feb/21/carillion-was-in-trouble-by-mid-2016-says-whistleblower accessed 22 February 2018.
[865] Federico Mor, House of Commons Library: 'Carillion Collapse: What Went Wrong' (House of Commons, 19 January 2018) https://commonslibrary.parliament.uk/carillion-collapse-what-went-wrong/ 19 January 2018.
[866] ibid.
[867] Federico Mor et al*, The Collapse of Carillion* (HC Library Briefing Paper 8206,14 March 2018) https://researchbriefings.files.parliament.uk/documents/CBP-8206/CBP-8206.pdf accessed 14 March 2018.

pressure if it had agreed to stop paying dividends. Thus, the EM approach is placed on the entity itself and how to improve its standing. Investors derive benefits directly from that specific object. Therefore, based on the critical analysis above, this thesis submits that by applying the entity approach Carillion directors could have minimise the impact of the collapse of the company.

4.13 RBS under the Entity Maximisation approach (EM)

The entity maximisation approach emphasises the firm as an independent entity or organisation, meaning that the company is a distinct institution in and of itself.[868] Therefore, the corporation is entitled to all directorial responsibilities. The strategy primarily focusses on enhancing the wealth of the organisation by encouraging directors to actively work towards increasing the company's long-term market worth.[869] This would involve increasing the overall value to the organisation, considering the investments made by different individuals and groups. An entity maximisation strategy involves the board making decisions that will optimise the overall wealth of the company.[870] Put simply, directors should prioritise actions that maximise the worth of the corporate entity, resulting in an overall increase in the net present value of the company.[871]

It is, therefore, proper in the circumstances to evaluate in this section, what could have been different on RBS under the entity maximisation approach. Had the directors applied the company centred approach would that have made a difference in given circumstances? The objective of maximising entity value is intended to result in growth; however, it is only one aspect of the overall picture. Additionally, it was imperative for RBS to strive for long-term viability. Growth and survival are intrinsically linked, and prioritising one over the other does not guarantee the achievement of either or both. This

[868] Andrew Keay The Ultimate Objective of the Company and the Enforcement of the Entity Maximisation and Sustainability Model, (2010) 35-71, Journal of Corporate Law Studies, 10:1.

[869] Ibid.
[870] Ibid.
[871] Ibid

was the biggest mistake RBS made, for example, RBS pursued a radical acquisition strategy approach. ABN Amro was successfully bought for £80 billion, a price which financial analysts termed aggressive and overpriced.[872] Leading the consortium was a bad decision, as RBS already had high leverage. Between May and August of 2008, it raised about £20 billion of funding, which became an issue as the funding started to dry up.[873] RBS relied heavily on short-term financing.[874] RBS was accused of pursuing a profit maximisation approach. However, growth and profit maximisation accompanied by a clear strategic risk review is beneficial to a company.[875] RBS was contrary; it pursued a radical approach towards acquisitions without thorough due diligence, an approach which proved very costly in the end.[876] Growth and survival are intrinsically linked when pursuing an entity maximisation approach. RBS failed to anticipate its own survival. RBS did not consider the impact it would have upon its stakeholders before it went on to acquire ABN Amro. A single unsuccessful risk led the corporation to near- insolvent. Under the entity maximisation approach, RBS directors must formulate a plan that effectively balances the optimisation of long-term value and the preservation of the company's existence.

Attaining sustainability throughout time demonstrates that a corporation is optimising its long-term market worth or the wealth of the organisation, while also minimising any inherent risks associated with its commercial activities. Ensuring sustainability is crucial to avoid short-term thinking, as RBS must guarantee the ongoing growth of its value and avoid the risk of bankruptcy by prioritising long-term profits over immediate gains. Therefore, it is imperative to attain equilibrium to guarantee both sustenance and expansion.

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[872] Harry Wilson, 'Royal Bank of Scotland': the full story of how the world`s biggest bank went bust (London, 5 March 2011) https://www.telegraph.co.uk/finance/newsbysector/banksandfinance/8363417/Royal-Bank-of-Scotland-investigation-the-full-story-of-how-the-worlds-biggest-bank-went-bust.html accessed 5 March 2011.

[873] FSA, *The Failure of the Royal Bank of Scotland,* HC 640 (n 634).

[874] Ibid.

[875] Treasury Committee, *The FSA's Report into the Failure of RBS,* HC 640 (n 634).

[876] Ibid.

The EM, stipulates that directors should allocate earnings in a way that allows the firm to endure, ensure long-term viability, and maximise its value in the future. Under the EM, maximising profits for RBS could have result in various benefits, such as increased dividends for shareholders, timely repayment and reduced risk for creditors, improved working conditions. It was asserted that RBS directors profited from exorbitant incentives and ascribed the bank's accomplishment to these liberal bonuses,[877] and yet the bank was underperforming and on the verge of collapse. For example, in RBS case, generous compensation expanded beyond salary and bonuses. Generous pensions became another characteristic.[878] The investigation turned up information about one such pension that was given to Sir Fred Goodwin, the former CEO of RBS, which raised a lot of public alarm.[879] The extent of Sir Fred Goodwin's pension was initially reported in the media on February 25, 2009, following a blog post by BBC Business Editor Robert Peston.[880] The amount that was stated at the time for Sir Fred's yearly pension was £650,000, but increased to £703,000.

To many, it was unthinkable that a CEO who had led his bank to such disastrous heights should receive such a large payout for actions that had caused such harm to the investors of his company, the British economy, and the taxpayers in the United Kingdom.[881] The Prime Minister then urged Sir Fred to give up his pension amid a heated political discussion.[882] Such exceptional payments caused the disparity in justifying the underperforming directors and brought about the issue of distributional justice. It caused

[877] John Plender, 'Capitalism in Crisis: The Code that Forms a Bar to Harmony' *Financial Times* (London, 8 July 2012) https://www.ft.com/content/fb95b4fe-3863-11e1-9d07-00144feabdc0 accessed 8 January 2012.
[878] Banking Crisis: reforming corporate governance and pay in the City Ninth Report of Session 2008–09 Report, 15 May 2009, HC 519.

[879] Ibid.
[880] Ibid.
[881] Banking Crisis: reforming corporate governance and pay in the City Ninth Report of Session 2008–09 Report, 15 May 2009, HC 519.
[882] Ibid.

social discontent among groups such as the Occupy London movement that protested high bonus payments.[883]

Instead, the concept of the EM dictates that directors should distribute earnings in a way that allows the firm to continue operating, ensuring its long-term viability and maximising its financial resources in the future. The assessment of all these factors might be based on the objective of maintaining the company's economic and financial stability. This task will require careful consideration of several factors to achieve a state of equilibrium. The goal is to optimise the entity's performance and ensure its long-term viability. The actions taken regarding distribution are anticipated to significantly impact the company's future. The principle of EM is to ensure that distribution is carried out in a manner that maximises entity enhancement. EM prioritises its distribution plan to maximise the company's long-term value creation, rather than solely focusing on keeping everyone happy, although that is desirable if feasible. Therefore, according to the critical examination, this thesis argues that the use of the entity maximisation approach could have reduced the consequences of RBS's collapse.

4.14 *Conclusion*

The case studies covered in this chapter, proven that applying certain provisions under s 172 and s174 of the CA 2006 fails to deliver justice when dealing with directors' conduct and holding them to account. Though the legislative framework is well designed, it is prone to be exploited by company directors in evading justice because of loopholes. The provision fails to deliver the expected outcomes. It would be extremely difficult to prove an infringement against company directors under all practicable avenues of recourse under s 172 and s174. Moreover, the overeager dependence on a subjective assessment makes it difficult to hold a director liable. This chapter also examined what could have looked different on Carillion and RBS under the entity maximisation approach. Had the directors applied the company centred approach would that have made a difference in given circumstances. This thesis argues that the use of the entity maximisation approach could have reduced the consequences of RBS's and Carillion`s collapse. The rationale

[883] Kevin Roe, *Leadership Practice and Perspective* (3rd edn, OUP 2020).

for advocating the entity maximisation approach lies in its potential to effectively attain the normative target of enhanced benefits for all stakeholders of the organisation, including shareholders. In fact, shareholders are more inclined to derive advantages by prioritising the advancement of the company's interests as a collective entity, rather than solely chasing shareholder profit. This approach is more likely to result in the company's overall success, longevity, and growth.[884]

[884] Andrew Keay, 'Ascertaining the Corporate Objective: An Entity Maximisation and Sustainability Model' (2008) 71(5) The Modern Law Review 663, 689.

Chapter Five

5 Enforcing Directors' Duties: The Statutory Derivative Action as an Instrument of Change?

5.1 Introduction

This thesis has laid the theoretical foundation in chapter two and demonstrated the weakness of directors' duties in chapter three and painted a picture with case studies in chapter four. When introducing the derivative action in chapter 5, the author is implying that the derivative action will be a solution to bridge directors' duties. This is the theatrical part behind the introduction of the statutory derivative action, but it has proven inadequate because of the uncertainty and complexities of Part 11 of the CA 2006, lack the potential to have an impact on directors' duties. It has proven ineffectual in enforcing directors' duties, due to its procedural difficulties.[885] However, even if the derivative action works, would it have worked in the Carillion and RBS cases. Could the statutory derivative actions have solved the problems in Carillion and RBS cases. Why could not the shareholders bring a claim out of these crises? This chapter will critically analyse common law`s limits in defending the interest of minority shareholders. Additionally, the impact of statutory action, as opposed to common law principles, will be closely examined. The chapter will draw conclusions from the interpretation and application of the statute as to whether the derivative action is an effective instrument for enforcing accountability on directors' duties.

Directors are responsible for a company's wellbeing. As fiduciary agents, they owe their duties to the company. Furthermore, no company can be competitive unless its directors are competent and trustworthy. If directors' responsibilities are not strictly enforced, they are meaningless. Viable enforcement deters bad behaviour and motivates directors for fear of unfavourable financial repercussions.[886] An absence of enforcement can be a

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[885] Arad Reisberg, *Derivative Actions and Corporate Governance: Theory and Operation* (Oxford University Press 2007).

[886] Brian Cheffins and Bernard Black, 'Outside Director Liability Across Countries' (2006) 84 Texas Law Review 1385, 1480.

catalyst for financial misconduct and bad corporate governance.[887] Derivative arguments have been allowed in common law for several years.[888] The report of the Law Commission criticised them that, lacked clarity and were unduly complex.[889] The format of this chapter will be as follows: sections 5.2, 5.3,5.4,5.5, and 5.6 gives a brief analysis of the common law derivative action and its flaws in providing accountability for minority shareholders. This will do by looking at the issues of the internal regulation principle, the proper plaintiff principle, and the Foss rule. To remedy these flaws section 5.7 explains the need for introducing CA 2006`s statutory derivative proceedings scheme. Sections 5.7.1, 5.7.2, ,5.7.3 and 5.7.4 gives an analysis of the structure of the statutory derivative action and the two-stage requirement for a member to establish prima facie and the challenges and controversy surrounding the two stages.

Section 5.7.5 explains the requirement for a claimant to be acting in good faith, as a deciding factor in granting permission for his/her case to be heard in court. Section 5.7.6 explains the importance of understanding the responsibility to advance the company`s performance as the deciding factor before courts can allow the continuation of a derivative action by a director. Section 5.7.7 determines whether a derivative claim should be refused or not through authorisation and ratification factors. Sections 5.7.8 and 5.7.9 explores the debate and complexities surrounding ratification under the common law and the CA 2006. Section 5.8.0 will discuss costs as the biggest hurdle on the part of any shareholder who desires to bring a claim.

The section will seek to establish whether the situation regarding costs has changed under statutory derivative claims or is still the same as in common law. Section 5.8.1 will evaluate the statutory derivative action vs Carillion. Section 5.8.2 will evaluate the statutory derivative action vs RBS Sections 5.9, 5.9.1, 5.9.2,5.9.3, 5.9.4 and 5.9.5 will examine other actions available to shareholders and their limitations. Section 5.10 will highlighting the recent published growing corporate accountability reports. Section 5.11

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[887] Zhong Zhang, 'Legal Deterrence: The Foundation of Corporate Governance: Evidence from China' (2007) 15(5) C G 741, 767.
[888] *Shareholders' Remedies* (Law Com No 246, 1997) para 6.4.
[889] ibid.

will conclude by restarting the problems with the statutory provision in addressing the issue of accountability in company directors because of its shortcomings.

5.2 The Need to Introduce CA 2006's Statutory Derivative Proceedings Scheme

To remedy these flaws, there was a need to introduce CA 2006's statutory derivative proceedings scheme. The Law Commission advocated for a new and flexible approach that would determine the merits of a claim.[890] It was hoped that this would be a better channel to allow cases to be heard in appropriate ways.[891] Customarily, it was very difficult to enforce directors' duties, and there was a low number of claims.[892] There are many explanations for a company's lack of compliance. As explained that if a company has been wronged, the company is considered the proper plaintiff. [893] For that reason, no minority shareholder would bring any proceedings in dispute to the decision of the firm.[894] The board is placed with the responsibility of managing the corporation as explained in the articles of association.[895] However, these individuals may refrain from pursuing litigation for many reasons. Since they have the authority to sue the corporation for any wrongdoing, they have the autonomy to decide on individuals within the corporation. For example, if it is the directors who have wronged the company, the board is more less to open litigation against them.

Though the board of directors should exercise independent judgment when executing a claim for the company, the board is frequently at ease to do so, as *John Shaw & Sons Ltd v Shaw* states that directors have the discretion to execute their powers accordingly.[896] Directors are often reluctant to act against other directors to maintain fellowship. On the other hand, shareholders are highly unlikely to take any action because

[890] *Shareholders' Remedies* (n 888) para 6.15.
[891] *Shareholders' Remedies* (n 888) para 6.14.
[892] David Gibbs, 'Has the Statutory Derivative Claim Fulfilled its Objectives? A Prima Facie Case and the Mandatory Bar: Part 1' [2011] Co Law 42.
[893] Sternberg (n 224).
[894] Thomas Courtney, *The Law of Companies* (3rd edn, Bloomsbury 2012).
[895] Companies House, 'Model Articles for Private Companies Limited by Shares' (18 September 2018).
[896] [1935] 2 KB 113.

of the lack of sufficient information to detect breaches.[897] Therefore, the guilty directors will continue to exercise authority over the board to the loss of the company.

Lord Denning reasoned and affirmed that a company should be treated differently from its directors and shareholders because of its distinct personality.[898] Because it has no attachments, it has the power to sue whoever wrongs it.[899] When the company fails to do so, it is deprived of its justice, and the law becomes meaningless.[900] The derivative action was created by common law to address these issues. Common law created hindrances to shareholders filing an action or if the injustice brought about is one the majority rule can ratify.[901]

The case, *Edwards v Halliwell* affirmed that the company is the proper person to file a litigation.[902] The rule in *Foss* did, however, have exceptions to allow a shareholder to sue. These occur when the act accused is ultra vires, when a special procedure has been defied, when a member's personal right has been violated, when there is minority fraud and, when the wrongdoers are in charge.[903]

It must be proved that the fraud was ineligible for ratification at shareholders' general meetings based on these exceptions.[904] Additionally, it must be demonstrated that the wrongdoers still had influence over the company.[905] Regardless of the theoretical prospect of shareholder remedy through a derivative claim under common law, there were significant shortcomings in terms of shareholder protection. In this regard, the Law Commission concluded that the *Foss* rule and its exceptions were outdated.[906] Several key issues were pointed out as weaknesses within the common law regime on derivatives. First, the rule of *Foss* was regarded as outdated and inconsistent, dating

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[897] Stephen Bainbridge, 'Director Primacy and Shareholder Disempowerment' (2006) 119(6) Harvard Law Review 1735, 1754.
[898] *Foss* (n 263).
[899] ibid.
[900] *Wallersteiner v Moir (No 2)* [1975] QB 373.
[901] Sternberg (n 224).
[902] [1950] 2 ALL ER 1064.
[903] *Foss* (n 263).
[904] ibid.
[905] *Prudential Assurance Co. Ltd v Newman Industries Ltd No 2* [1982] Ch 204, 219.
[906] *Shareholder Remedies* (Law Com No 142,1997) para 14.1.

many years back.[907] Second, though a derivative claim is able to be commenced, there has to be evidence that the wrongdoers were in charge, and the definition of 'control' was ambiguous.[908] Moreover, the Law Commission stipulated that 'control' does not depend on the wrongdoer's position in the company.[909] Last, the Law Commission was worried by the procedure the claimant had to take to demonstrate their standing to bring the action, which might create a mini-trial at the preliminary stage of the claim and might increase the length and costs of the litigation.[910]

Minority shareholders under common law faced a major challenge to bring a claim because the method for determining *locus standi* was awkward and the *Foss* rule was ambiguous.[911] For that reason, there was a need to reform derivatives to bring fairness and flexibility. [912] The Commission`s report concerning shareholders' remedies states that the introduction of a statutory derivative was going to mark a new dawn for shareholders' remedies to be accessible in today's world.[913]

However, understanding the intent and function of the new legislative derivative requires knowledge of its evolution under the *Foss* decision and the problems that came with the common law that led to its reform. The main principle behind *Foss* was to restrain and stop the courts from interfering with issues that relate to the internal management of companies. This brought severe effects on individual shareholders, who were unable to file a lawsuit on behalf of the corporation, with only some exceptions.

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[907] ibid para 14.2.
[908] ibid.
[909] ibid para 4.14.
[910] ibid para 14.4.
[911] ibid
[912] ibid para 6.15.
[913] ibid.

5.3 *The Common-Law Derivative Action and its Flaws in Providing Accountability for Minority Shareholders*

This section will look at the *Foss* rule's history as well as its exceptions and how it affects individual lawsuits brought by minority shareholders. The emphasis will be on the common law's inability to have a clear definition of minority fraud and 'wrongdoer control.'

The evolution of the *Foss* rule and its effects on English law can be traced back to partnership decisions in the early nineteenth century.[914] It was customary then for the Chancellor of Exchequer not to be involved in a partnership's internal problems unless it was with the intention of dissolving it.[915] The decision was made in response to the growing number of unincorporated corporations.[916] As a result, it was a situation involving internal control.[917] It was well confirmed in *Burland v Earle* that it was not the duty of the courts to have a say in the administration of corporations working within their powers; to correct harm done to the firm was the responsibility of the firm.[918] The above statement introduced two significant concepts, namely, the internal management and the proper plaintiff principles known as *Foss v Harbottle*. Therefore, the *Foss* rule originated from both partnership and the proper plaintiff principle. It will be intriguing in this regard to analyse the *Foss* principle, looking at these two principles and how they shaped corporate law.

5.4 *The Internal Regulation Principle*

As stated above, the chancellors did not want to be drawn into making decisions that involved companies, as they perceived them as 'partnership squabbles' or 'mere passing improprieties'[919] because partnerships were rooted and based on rules of good faith during that period. Therefore, considering such a delicate relationship, it was not

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[914] Kenneth Wedderburn, 'Shareholders' Rights and the Rule in Foss v Harbottle' (1957) 15(2) CLJ 194, 198.
[915] ibid.
[916] ibid.
[917] ibid.
[918] [1902] AC 83.
[919] *Marshall v Colman* (1820) 2 J&W 266.

imperative for the courts to interfere.[920] The unwillingness of the courts to be involved in the partnership`s business matters was verified in *Carlen v Drury*.[921] The court, refused to be involve in the management decisions of the corporation.

It is only situations where it can be shown that there was ‘refusal or neglect to act’ by the parties themselves that might force ‘prompt and immediate interference.’[922] The refusal to intervene was to give the parties the right to exercise the articles of partnership. The profound judgement of Lord Eldon on the ideal of the courts’ non-intervention in a partnership's internal matters was later adopted in the *Foss case,* where it was acknowledged that it was the responsibility of the shareholders to make a sound judgment on internal issues of the corporation. This resulted in a paradigm shift, transforming the ancient partnership rule into one of the most important rules in current business law.[923]

5.5 *The Proper Plaintiff Principle*

This principle is an interpretation of *Foss*; where harm is done against a firm, the corporation has the power to sue on its own.[924] The principle was extended to also mean that if the majority shareholders approve of alleged injustice, the minority has no right to sue. Minority shareholders were harmed by the majority rule principle, which prioritised and respected the company’s controlling stockholders.[925]

It is important to remember that when a company is formed, it becomes a different persona from its shareholders.[926] This gives it the authority to exercise its legal rights.[927] Nevertheless, the action to sue is not available to individual shareholders. The decision rather lies with the shareholders, who have the benefit of the majority rule over the minority.

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[920] Anthony James Boyle, *Minority Shareholders’ Remedies* (Cambridge University Press 2002).
[921] (1812) V&B 154.
[922] ibid.
[923] *Shareholder Remedies* (n 888).
[924] *Foss* (n 262).
[925] ibid.
[926] *Salomon* (n 32).
[927] *Edward v Halliwell* [1950] 2 All ER 1064, 1067.

5.6 *The Rule in Foss v Harbottle*

The above decision prompted Julia Tang to wonder whether there was any possible way an individual shareholder could sue a company.[928] The courts have shown their dissatisfaction with interfering with the management of the company as shown above. They have distanced themselves and resigned to the majority rule.[929] Wedderburn expressed his dissatisfaction with the rule of *Foss* by claiming that it provides unsatisfactory answers because it is subject to certain exceptions.[930] It does not bring balance when it comes to who should bring relief when harm is caused to the company. The majority shareholders are graced with unfettered powers to preside over the company. Hence, within those parameters, they exercise unrestricted measures to deny remedy for harm caused to the company. Moreover, in general meetings, majority shareholders enjoy their discretion by exercising their voting rights to escape liability caused to the company by its directors. It gives them the edge to relieve the wrongdoing of directors from personal liability.[931]

The majority rule principle was disadvantageous because it favoured the majority shareholders. For example, in *Foss*, even though majority shareholders had defrauded the company, it was for them to bring a claim and not the claimant. Explaining this decision, Sir James Wigram concluded that any harm done is to the company by custodians, and, therefore, the directors could file a lawsuit and not individuals.[932] The argument was that the firm should make the claim, not the individual shareholders.

The above case raises the question of who can enforce directors' duties. Kershaw conceded that remedy should be rendered to the injured party.[933] However, directors' responsibilities are meant for the corporation; accordingly, they should be enforced by the corporation or those who act on behalf of it, namely, the directors of the company.[934]

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[928] Julia Tang, 'Shareholder Remedies: Demise of the Derivative Claim' [2012] UCL Journal of Law and Jurisprudence 178, 180.
[929] Wedderburn 'Shareholder's Rights' (n 914).
[930] ibid.
[931] Jennifer Payne, 'A Re-Examination of Ratification' (1999) 58 CLJ 604, 626.
[932] *Foss* (n 262) 491.
[933] Kershaw (n 502) 589.
[934] Paul Davies, *Introduction to Company Law* (2nd edn, 2010).

Nevertheless, arming directors with such unfettered powers comes with serious consequences if directors deviate from their duties. In most cases, directors might not use their power for the right purposes. They might decide not to sue their colleagues, or the wrongdoing directors, for personal reasons, even at the expense of the company. Hence, it was criticised, the unrestricted powers imposed upon the directors as unreasonable and risky.[935]

One means of resolving this problem could be using independent directors to bring action for the company. The disinterested directors are not affiliated with the wrongdoing directors. However, as good as it may sound to have independent directors, it is also open to criticism concerning the meaning of independence.[936] This is because some disinterested directors might find it hard to act against their fellow directors. They might be hesitant to sue fellow directors to maintain friendship and might simply believe that it will not be for the company's good.[937] It was contended that allowing directors to have exclusive power in decision-making would only result in injustice to both minority shareholders and the company itself.[938] It was further stated by Arad Reisberg that consistent use of the majority rule brings nothing but inequity to the company and a shield from liability for wrongdoers.[939] Therefore, it is imperative to strike a balance by allowing the minority to pursue a claim for the corporation while at the same having checks to make sure the action serves the company's interest.

The difficulties that the *Foss* rule poses to minority shareholders in bringing a derivative action for the corporation have been demonstrated in the passage above. The injustices suffered by minority shareholders could only be resolved by reforming the derivative regime, bringing a more flexible and accessible one whereby a shareholder could pursue

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[935] Davies and Worthington (n 460).
[936] ibid.
[937] Lucian Bebchuk and Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press 2006).
[938] *Salford* (n 61) 113.
[939] Reisberg, *Derivative Actions and Corporate Governance* (n 84) 78.

an action[940] and a new derivative regime that would tackle the problems that came with the *Foss* rule.

5.7 Advent of Statutory Reform

The common law derivative regime was replaced by Part 11 of the CA 2006[941] to avoid the burden of exceptions.[942] The main objective of the statutory regime was to bring simplicity, modernisation, and better accessibility to the law since the common law regime was opaque and difficult to understand.[943] However, the courts would be very cautious about allowing cases to continue in inappropriate circumstances to avoid floodgate claims.[944] The courts would take a gatekeeper's position to deal with and exclude petty cases that would be outweighed by costs and time.[945] It would also act as an assurance to directors that the new changes would not be detrimental to them in terms of increased shareholder litigation. Lord Goldsmith believed that the new statutory derivative claim would motivate directors to make sound decisions for the benefit of their companies.[946]

This would encourage shareholders to file credible applications against directors and reduce vexatious claims in time.[947] It was all about creating an environment whereby prospective talented directors are not deterred from taking up positions.[948] However, David Gibbs stressed that although the government conceded having sufficient mechanisms to avoid weak claims being put forward, it responded to these concerns by introducing that claimants would have to satisfy a two-part test.[949] The statutory derivative claim was introduced to tackle the controversial rules that came from the *Foss* rule, and

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940 Tang (n 928) 178.
941 *Shareholder Remedies* (n 888) para 6.55.
942 *Foss* (n 262).
943 *Shareholder Remedies* (n 888) para 6.4.
944 ibid para 6.14.
945 Andrew Keay, 'Assessing and Rethinking the Statutory Scheme for Derivatives Actions under the Companies Act 2006 (2016) 16(1) Journal of Corporate Law Studies 39.
946 David Gibbs, 'The Statutory Derivative Claim: A Case Based Analysis. Has the Statutory Derivative Claim Fulfilled its Objectives?' (2011) 32 Company Lawyer 42.
947 CA 2006 (n 26) s 239.
948 Hansard, HL vol 681, col 883 (9 May 2006).
949 Gibbs (n 892).

a number of cases[950] applied its ruling in a different capacity. However, there are mixed feelings and concerns pertaining to its interpretation and application.[951] Therefore, the following sections will assess the implications regarding the courts' recent approach to derivative claims since Part 11 of the CA 2006 was enacted. Its efficiency in enforcing directors' duties will be examined in this thesis.

5.7.1 The Structure of the Statutory Derivative Action

To establish a prima facie case, in accordance with the statutory, a member[952] must file a lawsuit for conduct relating to negligence, default, and trust.[953] It can be perceived from the previous section that the statutory derivative action gave *locus standi* to a member to act for the company, which was contrary to the common law regime.[954] This was a remarkable development. Section 260(3) now includes a broader variety of violations, eliminating the need for a business member to prove their position.[955] The wording submits that proving a case is now less onerous than previously under the *Foss* rule.[956]

Moreover, negligence is now inclusive across the board on all types of breaches under a derivative claim. It is no longer required to differentiate between mere negligence and gross negligence.[957] The requirement takes no regard for fraud on the minority; as a result, an applicant can now present a derivative action under negligence without having to prove that the wrongdoing director has profited from their negligence. It was conceded by Lord Hodgson of Astley Abbotts that the statutory derivative action gave a new dimension on the grounds of negligence better than under the common law.[958] The flexibility that came with the statutory derivative regime on the grounds of negligence

[950] *Edward v Halliwell* (n 896) and *Smith v Croft* (No 2) [1988] Ch 114.
[951] Gibbs (n 892).
[952] CA 2006 (n 26) s 260(1).
[953] ibid, s 260(3).
[954] *Foss* (n 262).
[955] Andrew Keay, 'Assessing and Rethinking the Statutory Scheme for Derivatives Actions under the Companies Act 2006 (2016) 16(1) Journal of Corporate Law Studies 39.
[956] ibid
[957] *Pavlides v Jensen* [1956] Ch 565.
[958] HL Deb 27 February 2006, vol 679, col GC3.

meant that minority shareholders could escape the injustices of wrongdoings committed against the corporation, free from showing that wrongdoers profited from their neglect.

However, some feared that this flexibility would deter future candidates for directorship posts for fear of increased litigation against them due to the excessive powers given to shareholders.[959] However, Lord Goldsmith recognised and conceded that the new reforms would bring tight judicial control between both parties for equity purposes and would encourage claims to be dealt with internally to avoid unnecessary court prospects.[960] The key element was to properly balance strike a better balance, shielding directors from frivolous lawsuits and safeguarding shareholder rights.[961] Therefore, introducing a derivative action on a statutory footing would bring justice to both parties.

5.7.2 The Two-stage Procedure

The statutory derivative action required a two-stage procedure to be satisfied for permission for a claim to be granted, and Lord Goldsmith believed that this would bring balance because it risked increasing directors' liability and giving unhappy shareholders more opportunities to sue them, thereby encouraging directors to act in a proper way.[962] It would also encourage credible claims to be brought forward against directors and have them turned away before the process begins.[963] Thus, a two-stage test was set up to evaluate the validity of the claim in all circumstances. It was hoped that the complications that came with the common law would be abolished.[964] In its report, the commission commended the repeal of the entire common law regime claim with a statutory procedure.[965]

Initially, the Law Commission did not support including the first stage, where a case must be established by the claimant for the claim to go through to the next stage.[966] Rather, it

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[959] Keay, 'Assessing and Rethinking the Statutory Scheme for Derivatives` (n 955).
[960] HL Deb 27 February 2006, vol 679, cols GC5.
[961] ibid.
[962] ibid.
[963] Hansard HL Vol 681, Official Report, 9/5/2006, col 883.
[964] *Shareholder Remedies* (n 888) para 6.4.
[965] ibid, para 6.55.
[966] ibid paras 6.4 and 6.71.

was the court that implemented it with the hope that the courts would make sound decisions about whether to dismiss or allow a claim. The corporation was compelled to present evidence to the court at the second step and consider numerous factors under ss 263(2) and 263 (3) as to whether to dismiss or allow a claim.[967] This will be examined fully below. However, it will be established that though some courts have adhered to the two-stage procedure, others have shunned doing so. For that reason, the thesis will endeavour to identify gaps and exploit the loopholes within the statutory derivative procedure to establish whether it can be enforced effectively against directors' duties.

5.7.3 First-stage Test

The CA 2006 requires a member who wants to file a lawsuit to get permission from the court.[968] For that permission to be granted, the member has an obligation to satisfy a two-stage procedure. It is at the beginning of the process that satisfaction is given by a court that a derivative claim warrants permission because of the existence of a prima facie case.[969] If it cannot be established, then the application must be dismissed,[970] enabling the dismissal of unscrupulous claims at a premature stage.[971] It was not required at the first stage for the company to be involved; the burden was on the individual to prove a case to ensure the hearing.[972] The applicant's evidence is crucial to the claim's success.[973]

However, some commentators[974] have expressed dissatisfaction with the requirement of a prima facie case under s 261 (2), noting that its meaning is unclear and creates uncertainty because of its failure to provide any definition or guidance. Proving a prima facie case has been the norm even under the common law, but its meaning remains ill-

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[967] ibid.
[968] CA 2006 (n 26) s 261(1).
[969] ibid, s 261(2).
[970] CA 2006 (n 26) s 261(2)(a).
[971] Hansard HL Vol 681, Official Report, 9/5/2006, col 883.
[972] ibid.
[973] CA 2006 (n 26) s 261(3).
[974] Qamarul Jailani, 'Derivative Claims Under the Companies Act 2006: In Need of Reform' (2018) 7(2) UCL Journal of Law and Jurisprudence 72, 100.

defined.[975] Keay and Loughrey further commented that not only have the courts failed to define prima facie but also how to establish it.[976] The applicant only needed to demonstrate a good cause for the claim to be heard under common law. As explained by Keay and Loughrey, the applicant needed to establish that the case is deserving of a full hearing.[977] However, under the statutory derivative claim, there is no obligation to meet the exceptions to the *Foss* rule. Some critics have claimed that the judiciary's first-stage method is unnecessary.[978] It could be argued that the idea to have a claim go through second stage and have it dismissed at that stage could be a waste of important time and effort. The screening could easily be done at the second stage.

Since the cases under the common law derivative action failed to establish what is required to allow a claim to go through under the first stage, it is imperative to focus our attention on decided cases under the statutory derivative action because it will assist in identifying the flaws and discrepancies of the first stage. It was considered that to determine whether prima facie exists is overly complicated.[979] The court ruled against the inclusion of the first stage when determining to accept a claim, even though the defendants suggested to the court to consider the two stages. However, the court's approach did not go without criticism from other commentators; Keay and Loughrey criticised the court for setting the bar too high.[980]

Despite the reasoning, this approach was welcomed by Tang, who stated that the question of whether a corporation can be sued will only be determined at the second stage after a comprehensive number of considerations have been considered.[981] Other

[975] *American Cyanamid Co v Ethicon Ltd* [1975] AC 396.
[976] Andrew Keay and Joan Loughrey, 'Something Old, Something New, Something Borrowed: An Analysis of the New Derivative Action under the Companies Act 2006' (2008) 124 LQR 469.
[977] ibid.
[978] Brenda Hannigan and Dan Prentice, *The Companies Act 2006: A Commentary* (LexisNexis Butterworths 2007).
[979] *Stimpson v Southern Private Landlords Association* [2010] BCC 387.
[980] Keay and Loughrey (n 976).
[981] Tang (n 928) 178.

interesting cases were[982] where the decision was made to combine the two phases into one. In *Mission Capital*, the judge regarded the decision of the two parties to combine the two processes as 'sensible'.[983] In *Iesini v Westrip Holdings Ltd & Others*, however, the court took a firm stance, emphasising the importance of the prima facie case.[984] The argument was that the first stage should serve its purpose, that is, to establish prima facie, as evidenced in *Prudential (No 2).*[985] However, notwithstanding its precision, the *Prudential* decision was founded on common law principles rather than statutory derivative regulations.[986]

The cases thus far have failed to give a clear and consistent meaning of what prima facie requires. This is further demonstrated from the observations. The court's reasoning in *Iesini* was that the focus in s 261 (2) was for the company to prove that there was a viable legal claim stemming from a director's conduct. However, it was not so with Mark Pelling QC in *Stimpson*; he argued that the court should consider, among other things, the factors laid out in ss 263(3) and 263(4) to prove a prima facie case.[987]

Therefore, prima facie is difficult to satisfy from the above, as with other cases when dealing with s 261(2).[988] Morgan J admitted that even though the term prima facie is often used, its meaning is still unclear. Gibbs even called for the abolishment of the prima facie test, claiming that the threshold is very low.[989]

It could be argued that prima facie creates needless hurdles for applicants. If the intention of the statutory derivative claim was to create a better and more flexible criterion, its principles were twisted by the addition of a prima facie case. As demonstrated from recent cases above, there are mixed feelings towards the first stage, which is overlooked in certain cases.[990] In view of the ongoing problems surrounding establishing the prima

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[982] *Mission Capital and plc v Sinclair* [2008] EWHC 1339 (Ch), and *Franbar Holdings Ltd v Patel* [2008] BCC 866.
[983] [2008] EWHC 1339 (Ch).
[984] [2009] EWHC 2526 (Ch).
[985] [1982] Ch 204.
[986] ibid.
[987] [2010] BCC 387.
[988] *Bhullar v Bhullar* [2015] EWHC 1943 (Ch).
[989] Gibbs (n 892).
[990] *Iesin v Westrip (*n 987).

facie, it is proposed that the first-stage requirement to establish a prima facie case should be removed, with the application to continue a claim to be heard in a single stage. This will remove the uncertainty, time, and costs associated with the problematic first stage of the application process and, in turn, encourage more shareholders to bring credible cases but with enough safeguards against frivolous claims.[991]

5.7.4 *The Second Stage*

As established from the above section, for a claim to proceed past the first stage, a prima facie test needs to be satisfied for the shareholder to move to the second stage. For a court to give permission for a derivative claim to continue, certain factors must be met under s 263. The court will not allow a lawsuit file if an applicant is unwilling to pursue in reference to s 172,[992] if the wrongdoing was because of the company[993] and if the result of the action was authorised by the company beforehand.[994] Since these factors play a pivotal role in allowing a claim, it is imperative to examine them in depth.

5.7.5 The Requirement for a Claimant to be Acting in Good Faith

Under CA 2006 s 263(3), the applicant's good faith is a deciding factor in granting permission. The provision looks at whether the claim was made in good faith. The focus on this provision is imperative, as shown in previous cases since a lack of good faith is often claimed.[995] It will be shown in this section that s 263(3)(a) is an obstacle and that its meaning and applicability is vague when it comes to a derivative claim.

The Implications of s 263(3) and its Complications

Under s 263(3), the court looks at whether the claim is made in good faith. The provision was designed to stop derivative claims from being used for personal gain rather than the good of the company.[996] However, it is difficult to consider whether an individual is acting honestly. Regrettably, this cannot be defined and is assumed to be widely understood.[997]

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[991] Gibbs (n 892).
[992] CA 2006 (n 18) s 263(2)(a).
[993] ibid, s 263(2)(b).
[994] ibid, s 263(2)(c).
[995] Edwin Mujih, 'The New Statutory Derivative Claim' (2012) 33 Company Law 99, 101.
[996] *Alexander Marshall Wishart v Castlecroft Securities Ltd* [2009] CSIH 65.
[997] *Shareholder Remedies* (n 875) para 6.76.

Much will depend on the interpretation of the courts. The Law Commission, however, preferred the standard of honesty and without ulterior motive, despite accepting that though a person can profit commercially, they can still pursue an action.[998] Personal interest does not always preclude an applicant from seeking a derivative claim. Indeed, in *Iesini v Hughes*,[999] the court was convinced the individual was acting honestly, even though there was an allegation of the applicant having a collateral purpose. It was well concluded by Lewison J that the claim in essence was for company gain and that no attachments should be connected to it.[1000]

The same was true in *Mission Capital*;[1001] it was held that once 'real purpose' is established for bringing the claim, the argument that an applicant was not acting in good faith is immaterial. Even though good faith is not a mandatory bar, it is a discretionary element that the court considers before granting leave.[1002] Therefore, the burden is on the applicant to prove and show their good faith beyond the expectations of the Law Commission.[1003] However, though s 263(3) might have been seen as a filter of meritorious claims, without some sort of personal motive, it will be extremely difficult to litigate on behalf of the corporation. If the good faith test is only measured on the merits of ulterior motive, it would be very difficult for credible derivative claims to be brought forward.

It is argued that good faith should not solely be judged by whether there is an underlying motive behind the claim if it is brought in honesty for a collateral purpose following abuse of the company. As a result, Jennifer Payne admits that the court prioritises the firm at the expense of the shareholder using the derivative technique.[1004] Consequently, no applicant should be compelled to adopt a saint-like demeanour to bring a derivative claim. Therefore, the good faith test should not only be satisfied in situations of no 'ulterior motive' to the applicant. It is arguably irrelevant in the context of a derivative claim.

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[998] Tang (n 897).
[999] [2012] EWHC 2363.
[1000] ibid.
[1001] [2012] All ER 197.
[1002] ibid.
[1003] Jill Poole and Pauline Roberts, 'Shareholders Remedies: Corporate Wrongs and the Derivative Action' (1999) JBL 99, 101.
[1004] Jennifer Payne, 'Clean Hands in Derivative Actions' (2002) 61 CLJ 76, 77.

Moreover, any claim made is done so for the company. As a result, the derivative claimant should not be accused of acting in bad faith. The court's priority should be to do justice to the firm rather than the derivative claimant.[1005]

5.7.6 Section 172: Promoting Company Success

The commission requires courts to take into consideration the actions of the directors before allowing the continuation of a derivative action. This includes whether there is an objection from a director not to continue with the claim, meaning the onus is on directors to weigh their actions as to whether they benefit the company. In coming to this conclusion, the director must take note of factors under s 172(1)(a)–(f). The primary goal is to support and promote the best interests of the company.[1006] However, s 172 was developed from soft law and is thought to be identical to the present formulation; as a result, whether s 172 advances the law is debatable.[1007] Furthermore, it has been heavily chastised for being unfit for purpose.[1008] Though it reflects on how to improve corporate social responsibility, there is no still a legal remedy for a breach.[1009]

Section 172 is strongly disputed for its lack of protection.[1010] Keay highlights clearly that even though s 172 is a vital provision of the CA 2006, its meaning is unfounded.[1011] The parliamentary committee has not provided any clarification of its meaning.[1012] A lack of clarity surrounding its meaning could be a problem in deciding a derivative claim, hindering accountability purposes. The concept of good faith raises criticisms, as it focuses on the directors' state of mind when executing decisions.[1013] The subjective element may be the reason for this provision's failure, as it gives directors unrestricted

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[1005] ibid.
[1006] ibid.
[1007] Gibbs (n 892).
[1008] Keay, 'The Duty to Promote the Success of the Company' (n 18) 1.
[1009] ibid.
[1010] ibid.
[1011] Andrew Keay, 'Enlightened Shareholder Value, the Reform of the Duties of Company Directors and the Corporate Objective (2006) LMCLQ 335, 346.
[1012] ibid.
[1013] Rachel Tate, 'Section 172 CA 2006: The Ticket to Stakeholder Value or Simply Tokenism?' (2012) Student Law Rev 112,114.

flexibility in determining what constitutes the company's success, making it a daunting task for an applicant to object to their decisions and f pursue a claim.

5.7.7 Authorisation and Ratification Factors

Sections 263(2)(b) and 263(2)(c) determine whether a derivative claim should be refused or not through authorisation and ratification. This is done through the majority shareholder`s support at the general meeting[1014] acting as the company. However, it could also be the board of directors' approval.[1015] In circumstances when a firm has been wronged, ratification is the deciding factor between correcting the wrongdoer's mistake or initiating litigation.[1016] What can be deduced from the above section is that the majority shareholders have the upper hand to work in favour of a wrongdoer director because of their unrestricted powers. This raises the question as to whether the general meeting is the appropriate body to adjudicate such matters. In usual circumstances, a decision by the majority shareholders binds the rest and the company itself.[1017] Under common law, the principle of majority rule is linked with the courts' non-interference attitude in company-related concerns.[1018]

As was stated by Mellish LJ in *MacDougall v Gardiner (No.2)*, when the issue at hand is one that can be dealt with through majority rule, then litigation is a secondary option.[1019] The foregoing statement has the disadvantage that a wrongdoer director can use their voting power as a shareholder to confirm their wrongdoings in the general meeting.[1020] Nevertheless, the statutory derivative claim can be applauded for making changes to some of the problems that came with common law, for instance, excluding the wrongdoer from voting. However, the impact of the statutory derivative could be questioned based on ratification law. The burdens of the common law principles relating to ratification seem

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[1014] CA 2006 (n 26) s 263(2)(b).
[1015] ibid, s 175(4).
[1016] Payne (n 928).
[1017] ibid.
[1018] ibid.
[1019] (1875) 1 Ch D 13.
[1020] Jennifer Payne, 'Clean Hands in Derivative Actions' (n 928).

to be largely ignored.[1021] Thus, because of the complexities of this matter, ratification will be the focus. The following section will examine ratification under common law, contrasting it with the statutory derivative claim. It will help to find the loopholes and flaws of the statutory claim in assessing whether it is an effective tool to enforce directors' duties.

5.7.8 The Common Law Ratification

The debate and complexity surrounding ratification, according to Wedderburn, affect every part of company law.[1022] The Law Commission was also eager to point out that ratification law is far from transparent,[1023] relating to the uncertainty of its interpretation. The Commission went on to state that though there is a need to modernise the law on the aspect of ratification, much of the workload on the directors' duties must be considered.[1024] Nevertheless, nothing was resolved regarding the issue of ratification.

The confusion and uncertainties surrounding ratification at common law were well explained by Davis and Worthington, who noted that it is practically impossible to pinpoint breaches on which a director can be ratified.[1025] The problems of the common law ratification came from its 'transaction-based' approach.[1026] The success of ratification depended on whether the breach falls under 'fraud' and the character of the original wrongdoing. It did not look at the wrongdoers' possible use of their voting powers.[1027] The traditional approach concerning fraud was that it was simply unratifiable, no matter how it was presented. As a result, it can be understood to suggest that the focus should be on the nature of the crime rather than the ratification process.[1028] As interpreted by

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[1021] Christopher Riley, 'Derivative Claims and Ratification: Time to Ditch Some Baggage' (2014) 34(4) LS 582, 608.
[1022] Kenneth W Wedderburn, 'Derivative Actions and Foss v Harbottle' (1981) 44 MLR 202.
[1023] *Shareholder Remedies* (n 888) para 6.81.
[1024] ibid para 6.85.
[1025] Davis and Worthington (n 460).
[1026] Riley (n 1021).
[1027] ibid.
[1028] ibid.

Wedderburn, fraud is not in the motive but in the nature of the action.[1029] Therefore, 'fraud' does not consider whether the wrongdoers practised their voting powers to serve their own interests rather than the company's; instead, it is concerned with the character of the wrongdoing.

The transaction-based approach received criticism for its failure to address what constitutes 'fraud.' Baxter argued persuasively that fraud is a jumble of diverse deceptions that resist all attempts to categorise them into recognisable legal categories.[1030] It was traditionally accepted that misappropriating company property amounted to fraud.[1031] The definition of 'property' was expanded to encompass possessions or benefits that belong to the corporation.[1032] It was difficult to distinguish wrongs done fraudulently due to the uncertainty of the transaction-based methodology, which acts as a gate-away method for wrongdoers who misappropriate 'property'.[1033] There were also issues with the transaction-based approach's handling of negligence.[1034]

Basic negligence was not perceived to be a fraudulent act and consequently could be ratified under the majority rule.[1035] However, in *Daniels v Daniels*,[1036] selfishness could not be ratified, with Christopher[1037] confirming that fraud occurs when the board inadvertently utilises authority for its own good. The confusion and complexities surrounding the transaction-based approach led Riley to admit that there was a need for a 'voting-based' strategy to bring clarity to the issue of fraud.[1038] Therefore, the following section will look at how the new statutory derivative dealt with the problems of the transaction-based approach.

[1029] Kenneth W Wedderburn, 'Shareholders Rights and the Rule in *Foss v Harbottle* (Part 2) (1985) 93 Camb L J 96.
[1030] Colin Baxter, 'The True Spirit of *Foss v Harbottle'* (1987) 38 NILQ 6,14.
[1031] *Burland v Earle* [1902] AC 83, 93.
[1032] ibid.
[1033] Riley (n 1021).
[1034] ibid.
[1035] *Pavlides v Jensen* (n 957).
[1036] [1978] Ch 406.
[1037] Riley (n 1021).
[1038] ibid.

5.7.9 Ratification under *CA 2006*

The importance of ratification in derivative claims was highlighted by the Law Commission, who stated that it is not simple for one to predict ratification,[1039] yet refused to implement recommendations for reform. However, the Law Commission insisted that ratification was the deciding factor for any derivative claim[1040] while being unwilling to make any recommendations on the issue of ratification. However, the CLRSG was of the intention to make reforms to ratification.

The CLRSG acknowledged that simplicity on the law of ratification was desirable for clarity reasons.[1041] The CLRSG opined that in deciding whether a derivative claim should be permitted, consideration should be based on the wrongdoers' votes.[1042] The CLRSG seemed to introduce the 'voting-based' approach to ratification. If this method of ratification is used, it is evident that a derivative claim cannot be made.[1043] In its second consultation paper, CLRGS stressed that ratification should be made without any association with the wrongdoers' votes.[1044] Therefore, any ratification done independently of the wrongdoers is perceived to prevent any derivative claim. However, it can be noted without doubt that CA 2006 brought some changes in derivative claims. For instance, a member of a company can brings any claim of breach, regardless of the nature of the transaction.

It is no longer necessary to demonstrate that the harm inflicted on the corporation constituted fraudulent behaviour.[1045] On the other hand, s 239 of the CA 2006 states that the rule is not applicable to conduct that the firm cannot ratify. It is argued that the provision appears to be reverting to common law principles, thereby validating, and preserving the complexities and uncertainties surrounding the transaction-based approach. Therefore, it is contended that the new statutory claim fell short of resolving

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[1039] *Shareholder Remedies* (Law Com No 146,1997) para 5.2.
[1040] *Shareholder Remedies* (Law Com No 2,1997) para 6.84.
[1041] CLRSG, *Modern Company Law for a Competitive Economy: Developing the Framework* (DTI 2000).
[1042] ibid.
[1043] ibid.
[1044] ibid para 5.85.
[1045] CA 2006 (n 26) s 260(3).

the common law's flaws, which include defining fraud and differentiating what is termed ratifiable and non-ratifiable wrongs.

Furthermore, *Franbar Holdings Ltd v and Others* established that the statutory derivative claim brought no change for certain wrongs that remain unratified.[1046] In addition, wrongdoer control is still recognised in ratification cases where s 239(4)'s requirement has not been met.[1047] In general*, Frenbar* was a supporter of the ratification process based on voting. However, it later verified that some acts are unable to be ratified, indicating that the transaction-based approach has been approved.[1048] It can be argued that the decision of the court established the existence of the common law principles and their ambiguity. The other drawback that comes with ratification under CA 2006 is its assessment of voting and identification of associated individuals. The approach, it is stated, is suited to private organisations; but it poses a significant difficulty to major public businesses, which prefer a proxy voting method.[1049] The failure of the act to tackle the problems of the common law was well put across by Riley, who argued that it was a dismal indictment of the reform process.[1050] However, even though the statutory derivative claim was not able to deal with the common law problems, it can be heralded for bringing changes to the derivative claim.

For instance, ss 239(3) and (4) make it mandatory that ratification of breach of duty should not be connected to any parties. It could be argued that this has brought impartiality in the voting process, as the wrongdoers' acts are no longer ratifiable except when the voters are unconnected with the perpetrator. However, Keay disagrees with the reform by pointing out that it was not a successful resolution because 'connected persons' is only applicable to ratification but not to cases of authorisation.[1051] Hence, it is argued that it will act to the advantage of the wrongdoer by exercising their voting rights to seek authorisation against breach of duty.

[1046] [2008] BCC 885.
[1047] ibid.
[1048] ibid.
[1049] CA 2006 (n 26) s 260(1).
[1050] Riley (n 1021).
[1051] Keay, 'Assessing and Rethinking' (n 955).

According to Keay, the legislation on ratification is, without a doubt, the most complex legal issue.[1052] Friedman adds that, just like in common law, a minimal potential of ratification is enough to bar a shareholder from pursuing a derivative action.[1053] The confusion on ratification can lead to hearings into a fierce debate over whether the alleged wrongs are ratifiable or not.[1054] To make matters worse, the case law has not been helpful either; for instance, in the *Franbar* case, the court associated wrongdoer control with ratification. The most difficult aspect of ratification is the failure of the law to differentiate what can be ratified and what cannot.

It might be argued that removing all references to ratification from the statutory framework is the best option. This can be learned from other common law jurisdictions that share the same principles as the UK, yet they do not include ratification as a bar for granting the continuation of a derivative action. For example, in Australian law, ratification is not a paramount factor for a person bringing a derivative claim to continue.[1055] The same sentiments are shared in New Zealand law, which does not make any reference to ratification in derivative actions.[1056] The Law Commission stated unequivocally that any attempts to simplify the claim could be hampered by the difficulties that occur when an alleged crime is ratified.[1057] Therefore, a suggested approach to remove any reference to ratification would address those concerns.

5.8.0 Costs

Costs present the biggest hurdle on the part of any shareholder who wants to file a lawsuit. The situation regarding costs under statutory derivative claims is still the same as in common law. It compels the firm to indemnify a minority shareholder who files a claim for costs if the corporation benefits from the claim.[1058] If an abusive majority

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[1052] ibid.
[1053] Saul Friedman, 'Ratification of Directors' Breaches' (1992) 10 C&SLJ 252, 254.
[1054] Anthony Boyle, 'The New Derivative Action' (1997) 18 Co Law 256.
[1055] Corporations Act 2001, s 239 (1).
[1056] Keay, 'Assessing and Rethinking' (n 924).
[1057] *Shareholder Remedies* (n 888) para 6.81.
[1058] Paul Sykes, 'The Continuation Paradox: A Critique of Minority Shareholders and Derivative Claims Under the Companies Act 2006' (2010) 29(2) Civil Justice Quarterly 205.

shareholder cannot be restrained by some means, no minority shareholder will take the chance to bring a derivative claim. It was well explained by Denning LJ that a minority has a lot to lose apart from the claim, which includes unbearable court costs.[1059]

The introduction of the derivative procedure was meant to resolve the costs issue, through which the minority shareholder claim would be indemnified after having brought the claim in a reasonable manner.[1060] Even though on paper, it looked possible for the applicant to bring a claim and receive a remedy, there is no guarantee. Judges have often shunned taking the strict approach of refusing to grant an indemnity to a minority member for their costs in a bold action under the statutory regime,[1061] when, in theory, it was meant to act as an incentive to motivate and encourage derivative claims to be brought forward.[1062] However, some commentators have queried whether the granting of costs works as an incentive to an applicant.[1063] The purpose of an incentive is for the hope that the incentivised will be recompensed for the course of action they took. Keay, on the other hand, questioned whether the costs order didn't just uphold the shareholder`s current situation.[1064] It could be argued that, in most cases, the minority incur heavy legal costs through solicitors regardless of the outcome.

The biggest challenge is the power invested in the courts, which get to exercise their discretion at the expense of the applicant. It was well explained by Keith[1065] that the judiciary's role in granting costs is a stumbling block to the applicant having any chance to hold the company liable for costs incurred. The biggest worry is that both CA 2006 and CPR have not given any guidance on awarding indemnities. It is guesswork for shareholders, as they are left in limbo as to whether they would be entitled to any assistance on costs after the derivative proceedings. Furthermore, no case law has

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[1059] *Wallersteiner v Moir (No.2)* [1975] 2 WRL 389 CA (Civ Div).
[1060] Paul Sykes (no 1058).
[1061] Paul Carsten, 'Derivative Actions under English and German Corporate Law' [2010] ECFR 81, 115.
[1062] HL Debates, 27 February 2006, vol 679, col GC13.
[1063] Arad Reisberg, 'Funding Derivative Actions: A Re-examination of Costs and Fees as Incentives to Commence Litigation' (2004) 4 JCLS 345, 383.
[1064] Keay, 'Assessing and Rethinking' (n 955).
[1065] Keith Fletcher, 'CLERP and Minority Shareholder Rights' (2001) 13 Australian Journal of Corporate Law 290, 303.

clarified at what point a court can exercise its discretion on the issue of granting an indemnity order.[1066]

Some cases, such as *Stainer v Lee*[1067] and *Iesini*, have pointed out that an indemnity order can be made once the applicant gains permission to bring a lawsuit file. However, this is still unclear, for both cases are silent about the exceptions to this principle. Therefore, the contended lack of clarity and confusion surrounding the indemnity order will be a barrier to successful claims to be brought forward by shareholders. However, the cases established that where an indemnity order was granted and shareholders were successful, still the court refused to grant the full costs of the claim.[1068]

This was the issue, for instance, in *Stainer v Lee*,[1069] where an order limit of £40,000 was granted. Keay termed it unfair and unreasonable for the courts to refuse an indemnity for costs when an applicant has satisfied the test of the two-stage process.[1070] He submits that it leaves unanswered questions for the applicant as to what exactly should be done.[1071] To make matters worse, the applicant cannot find any counsel or relief from the legislation or courts. Tang, on the other hand, has advocated for a balanced approach by the courts, with indemnity expenses granted in a manner that is neither excessively generous nor excessively punitive.[1072] Tang's comment might sound very reasonable, but it could be argued that unless there are good grounds against the granting of such indemnity costs, the applicant deserves full grant costs without limit.

Therefore, the thesis proposes reforms to the problematic issue of granting indemnity costs. There is a need to address rule 19.9E of the CPR, which should be revised to allow a derivative claimant access to an indemnity order once established that permission has been given. This should cover full grant costs, taking note of all heavy legal costs incurred by the applicant during the claim. The court's decision on whether to award indemnity

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[1066] Jailani (n 974).
[1067] [2010] EWHC 1539 (Ch), [2009] EWHC 2526 (Ch).
[1068] Reisberg, *Funding Derivative Actions* (n 1063).
[1069] *Stainer v Lee* (n 1067).
[1070] Keay `Assessing and Rethinking` (n 955).
[1071] Ibid.
[1072] Tang (n 928).

expenses will be left to its discretion. The obligatory indemnity order will open doors for successful claims to be heard and give confidence to shareholders in the system.

It is argued unreasonable for a court not to authorise a company to exercise sound, fair and sensible judgment to pay incurred costs by a claimant who has obtained permission.[1073] Furthermore, it would be unfair for the company to obtain relief because of the applicant's successful derivative claim and yet fail to pay indemnity costs accrued by the claimant.[1074] As argued above, the introduction of an obligatory indemnity order would bring fair justice and faith in the derivative regime, thereby encouraging shareholders to bring successful claims. However, more needs to be done, as it has been established that a cost indemnity order by itself does not encourage a shareholder to bring a derivative claim because of its uncertainty.[1075] Therefore, this thesis calls for amending CA 2006 by giving the court the power to award monetary incentives over a successful claim.

The amount of the reward should be reasonably based on the percentage calculations of the takings from a successful claim. For example, a director should be compensated by the company if they incur expenditure in bringing a successful claim against the individual who has injured the firm. As submitted by Reisberg, the incentive offered could be a fraction tied to a financial gain by the corporation.[1076] Moreover, the court should obligate the losing party to pay the allocated amount directly to the claimant. This idea can be learned and adopted from other jurisdictions that have exercised it. A good example of rewarding a derivative claim to the claimant is Israel. Section 201 of the Israel Companies Law 5759–1999 states that if the decision is in favour of the corporation, then the corporation should pay an incentive to the plaintiff for the benefit made from the claim. Another outstanding example is New Zealand, where a court is empowered to make proceedings from a company's benefit from a claim go to shareholders and not the

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[1073] CA 2006 (n 26) ss 263(2)(a) and 263(3)(b).

[1074] Reisberg, *Funding Derivative Actions* (n 1063).

[1075] Ibid.

[1076] Reisberg, *Funding Derivative Actions* (n 1063).

company itself.[1077] The court will take into consideration the constraints and the gravity of what the shareholder went through because of the defendant`s actions.

The reasoning behind a personal financial reward is that the company would have benefited because of the applicant's effort. Therefore, an obligatory indemnity order on its own without a personal financial reward on top will not benefit the applicant. The efforts will go unnoticed, like any other shareholder who has done nothing to make the derivative claim a success.[1078] The financial reward will propel applicants to initiate meritorious derivative claims. Moreover, if there is nothing to motivate a shareholder from bringing a derivative claim, it is more likely that the wrong against the company will not be dealt with, resulting in it failing to obtain a remedy. Therefore, it is submitted that the introduction of an obligatory indemnity order and monetary incentive will have positive effects in dealing with issues of costs. At the same time, there will be total control and protection against petty claims, for they will have been dealt with at the second stage of the application.

5.8.1 Evaluation of the New Statutory Derivative Action in light of the Carillion case

When introducing the derivative action in this chapter, the author was implying that the derivative action will be a solution to holding company directors to account for their actions. This is the theoretical part behind the introduction of the statutory derivative action. However, it has been inadequate for the task because of the uncertainty and complexities of Part 11 of the CA 2006, lack the potential to have an impact on directors' duties. It has proven ineffectual in enforcing directors' duties, due to its procedural difficulties.[1079] However, even if the derivative action works would it have worked in Carillion and RBS circumstances. Could the statutory derivative action have solved the problems in Carillion and RBS cases. Why couldn't the shareholders bring a claim out these crises?

[1077] New Zealand 167(d) of the Companies Act 1993.

[1078] Reisberg, *Funding Derivative Actions* (n 1063).

[1079] Arad Reisberg, *Derivative Actions and Corporate Governance: Theory and Operation* (Oxford University Press 2007).

It is improbable that the debatable matters concerning directors' obligations would be brought to trial, as it was unlikely that the shareholders would initiate derivative litigation against the directors who supervised the institutions throughout the crisis.[1080] The shareholders of Carillion had no incentive to police the directors because they were bought off. Carillion's directors were determined to portray a healthy and successful company through increasing dividends paid each year. Despite unsteady profits, Carillion's executives issued growing dividends to shareholders to avoid bad publicity.[1081] This dividend strategy was meant to attract investors and cover bad publicity. With dividend payments increasing year by year, investors failed to notice that the company was encountering severe financial hardship.[1082]Carillion had derivative action on their books and the parliamentary report on Carillion[1083] made it clear what the shareholders did when they were fed up. They sold their shares and exited. It was easier for them.

Shareholders observed that Carillion was on a path towards catastrophe and promptly withdrew their support. The corporation was burdened with very high levels of debt, had inadequate cash flow, and faced an expanding pensions deficit.[1084] Although it does not directly entail legal action, this approach may be the most economical method for a shareholder to disengage from a firm they are unsatisfied with. Furthermore, the act of selling shares does not provide the company with compensation for a director's breach, nor does it hold directors responsible for their misconduct.[1085]

[1080]Iris H-Y, Chiu Regulatory Duties for Directors in the Financial Services Sector and Directors duties in Company Law, (2016) Journal of Business Law.

[1081] Work and Pension Committee, *Carillion 'Trying to Wriggle Out of Pension Obligations* (n 769).

[1082] Federico Mor et al*, The Collapse of Carillion* (HC Library Briefing Paper 8206,14 March 2018) https://researchbriefings.files.parliament.uk/documents/CBP-8206/CBP-8206.pdf accessed 14 March 2018.

[1083] UK Parliamentary Committees, (Major shareholders Views on Carillion Collapse) 19 February 2018.

[1084] Ibid.

[1085] Andrew Keay, The Public Enforcement of Directors' Duties: A Normative Inquiry (2014) Common Law World Review, 89 VL - 43.

In addition, shareholders may be reluctant to initiate derivative litigation as it would be unproductive to pursue legal action that could further decrease the value of the firm, especially after it has already suffered significant damage from the crisis. Moreover, it is paradoxical for shareholders to accuse directors of wrongdoing when the directors have effectively acted in the best interests of the shareholders by pursuing ambitious and lucrative economic initiatives.[1086] Prior to the current crisis, there seems to have been a general acceptance by the market and institutional investors of the bank and many other corporations' balance sheets being geared up to increase returns on equity.[1087]

From the standpoint of shareholders' immediate interests in a bank's leveraged limited liability business, where they receive all potential gains while their losses are limited to their equity stake, regardless of the overall losses incurred by the bank/company in a disaster, this may not be considered irrational.[1088] Critical issues faced by certain banks (and other corporations) were made worse by the atmosphere of at least consenting to and encouraging heavy leverage on the side of shareholders. Therefore, from the analysis above it can be argued that even if the derivative action works, it would have not worked under Carillion`s circumstances. How could the Carillion`s shareholders ever bring a claim out of such financial crisis.

5.8.2 Evaluation of the New Statutory Derivative Action in light of the RBS case

Since it is improbable that the banks or their shareholders will file derivative lawsuits against the directors who managed RBS throughout the crisis,[1089] it is also improbable that the contentious questions surrounding the duty of directors will be heard in Court. Furthermore, after experiencing a financial crisis, shareholders might not be eager to

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[1086]Iris H-Y, Chiu Regulatory Duties for Directors in the Financial Services Sector and Directors duties in Company Law, (2016) Journal of Business Law.

[1087] A Review of Corporate Governance in UK Banks and Other Financial Industries Entities: Final Recommendations 26 November 2009.

[1088] Ibid.

[1089] Iris H-Y (n 1086).

launch derivative action because it would be counterproductive to do so and could further lower the corporation's worth. Furthermore, it would appear illogical to put the onus of suing directors who have accurately represented the interests of shareholders by pursuing high-risk, high-return business strategies on the shareholders.[1090] The incentives to sue directors are generally weak. Furthermore, shareholders would not know if directors' D&O insurance would cover director claims, should they be successful. Numerous studies[1091] demonstrate the link between boards that are supportive of shareholders and increased risk-taking in banks. Suit incentives are significantly impacted by the likelihood of recovery under D&O regulations. Should courts rule, for instance, that taking careless risks violates one's obligation to act in the best interests of the company, will a finding of bad faith be outside the purview of D&O insurance coverage? The goal of compensation may not be achieved even though directors may be held accountable in case law jurisprudence if the applicable D&O cover is not applicable.[1092]

RBS directors pursued aggressive risks and hostile acquisitions in the name of making money, profit maximising and paying dividends to its shareholders. RBS shareholders exerted pressure on management to enhance leverage, in certain cases, investors demanded returns that were potentially not feasible in the long run, leading to the need to raise borrowing and assume more financial risks.[1093] The Treasury Committee[1094] also affirmed that RBS shareholders were exerting significant pressure, seeking improved returns and highlighting business models that have retrospectively proven to be flawed,

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[1090] Ibid.

[1091] Andrea Beltratti and René M Stultz, 'Why Did Some Banks Perform Better during the Credit Crisis? A Cross-Country Study of the Impact of Governance and Regulation' (July 2009) NBER Working Article No 15180.

[1092] Iris H-Y (n 1086).

[1093] Parliamentary Commission on Banking Standards: First report of Session 2013-2014, Changing Banking for Good, HL Paper 27-11, HC 75-11.

[1094] Treasury Committee, Ninth Report of Session 2010–11, Competition and choice in retail banking, HC 612, Qq 833-835.

particularly those with high levels of leverage. The shareholders criticised the inefficiency of the management. Claiming that their balance sheet reveals a lack of productivity or effort and that some organisations were achieving greater success than them, and this created significant pressure.[1095] The shareholders were primarily concerned with pursuing growth and achieving high returns, often without considering the possible dangers involved. This was a contributing factor in establishing a culture that plausibly resulted in failure in the industry.[1096] Often, this practice undermined the active involvement of shareholders. Their impact on the company's management was mostly demonstrated by selling their stock, rather than actively participating in voting or engaging with the boards of their invested companies. This phenomenon, referred to as "exit over voice" in the Kay assessment[1097] highlights their preference for exiting their investments rather than using their voice to influence decision-making.

The success of RBS would have put it into second place in the UK banking field.[1098] There was also the need to position RBS in the transnational field, particularly within Europe.[1099] How could the shareholders bring a derivative action against directors with such a trajectory of company growth. A damning report from the Walker[1100] Review condemned the actions of the shareholders. The Review assigns a fair amount of blame for the banking crisis to RBS shareholders for their widespread complicity in the banks' balance sheet strengthening. Sir David believes that more intense examination and tenacity from large investors acting as owners would have resulted in a more effective response to the many board and director deficiencies in some of the dysfunctional BOFI boards.[1101]

1095 Ibid.

1096 Ibid.

1097 John Kay, The Kay Review of UK Equity Markets and Long-term Decision Making: Final Report, 23 July 2012, p 21.

1098 Ron Kerr and Sarah Robson, 'Leadership as an Elite Field: Scottish Banking Leaders and the Crisis of 2007–2009' (2011) 7(2) Sage Journal 151.

1099 ibid.

1100 David Walker, A Review of Corporate Governance in UK Banks and other Financial Industry Entities (2009).

1101 Ibid.

Therefore, from the analysis above even if the derivative action works would it have worked in RBS`s circumstances. How could the RBS shareholders ever bring a claim out of the financial crisis. The directors believed that they were fulfilling the desires of the shareholders. The directors perceived themselves as executing the instructions and authority given by the shareholders.

5.9 Other Actions Available to Shareholders

5.9.1 Unfair Prejudice Remedy

This section looks at other actions available to shareholders namely, Unfair prejudice, Shareholder agreement and the Rights and Power of Shareholders to use against company directors. However, through critical analysis this section will prove that the weaknesses of these actions supersede their strengths. Therefore, this section argues that these remedies are not effective tools for shareholders to use against rogue behaviour of company directors.

According to section 994 of the Companies Act 2006, members have the right to bring a case to court if they believe the company's business practises have been unduly harmful to the interests of its members overall. It must be shown that the membership interests have been unjustly affected. Unfair prejudice must be unjust and damaging to prevail. Therefore, unjust prejudice is generally understood to cover both illegal behaviour and legal but unfair behaviour. The goal of this expansive judicial power and its interpretation of section 994 is to provide the harmed shareholders with the greatest amount of justice possible while fostering fairness in the management of corporations. Section 996(2) gives the court broad latitude to award remedies in any way it sees right.

Unfair prejudice is defined broadly to involve compensation for corporate wrongdoing. According to the ruling in *Clark v Cutland*[1102], remedy for corporate wrongs is possible. The court acknowledged in *Atlasview Ltd v Brightview Ltd*[1103] that behaviour that

[1102] [2003] EWCA Civ 810.
[1103] [2004] EWHC 1056 (Ch).

undermines the interests of the members is a breach of duty. Therefore, the court may grant corporate remedy directly for unfair prejudice in situations where a wrong has been done to the firm and corporate relief is requested by the member. However, it is argued that abuse of process could result from using Section 994 to correct corporate wrongs without overcoming the complicated procedure of derivative proceedings.

Some commentators[1104] argue that unjust prejudice can be exploited by minority shareholders to persecute due to its accessibility and wide application. Therefore, protections against such exploitation should be present for unfair prejudice remedies to be employed to pursue corporate remedy. As a result of the personal aspect of the remedy, Jennifer Payne[1105] contends that ideas like ratification should not be included in unfair prejudice claims; but, if employed as a means of obtaining corporate relief, these concepts should be significant. Therefore, a claim for what amounts to corporate remedy should be dismissed, and the claimant should be compelled to request authorisation from the court to pursue a derivative claim instead.

A more accurate interpretation is a claim for unfair prejudice allows for legal action to be taken if the firm has been wronged. Therefore, it can be applied to correct company wrongs and could act as a director check. However, it could be argued that its effectiveness may be constrained by being essentially a personal remedy, meaning that a shareholder can only file a claim if he is personally harmed. This would leave the company at risk of the shareholders, who might not file a claim even if the business has been harmed, unless their own interests are at stake.

5.9.2 Protection through Shareholder Agreements

The shareholder agreement is a different form of protection available in private firms outside the unfair prejudice action. Ownership relationships in private companies are

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[1104] Sarah Worthington and L. S. Sealy, *Cases and Materials in Company Law* (11th edn, Oxford University Press 2016) 723.

[1105] Jennifer Payne, Sections 459-461 Companies Act 1985 in Flux: The Future of Shareholder Protection (November 2005). Cambridge Law Journal, Vol. 64, November 2005, pp. 647-677, Available at SSRN: https://ssrn.com/abstract=2283883.

governed by shareholder agreements. The discussion of shareholder remedies from the perspective of shareholder agreements has taken on a fresh perspective. These agreements provide shareholders the possible ability to anticipate the future management and conflict resolution strategies of the organisation. Minority shareholders possess the ability to safeguard their interests in the face of potential exploitation by majority shareholders through the pursuit of appropriate safeguards within the articles of association or through distinct shareholder agreements.[1106]

Hence, like other systems, shareholder agreements have the potential to function as a means of safeguarding the personal interests of shareholders within the firm, rather than primarily benefiting the organisation. The primary advantage is in its inherent protection against modification by majority shareholders via a special resolution, in contrast to the company articles. The alteration of agreements necessitates the unanimous consent of all parties involved in the agreement. Therefore, minority shareholders in privately held companies can enhance their safeguards against potential exploitation by controlling shareholders by engaging in negotiations for shareholder agreements, in addition to the rights already granted to them under the articles of association.

Shareholders possess the freedom to establish agreements with unrestricted terms within the confines established by prevailing legal statutes. For example, it is possible to mitigate conflicts inside these organisations by establishing predetermined protocols for conducting corporate operations.[1107] Several significant features that can be incorporated into shareholder agreements include the provision of management information to shareholders, the payment of dividends, and the establishment of a

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[1106] Stephen Copp, Company Law and alternative dispute resolution: an economic analysis (2002) 23 Company. Lawyer 361, 373.

[1107] Sean FitzGerald and Graham Muth, *Shareholders' Agreements* (Sweet & Maxwell 2012).

dispute resolution system. The inquiry pertains to the potential safeguarding capacity of these agreements in shielding private enterprises from detrimental actions by majority owners, and the extent to which such protection may be afforded.

5.9.3 The Limitations on Shareholder Agreement

While shareholder agreements have the potential to safeguard the personal interests of minority shareholders in privately held corporations, some limitations exist that may hinder their overall effectiveness. One primary issue pertains to the legitimacy of these agreements, which hinges upon the unanimous approval of all shareholders inside the corporation. The effectiveness of the agreement may be enhanced by both parties being in one accord. If, in contrast, only a portion of the owners are involved in the agreement, the legitimacy of the agreement may be at risk, contingent upon the specific objectives it seeks to achieve.

The agreement may face susceptibility to opposition from minority shareholders who are not part of the agreement if it seeks to modify the existing business policy through the election or removal of directors, particularly if these shareholders are against such changes. Another limitation is that the provisions of the agreement may have been formulated in a manner that prioritises the personal interests of individual shareholders, rather than considering the optimal interests of the company. Consequently, such agreements may prove ineffective in safeguarding the company as a collective entity against any misconduct.

The other issue pertains to the inherent limitations of these agreements, like any other contractual arrangement. Consequently, it becomes impractical for the creators of the agreement to anticipate all potential issues that may arise in their interactions with directors or accurately predict all potential instances of misconduct by majority shareholders. Finally, the effectiveness of the clause in the agreement is contingent upon the presence of an enforcement mechanism. The resolution of this matter is contingent upon the stipulations outlined in the shareholders agreement and may be

pursued either through legal proceedings or other dispute resolution methods such as arbitration.

Nevertheless, it is important to note that in most cases, conflicts arising from shareholder agreements extend beyond mere contractual issues outlined in the shareholders' agreement. Instead, they manifest in the form of conventional remedies provided by company law for shareholders, including claims of unjust prejudice and derivative claims.[1108] In general, shareholder agreements serve as a vital tool for safeguarding the interests of shareholders. Moreover, these agreements can provide a certain level of protection for the company against opportunistic actions by majority shareholders. Nevertheless, despite the limitations, these agreements are unable to effectively mitigate the potential wrongdoing of majority shareholders towards the corporation in all circumstances. Hence, the derivative claim remains the primary mechanism employed by private enterprises to safeguard their interests.

5.9.4 The Rights and Power of Shareholders

In the realm of company law, shareholders' corporate rights serve as the primary safeguard for the interests of shareholders in the United Kingdom. The contention posits that shareholders, particularly those invested in publicly traded companies, possess substantial influence in shaping the parameters of corporate governance. The establishment of UK corporate governance is primarily rooted in the authority of shareholder governance.[1109] As shareholders they have authority to exercise a veto power in relation to several transactions that may pose potential issues. These transactions include management services contracts beyond a period of two years, significant property transactions between a director and their firm, loans, and salary provided to directors, among other similar cases.[1110] Furthermore, the attainment of shareholder approval is imperative in cases of conflicts of interest transactions, and it is

[1108] Ibid.

[1109] John Armour et al, Shareholder Primacy and the Trajectory of UK Corporate Governance (2003) Vol. 41(3) 531,555.
[1110] Companies Act 2006 ss 188, 190, 196.

mandatory, especially for significant property transfers.[1111] Shareholders possess the entitlement to obtain a duplicate of the company's yearly financial statements,[1112] in addition to casting votes on the remuneration of directors.[1113]

Furthermore, stockholders possess significant influence over the governing structures of the company. For example, the articles of association can be amended through a special resolution requiring a majority of 75 percent.[1114] The shareholder has the authority to mandate the directors, by a special resolution, to undertake specific acts or prohibit them from executing certain transactions.[1115] Moreover, the Companies Act of 2006 confers significant authority upon shareholders to determine the composition of the board of directors. Shareholders with a voting capacity of five percent have the authority to request a meeting at their discretion. During this meeting, a director can be removed without any specific justification through the passing of an ordinary resolution, requiring a simple majority vote.

Nevertheless, it is important to acknowledge that the director possesses the right to express their views regarding the resolution within the meeting.[1116] According to some commentators,[1117] it is suggested that the authority wielded by shareholders in making crucial choices within a company potentially functions as an alternative to the official civil enforcement mechanisms in place in the United Kingdom. The author posits that the implementation of governance rights has the potential to mitigate managerial agency costs. This is achieved by granting shareholders the authority to dismiss directors who fail to act in the best interests of shareholders. Additionally, governance

[1111] Companies Act 2006 s 196.
[1112] Companies Act 2006 s 431.

[1113] Companies Act 2006 ss 280-360.

[1114] Companies Act 2006 s 18.

[1115] Companies Model Articles Regulations 2008, schedule 3, article 4 (1).

[1116] Companies Act 2006 ss 168–169, 282, 303 & 304.

[1117] John Armour et al., 'Private Enforcement of Corporate Law: An Empirical Comparison of the UK and US' (2009) 6 Journal of Empirical Legal Studies 687-722.

rights provide shareholders with decision-making authority prior to transactions that may potentially jeopardise their interests.[1118]

According to some commentators,[1119] the ability of shareholders to remove directors serves as a means of conveying the message that if directors do not align with shareholders' perspectives, they may face potential removal from their positions through a simple majority vote. The author contends that the authority of shareholders to remove directors can serve as a potent incentive for directors to comply with the desires of shareholders.[1120] However, in practical application, it is important to acknowledge that there exist many constraints on the use of certain corporate privileges.

5.9.5 Limitations on Shareholder Voting Rights

When examining the various arguments supporting shareholders' powers within the framework of UK corporate governance, a pertinent question arises regarding the efficacy in deterring undesired conduct of directors that may lead to the corporate harm and loss. While the legal framework grants shareholders significant authority in ensuring directors' accountability to the company, there exist certain practical constraints that impede the use of this power. In the exercise of their voting rights, shareholders are required to possess comprehensive knowledge on the company's business.

To deliberate upon the appropriate course of action, which may encompass the exercise of veto power over a potentially detrimental transaction or the removal of directors via a resolution, shareholders must initially acquire knowledge pertaining to instances of mismanagement or wrongdoing by said directors.

However, in the case of public corporations, the ownership and control are separated, resulting in a large dispersion of shares. Consequently, minority shareholders may not have knowledge of the directors' wrongful behaviour, thereby hindering their ability to resist such actions. To possess a comprehensive understanding of the firm`s management and make informed voting decisions, shareholders are expected to invest

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[1118] Ibid.
[1119] Paul Davies, *Principles of Modern Company Law* (Sweet & Maxwell 2008).
[1120] Ibid.

a considerable amount of time in acquainting themselves with the company's operations. However, it is worth noting that shareholders in publicly traded firms may not always fulfil this need in practise. A potential explanation for this phenomenon could be the absence of mandatory voting, which may result in a lack of participation from shareholders who hold a very small number of shares and hence may exhibit reluctance to engage in general meetings and exercise their voting rights.

Due to the decentralised nature of the capital market in the United Kingdom and the associated expenses involved in acquiring information about company matters a significant number of minority owners opt to adopt a state of rational apathy. The individuals in question exhibit a tendency to neglect the careful evaluation of specific proposals, instead opting to align themselves with directors without engaging in thorough deliberation of the matter at hand.[1121]

Based on the considerations, it can be suggested that voting rights in public firms may not always provide obstacle for directors, particularly in relation to minority shareholders.

5.10 The Vedanta v Lungowe case: An Analysis of Transnational Corporate Liability Litigation

There is growing corporate accountability on corporations in recent published reports especially on transnational corporate liability, for instance, the *Vedanta v Lungowe case.*[1122] This pertains to the potential legal responsibility of a parent business based in England for purported environmental harm inflicted by one of its subsidiaries in Zambia.

The detrimental impact of business entities' polluting practices on populations in developing nations is readily apparent. This poses a barrier for conventional systems of legal control. In Western nations, there has been a growing legal focus on scrutinising enterprises that result in environmental harm. However, in developing countries, such

[1121] Cheffins, Brian R., Corporate Law and Ownership Structure: A Darwinian Link? (2002). Available at SSRN: https://ssrn.com/abstract=317661 or http://dx.doi.org/10.2139/ssrn.317661.

[1122] [2019] UKSC 20.

activities frequently evade regulatory oversight. Vulnerable populations encounter substantial challenges when seeking to secure efficacious legal redress inside their respective domestic jurisdictions.[1123] First and foremost, individuals residing in these communities typically lack the financial resources to engage legal professionals for the purpose of initiating legal proceedings within their respective countries. Furthermore, a portion of these professionals exhibit hesitancy in engaging in tasks that involve providing evidence against businesses involved in pollution, as they prioritise safeguarding their prospects for future employment. Furthermore, it is worth noting that the operational endeavours of a corporation might be overseen from the offices of its parent company, which are frequently situated in developed nations and geographically far from the actual locations where these operations occur.[1124]

In a recent ruling, the Supreme Court of the UK issued a judgement that affirms the potential liability of an English domiciled parent corporation in relation to environmental matters. The adverse effects resulting from the operations of a foreign subsidiary situated in Zambia. The Court's decision in the case of *Vedanta Resources Plc & another v Lungowe & others*[1125] permitted the continuation of this legal matter by considering the potential obligation of the parent firm to exercise duty of care towards foreign claimants who had been impacted by the detrimental activities carried out by Vedanta's overseas subsidiaries. According to the plaintiffs, the Copper Mine engaged in a pattern of repeatedly releasing hazardous substances into nearby watercourses over a duration of 15 years.[1126]

Given that these watercourses served as the sole means of obtaining drinking water and supporting irrigation for the villagers, they contended that the discharges had a permanent detrimental impact on their well-being, means of subsistence, and

[1123] Elvis Ojeda, Transnational Corporate Liability Litigation and Access to Environmental Justice: The Vedanta v Lungowe Case, The London School of Economics Law Review (2021) Vol.6 (3) 223,248.
[1124] Ibid

[1125] [2019] UKSC 20.
[1126] Ibid.

agricultural endeavours.[1127] Additionally, they made claims about personal injury, property damage, impairment of amenities, and deprivation of land enjoyment. According to the *Vedanta case*, the Supreme Court determined that the plaintiffs possessed a plausible argument that Vedanta had a legal obligation towards them. The Court found that the main firm, Vedanta, exercised a certain level of managerial oversight and control over the actions of its subsidiaries.

The Vedanta case raises concerns among multinational corporations due to its indication of an expansion in the conditions under which English courts are willing to acknowledge a plausible argument that a UK-based parent firm may bear a legal responsibility for the actions of its subsidiaries operating abroad. The phenomenon of the *Vedanta case* represents an emerging trend observed in the courts of the home states of parent businesses, wherein they increasingly agree to exercise jurisdiction over such disputes.[1128] As an illustration, shortly after the Vedanta case, a Dutch court made a ruling in Esther Kiobel v Royal Dutch Shell PLC,[1129] asserting its competence to adjudicate a lawsuit involving a Dutch-incorporated parent firm and its Nigerian subsidiary. The lawsuit pertained to accusations of human rights breaches. The *Vedanta case* has broadened the scope for individuals to assert their rights and actively pursue equitable outcomes.

5.11 Conclusion

This chapter`s objective was to investigate and evaluate the derivatives claim amendments considering common law procedures and whether the changes would hold directors accountable and enforce their duties. It cannot be disputed that, at first glance, the new derivative provision appears to bring something new from the old common law principles to shareholders' remedy. This notion, however, is not without flaws. Regrettably, there is little in the provision to persuade rational shareholders to utilise the litigation process. The same old problems of the common law were adopted into the new provision. The common law position has not changed in terms of who bears the cost of a

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[1127] Elvis Ojeda (n 1301).
[1128] Ibid.
[1129] [2019] ECLI:NL: RBDHA: 2019:4233.

derivative action. It is the same standard in litigation, where litigants are held responsible for their own costs and the costs of their counterparts.

The statutory provision has been broadened to include negligent behaviour and breach of duties, which were not previously available under common law. Furthermore, the omission of terms like 'fraud' from the definition of 'minority' has made it simpler for claimants. Nevertheless, it is doubtful that these adjustments will have a significant impact. This will deter potential litigants for fear of injustice. Having said this, it could be very difficult for one to claim with conviction that the statutory claim has increased accountability for directors. This chapter has demonstrated the problems with the statutory provision in addressing the issue of accountability in company directors because of its shortcomings. The most important point to keep in mind is that a derivative suit is a tool for safeguarding the firm as an entity. The derivative suit is founded on a long-standing shareholder theory that serves to defend shareholders' interests. According to this thesis, as stated in Chapter one, the firm's goal should be to maximise the entity's wealth and ensure it is financially sustainable in the long run to benefit all stakeholders. It is argued that the current derivative claim falls short of achieving such an objective.

Chapter 6

6. Disqualification: The Remedy for Enforcing Directors` Duties?

6.1 Introduction

In chapter 5, the author introduced the derivative action with the clear implication that it would serve to hold business directors accountable for their acts. Nevertheless, chapter 5 has demonstrated that the derivative action is inadequate due to the uncertainties and intricacies of Part 11 of the CA 2006, which do not possess the capacity to significantly affect directors' obligations. The current system has been ineffective in ensuring that directors fulfil their obligations, mostly due to its complex procedures. Therefore, the author introduces the Company Directors Disqualification Act 1986 (CDDA) in this chapter, hopping to provide the solution to the inadequacies of the derivative action. The CDDA grants authority to the courts to issue orders or accept commitments that prevent persons from serving as directors or participating in any capacity in the establishment, creation, or administration of a business upon disqualification. The author predictably implies that the CDDA will be a solution to bridge up directors' duties by removing rogue directors from companies and prevent additional misbehaviour. This is the rationale behind the introduction of the CDDA in this chapter.

This chapter will critically evaluate how the Company Directors Disqualification Act 1986 (CDDA) may be used to remove rogue directors from companies and prevent additional misbehaviour. The author will not have regard to wrongful trading because of its inability to enforce or encourage directors to minimise losses to creditors and other stakeholders. There is a contention that the wrongful trading provision, as currently formulated and interpreted by the judiciary, does not fulfil its original purpose. This provision fails to equip the liquidator with an efficacious tool for recuperating funds on

behalf of creditors, and it does not serve as a mechanism to incentivise directors to mitigate losses incurred by creditors.[1130]

This chapter promotes the objective of the thesis of improving accountability and enforcement in company directors. Legal cases will be utilised to illustrate how effective this method is. However, it is claimed in this chapter that the CDDA neither encourages nor punishes good business behaviour; as a result, directors who have been declared incompetent and disqualified are not held personally liable under the CDDA. The CDDA's inability to properly address inept behaviour reflects its weakness in promoting accountability in company directors.

The following will be a concise summary of the chapter: The CDDA's objectives are covered in Section 6.2 and why it was put in place in the first place. Section 6.3 and 6.4 will examine the meaning of unfit and when a director is deemed unfit, considering the CDDA. Section 6.5 will discuss the dichotomy between punishment and protection Section 6.6 will address the impact of case law regarding the meaning of unfit and the controversy surrounding the subject. Section 6.7 will attempt to define undesirable conduct as unfitness. Section 6.8 will address the conduct in question under section 6 and its interpretation to bring clarity to the issue of unfit conduct. Section 6.9 will critically assess the disqualification regime to determine whether the Act is an acceptable solution for promoting market trust and accountability to directors of companies. Section 6.10 will explain ignorance of legislation (CDDA) as one of the root causes of company directors` conduct. Why a lack of awareness of company law regulatory risks is resulting in failure to deter them. Section 6.11 will discuss how training and qualifications of directors can be used as a preventative tool to deter incompetent and unskilled directors from occupying offices. Which was one of the major causes of the collapse of banks like Northern Rock and HBOS. Section 6.12 will discuss on failure of the disqualification regime as a tool for restoring market trust and confidence.

[1130] Andrew Keay, Wrongful trading: problems and proposals. Northern Ireland Legal Quarterly, (2014) 65 (1) 63,79.

Section 6.13 will address the issue of why some organisations are protected from collapsing and its effects. The behaviour of company directors in banks will be discussed and the bailing out of banks by the government, as insurance for directors` mistakes and incompetence. Section 6.14 will conclude by arguing that the CDDA does not encourage good corporate behaviour or punish bad behaviour. As a result, those who have been deemed incompetent and disqualified are not held personally liable under the CDDA. Thus, the CDDA's inability to counter incompetent behaviour among other issues is a sign of its weakness.

6.2 Advent of the Cork Report Reform

The Kenneth Cork Report[1131] on insolvency law reform paved the way for the CDDA to be enacted. At the time, the Cork Report believed that the Companies Act 1948's fraudulent-dealing section lacked the competence to deal with reckless dealing.[1132] The Cork Report concluded that creditors were unprotected when they suffered losses because of directors' inappropriate behaviour and conduct,[1133] and as a result, current legislation was ineffective in dealing with corporate failures caused by the undesired conduct of directors. The Cork Committee pushed for a change in the legislation that would allow directors to be sued in a civil court for inappropriate trade activities and behaviour. The Cork Report aimed to make it illegal for directors to engage in behaviour leading to company collapse and creditor losses.[1134] As a result, the Committee proposed that directors who cause a firm to incur liabilities during insolvency should themselves be held liable.[1135] The act’s intention is to dissuade and remove unscrupulous directors from businesses, as well as to prevent future misbehaviour.[1136]

The CDDA was proposed to deal with directors who are unsuited to run corporations. It grants the Secretary of State the authority to exempt directors from limited liability if they

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[1131] *Insolvency Law and Practice: Report of the Review Committee*, Cmnd 8558 (1982).
[1132] ibid.
[1133] ibid.
[1134] Andrew Keay, ‘Wrongful Trading: Problems and Proposals’ (2014) 65(1) NILQ 63.
[1135] ibid.
[1136] *Insolvency Law and Practice* (n 1131).

cause a company to fail because of mismanagement.[1137] It was well stated in *Re Blackspur Group Plc & Others*[1138] that the primary goal of the CDDA is to remove unfit directors from the management of companies. The CDDA's goal is to safeguard the public, rather than punish individuals.[1139] Paragraph 7 of Schedule 1 of the CDDA underlines a director's responsibility to suppliers, reinforcing the idea of enlightened shareholder value.[1140] It compels board members to put the interests of their members ahead of those of their stakeholders. In accordance with s 8 the State is obliged to protect the public from an unscrupulous director.[1141]

The Secretary of State can exercise their discretion by considering a wide variety of stakeholder interests.[1142] As a result, directors may be disqualified if their actions are deemed to have harmed stakeholders in a way that is not in the public interest. The level of accountability for unsuitable conduct is not based on the overarching need to promote the company's members' interests.[1143] Rather, it considers both shareholders and stakeholders without creating any ambiguity or inconsistency. Comparing it to private enforcement, Keay[1144] suggests that the public enforcement of directors' duties promotes corporate governance. Unlike derivative action that caters solely to shareholders, public enforcement represents all constituents' interests.[1145] Disqualification actions are a type of publicly funded legal action brought by state agencies with a single goal in mind: to act in the public interest.[1146] Furthermore, public enforcement has a higher deterring effect

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[1137] ibid.
[1138] [1998] 1 BCLC 676.
[1139] ibid.
[1140] CDDA (n 89) sch 1(7).
[1141] ibid s 8(1).
[1142] Richard Williams, 'Enlightened Shareholder Value in UK Company Law' (2012) 35 UNSW Law Journal 360.
[1143] ibid.
[1144] Andrew Keay, 'Assessment of Private Enforcement Actions for Directors' Breaches of Duty' (2014) 33 (1) CJQ 76.
[1145] John Quinn, 'The Sustainable Corporate Objective: Rethinking Directors' Duties' Sustainability (2019) 11 MDPI 1.
[1146] Williams. 'Enlightened Shareholder Value' (n 1142).

than private enforcement, because a public enforcement regime causes a director far more reputational harm than a private enforcement regime would.[1147]

6.3 The 1986 Company Directors Disqualification Act's Objective

The legislation came in place to keep incompetent directors out of business ventures. The CDDA was enacted with the goal of restoring public confidence in business directors;[1148] it safeguards the public from directors who act irresponsibly. The CDDA strives to avoid misbehaviour by those whose previous acts as directors of bankrupt firms proved to be a danger to other stakeholders, as per Sir Nicholas Browne-Wilkinson V-C.[1149] The provision for disqualification aims to promote corporate participants' integrity.[1150] It was confirmed by Dillion LJ in *Re: Sevenoaks Stationers Ltd*[1151] that the primary goal of the CDDA is to safeguard the public from fraudulent directors, not fit to run the affairs of the company. To encourage the desired behaviour, the state seeks to disqualify rogue persons from serving as directors. The National Audit Office has verified that the purpose of the provision is to safeguard firms from directors who take advantage of the limited liability benefit by being negligent or incompetent, as well as from those who are lacking in business integrity.[1152]

The disqualification provision is intended to improve accountability standards for those who exploit restricted liability.[1153] The goal of the CDDA, according to *Re: Blackspur Group plc*[1154] is to safeguard the public through prohibitory corrective action, with an anticipated deterring effect on future misbehaviour. Prior to the establishment of the disqualification system, the courts did not do much to safeguard the public from reckless

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[1147] Andrew Keay, 'Enforcing Breaches of Directors' Duties by a Public Body and Antipodean Experiences' (2015) 15(2) Journal of Corporate Law Studies 255.
[1148] ibid.
[1149] *Re Lo-Line Electric Motors Ltd* [1988] Ch 477.
[1150] Jassmine Girgis, 'Corporate Directors' Disqualification: The New Canadian Regime' (2009) 46(3) Alberta Law Review 3.
[1151] [1991] Ch 164.
[1152] Jennifer Lane Lee and Bryan Gladstone, 'Ethics and Enterprise: The Role of The Company Director Disqualification Act (1 March,1997)4 Small Business and Enterprise Development 129.
[1153] *Secretary of State for Trade and Industry v Ettinger* [1993] BCLC 896.
[1154] [1998] 1 WLR 422.

directors' actions, other than convicting them for their role in a company's collapse.[1155] The measures were insufficient to dissuade future directors from repeating the same wrongdoing. As a result, effective public protection was required, which took the form of a rule prohibiting the directors of failed enterprises from taking on managerial roles in other businesses.[1156]

The Cork Commission's goal was to address how directors were able to avoid culpability if a firm went bankrupt by forming a phoenix business.[1157] A phoenix firm is a reincarnation of an old, bankrupt corporation; the owners generally take advantage of the previous company's goodwill by refusing to pay and abusing its existing contracts.[1158]

The new company thus formulated will have the same management and name as the previous insolvent company, allowing it to take over the old firm`s benefits while avoiding any liabilities.[1159] The phoenix company's directors are unconcerned about neither the old business's debts nor honouring obligations to their creditors.[1160] This results in the previous company's creditors receiving no payment and having their debts cleared off. Phoenixism has been criticised[1161] for being an easy way to avoid liability. Directors can hide behind the corporate company's independent legal identity and thereby avoid liability.[1162] The CDDA intends to address the issue by issuing orders to incompetent

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[1155] Jennifer Lane Lee and Bryan Gladstone, 'Ethics and Enterprise` (n 1172).
[1156] *Insolvency Law and Practice* (n 1151).
[1157] ibid.
[1158] Beth Holden, 'Dealing with Insolvent Companies: Phoenix Phenomenon' (8 July 2013). https://anthonygold.co.uk/latest/blog/dealing-with-insolvent-companies-phoenix-phenomenon/ accessed 8 July 2013.
[1159] ibid.
[1160] House of Commons Library: New Business Support Measures: Corporate Insolvency and Governance Act 2020 (5 October 2021). https://commonslibrary.parliament.uk/research-briefings/cbp-8971/ accessed 5 October 2021.
[1161] Vincenzo Bavoso and John Tribe, 'Phoenix Companies: Do Directors Learn from Failure?' (25 September 2011) SSRN: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2117241 accessed 25 September 2011.
[1162] ibid.

directors, with the hope of protecting the public interest and deterring unfit directors from repeating the same mistake.[1163]

The Conservative government, however, was not convinced, owing to high levels of corporate director wrongdoing, particularly in the financial services industry. As a result, in 2013, a BIS Discussion Paper[1164] was issued, with the hope that it would re-establish market trust in the commercial sectors. A detailed report on bank directors' behaviour states that directors, particularly at the highest levels, escaped liability easily because of a lack of personal accountability.[1165] By shielding themselves from the blame by claiming ignorance and hiding behind collective decision-making, directors avoided culpability for failures that occurred under their leadership.[1166] This led to public anger who voiced their unhappiness, expressing their frustrations and fury and calling for accountability measures for those responsible.[1167] The Business Secretary, Vince Cable, replied by putting forward reform ideas for the company director disqualification system, with the aim of building trust.[1168]

Recommendations were made for disqualified directors to be trained and educated and for courts to be able to issue reparation orders against insolvent companies' disqualified directors.[1169] Proposals were made to give the FCA the right to dismiss unfit directors.[1170] A call for a change to directors' duties was made, promoting the stability of institutions against shareholders' interests.[1171] However, the government released a revised set of

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[1163] Jennifer Lane Lee and Bryan Gladstone, 'Ethics and Enterprise` (n 1172).
[1164] BIS Discussion Paper: Enhancing the Transparency of UK Company Ownership and Increasing Trust in UK Business, September 2013. http://data.parliament.uk/DepositedPapers/Files/DEP2013-1248/Transparency_and_Trust_Discussion_Paper.pdf accessed 2013.
[1165] PCBS (n 384) First Report of Session 2013–14.
[1166] ibid.
[1167] ibid.
[1168] Vince Cable, Job Title, 'Trust: Why It Matters' (Speech at the Reform Conference on Responsible Capitalism, City, 15 July 2013) https://www.regulation.org.uk/library/2013_trust_why_it_matters.pdf accessed 15 July 2013.
[1169] Joan Loughrey, 'Smoke and Mirrors? Disqualification, Accountability and Market Trust' (2015) 9(1) LFMR 50.
[1170] ibid.
[1171] Parliamentary Publications: Banking Standards, Session 2012–13.

ideas in April 2014 that were ultimately integrated into the Enterprise and Employment Act 2015.[1172] The proposed reforms to financial services and banking were not implemented, since they were deemed superfluous.[1173]

6.4 Disqualification for Unfitness

The law does not impose any stringent qualifications for becoming a business director;[1174] its only criterion for becoming a corporate director is the minimum age requirement, which is 16 years.[1175] The CDDA, in comparison, applies to all business directors and should be considered a useful tool that can keep them accountable. When a director is deemed unfit, the term 'unfit' will be discussed considering the CDDA. If directors are to be held accountable, it is necessary to do so. Sections 6, 8, and 9 provide for disqualification due to ineligibility. A director will be disqualified under s 6 if they are, or have been, a director of a firm that has gone bankrupt and their conduct deems them unfit for business management.[1176]

It was thought that s 300 of the Companies Act 1985 would discourage directors from exercising their powers without restraint. The clause, however, was ineffective at resolving the problem. The clause aims to punish a director who runs two firms and causes both to be liquidated because of their actions. The CDDA was put into effect to replace this provision. The objective was to 'protect the integrity of the corporate environment' by discouraging those who took advantage of the limited liability privilege.[1177] Under the CDDA, a director might be disqualified through an order that entails court processes.[1178] The ruling forbids a director from participating in any company activity unless the court gives them permission.[1179] A director can be disqualified by

[1172] Loughrey (n 1169).
[1173] ibid.
[1174] David Milman, 'Disqualification of Directors: An Evaluation of the Current Law, Policy and Practice in the UK' (2013) 331 Sweet and Maxwell`s Company Law Newsletter 1.
[1175] CA 2006 (n 26) s 157(1).
[1176] CDDA (n 89) s 6(1).
[1177] ibid.
[1178] CDDA (n 89) s 1.
[1179] ibid.

undertakings, which are judgments made by the Secretary of State.[1180] When a firm falls bankrupt, undertakings are started on the grounds of unfitness.[1181] Disqualification orders and undertakings accomplish the same thing;[1182] the sole distinction is that undertakings do not necessitate legal action.

However, regardless of how it is carried out, the goal of disqualification is to safeguard the public. In terms of the concept of unfitness, disqualification is the principal focus of s 6. A court will only issue a ban when it is convinced the individual was a director at the time the firm went bankrupt because of their actions and, as a result, that they are ineligible to handle the company's operations.

6.5 The Dichotomy between Punishment and Protection

The government has consistently maintained that the major objective of disqualification is to ensure the protection of the public.[1183] Historically, the clarity of judicial and intellectual commentary has been significantly lacking. Some commentators[1184] have expressed significant criticism over the extent to which the existing method effectively encompasses protectionist notions. According to Finch, the determination of whether disqualification serves as punitive, or protectionist strategy depends on whether limited liability is perceived as a privilege.[1185] The main issue to be investigated in this case is how the regime adheres to protectionist ideals. The measurement of the effectiveness of the disqualification regime is commonly based on the extent to which the objectives set by Parliament are adhered to.

[1180] CDDA (n 89) s 1a.

[1181] Ibid, s 7.

[1182] Milman (n 1174).

[1183] Jennifer Lane Lee and Bryan Gladstone, 'Ethics and Enterprise: The Role of The Company Director Disqualification Act (1 March,1997) 4 Small Business and Enterprise Development 129.

[1184] Vanessa Finch, 'Disqualification of Directors: A Plea for Competence' (1990) 53(3) The Modern Law Review 385, 391.

[1185] Ibid

The desirability of a punitive system may be a subject of consideration; yet it is noteworthy that such an approach was not the one elected by Parliament. The primary issue for deliberation in this context pertains to whether the regime ultimately manifests as punitive in its implementation, notwithstanding the State's efforts to present it as a form of protectionism. This thesis posits that the characterisation of a regime as punishing is predominantly contingent upon subjective interpretation. Initially, it is important to note that the two purposes, namely punishment and protection, are not inherently contradictory. Despite the well-meaning efforts of the courts to adhere to the protectionist objective, potential repercussions could result, regarded as punitive in nature. The government has increasingly acknowledged the significant penal and financial consequences of disqualification on individuals.[1186] While it is undeniable that several cases have expressed punishing language,[1187] so have others adopted a protective stance.[1188]

However, according to Sealy, the debate on whether disqualification serves as a protective or punitive measure is inconsequential and subject to differing interpretations. The primary concern lies in determining whether the sanction, both in a general sense and in specific instances, effectively safeguards the welfare of the public.[1189] Therefore, in accordance with the rationale, if a disqualification is implemented with the aim of safeguarding the public, despite the possibility of penal consequences, it is imperative to conclude that its fundamental objective has been achieved.

[1186] The Small Business, Enterprise and Employment Act 2015 (SBEEA).

[1187] *Re CU Fittings Ltd* [1989] 5 BCC 210. *Re Cladrose Ltd* [1990] 6 BCC 11.

[1188] Vanessa Finch, 'Disqualification of Directors: A Plea for Competence' (1990) 53(3) The Modern Law Review 385,391.

[1189] Len Sealy, Personal liability of directors and officers for debts of insolvent corporations: a jurisdictional perspective (England). Current Developments in International and Comparative Corporate Insolvency Law. (1994) 485-98.

Nevertheless, with the recent implementation of compensation orders and undertakings in the field of disqualification[1190], there exists the possibility for this debate to continue over and over. The Secretary of State (SS) is empowered to apply to the court for compensation orders for the benefit of creditors and the company against a disqualified director.[1191] Should the SS choose to avoid legal action; a director may potentially provide an assurance of recompense to the SS.[1192] However, it could be argued that, this clause possesses significant potential to revitalise the direct protection advantage for creditors, sometimes referred to as the 'public', through the provision of compensation for any damaged caused. However, regardless of how it is carried out, the goal of disqualification is to safeguard the public.

6.6 The Effect of Case Law

This section outlines how the courts will evaluate whether a director is unfit. The court is not, however, limited to the factors listed in section 6.[1193] As a result, the act does not define the standard of liability for determining unfitness, leaving a lot of room for directors' behaviour to be supervised and monitored. In *Re Bath Glass Ltd*, it was asserted that a court can disqualify a director for any behaviour that falls below the level of unfitness. Arguments can be raised over the court's flexibility in finding the director`s unfitness undesirable. Directors are exposed to unknown liabilities because there is no clear definition of unfitness; they will appreciate the nature of any shortcoming or create a remedy to it if they have a clear awareness of the standard of liability required for unfitness.

The disqualification regime has sparked a debate over what constitutes unfitness in terms of incompetence vs fraud. In terms of unfitness, the statute is unclear. The courts will decide whether incapacity should be considered as a reason for disqualification. The accepted degree of incompetence has been a source of contention for many years; the

[1190] The Small Business, Enterprise and Employment Act 2015 (SBEEA).

[1191] CDDA 1986, s 15 A (1).

[1192] CDDA 1986, S 15 A (2).

[1193] *Re Bath Glass Ltd* [1988] BCLC 329.

bar has been lowered from recklessness to negligence.[1194] Three distinct cases have necessitated investigation and discussion; *Re Ipcon Fashions Ltd* is the first of these.[1195] Mr Hava, a director, oversaw four companies for a nine-year period, bringing them to bankruptcy. He was considered a 'cunning man' in his dealings over company assets.[1196] The fourth company, Ipcon Fashions, was the subject of the court case; the company only lasted a year (1985–1986) before going bankrupt. As a result, Mr Hava decided to close Ipcon, and four months later, he, his wife, and two other employees began receiving weekly pay. Mr Hava's behaviour was found to be unfit by the court, who disqualified him for five years. The conclusion was, without a doubt, not unexpected. Mr Hava's behaviour against Ipcon and other businesses exemplified the Phoenix Syndrome.

The scenario depicts a corporation managed by a small group of people that failed, with significant outstanding debts. The company was later acquired by another corporation, but the same people were in charge.[1197] Mr Hava's conduct exemplified Vinelott J's ruling in *Re Stanford Services Ltd*; namely, the court has a duty to protect the public against bad directors who cause more than one company to fail at the expense of limited liability.[1198] Limited liability, according to Harman J, is a privilege that must be utilised properly, and the courts have a duty to see that it is.[1199] Mr Hava failed to show regard for his duty and probity in dealing with some debtors, according to Hoffman, in addition to being irresponsible with regard to the interests of all creditors, including the Crown, and acting in an unethical manner.[1200] As noted by Harman J, Ipcon was written in the language of protection,[1201] with the provision meant to safeguard the public from being

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[1194] Vanessa Finch, 'Disqualification of Directors: A Plea for Competence' (1990) 53(3) The Modern Law Review 385,391.
[1195] [1989] 5 BCC 773.
[1196] ibid.
[1197] Johnny E Johnson, 'Ireland: Revenue Get Tough On 'Phoenix Syndrome'' (15 April 1997) https://www.mondaq.com/ireland/finance-and-banking/5045/revenue-get-tough-on-quotphoenix-syndromequot accessed 15 April 1997.
[1198] [1987] 3 BCC 326.
[1199] *Re Douglas Construction* [1988] BCLC 397.
[1200] Vanessa Finch, 'Disqualification of Directors: A Plea for Competence' (1990) 53(3) The Modern Law Review 385,391.
[1201] ibid.

taken advantage of through the use of limited liability.[1202] As a result, disqualification is not used to punish directors; rather, it is for the sake of public safety.

Ipcon, however, does not address whether the disqualification regulation is entirely protective, requiring some level of blameworthiness. Other decisions[1203] have shown that blameworthiness is a key component and that 'mere' mismanagement is inadequate to warrant disqualification.[1204] Disqualification is neither acceptable nor applicable in the situation of ordinary business misjudgement as stated in *Lo-Line Electric Motors Ltd.*[1205] However, Re *Grayan Building Services Ltd* ruled that disqualification is verified where behaviour has fallen below the required standard when considered cumulatively and taking into account any special situations[1206] seen as a need for company directors. As a result, despite the limited application of the disqualification rule, directors' behaviour should be scrutinised.

The case of *Re CU Fittings Ltd*[1207] sparked significant debate since it dealt with the notion of blameworthiness. The difference between honest commercial misjudgement and a lack of commercial probity was a point of contention for the court.[1208] Mr Turton, the director in charge of two companies that had gone bankrupt, was the subject of the investigation. CU Fittings Ltd, in 1982, claimed voluntary liquidation, and Packaging Ltd was in charge after accountants advised that CU Fittings Ltd was still viable for operation.[1209] Despite this, Packaging Ltd lost money, and in June 1984, its main supplier, Streamline, filed for bankruptcy. Packaging Ltd had been promised financial aid from Streamline, but the company failed to deliver. Mr Turton was ruled unsuitable for directorship by the court because he lacked business probity and should have known that the firm was no longer in a condition to trade.

[1202] *Re Douglas Construction* (n 1199).
[1203] *Re McNulty`s Interchange Ltd* [1988] BCC 533.
[1204] Finch, 'Disqualification of Directors: A Plea for Competence' (n 1194).
[1205] *Lo-Line Electric Motors Ltd.* [1998] Ch 477.
[1206] *Re Grayan Building Services Ltd* [1995] Ch 241.
[1207] [1989] 5 BCC 210.
[1208] ibid.
[1209] ibid.

Hoffman J, on the other hand, disagreed with the court's decision, claiming that directors who work tirelessly to save their firms from harm should not be expected to have fully impartial thoughts.[1210] Furthermore, Mr Turton had exclusively depended on Streamline's solid guarantees of assistance;[1211] therefore, he did not risk his creditors' money in expectation for something to show up.[1212] It can be argued that *CU Fittings Ltd* does not provide a purely protective concept, as it puts much emphasis on the honesty of the director, thereby promoting a lack of blameworthiness as a component. Thus, the court will show leniency towards honest and hopeful directors. Furthermore, the case affirms that misjudgement does not make up for incompetence. The courts permit a rather arrogant ethos to the actions of a director justifying himself/herself in the name of commercial enterprise. This is contrary to the disqualification order, which serves to protect the public and creditors.

Finally, *Re Cladrose Ltd*[1213] was based on punitive rather than protective principles. Insolvent company directors entirely failed to generate auditable accounts or file yearly reports. Mr Pollard, a director, relied on the expertise of Mr Platt, an accountant, as per arrangement. Only Mr Platt was disqualified, with the court ruling that Mr Pollard was much less culpable because he had put his trust in somebody's expertise.[1214]

Harman J argued that the director's disqualification due to gross carelessness or utter incompetence was not warranted.[1215] The centre of the question was instead the failure of Mr Platt to present audited accounts. Regarding his position, in his capacity as a chartered accountant, he was expected by law to present better knowledge and understanding than a novice.[1216] However, from a protective perspective, it could be contended that the public must be safeguarded from directors regardless of their qualifications or expertise. It was highlighted by Harman J that it is the responsibility of

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[1210] ibid.
[1211] Ibid.
[1212] ibid.
[1213] [1990] 6 BCC 11.
[1214] Pearlie Koh, 'Punishment and Protection: The Disqualification of Directors in Singapore' (2013) JLS 447.
[1215] *Re Cladrose Ltd* (n 1187)11.
[1216] ibid.

every director to be competent to some extent.[1217] Therefore, both directors should have been disqualified because of the protective approach.

By distinguishing between the two directors, the court moved away from a protective concept. Furthermore, both directors were required to provide financial statements and a protective principle would have resulted in their disqualification. The *Re Cladrose* case demonstrates that the CDDA provision is not purely protective, but punitive as well.

Therefore, the three cases[1218] might be considered to have failed to offer a clear method for safeguarding the public from incompetent directors. It is argued that there should be some expected minimum standards reflecting the responsible nature of modern directors. The disqualification regime is meant to bring deterrence to directors and confidence to the market. However, there are good grounds to question whether the disqualification system accomplishes its goal. Reforms are required to deal with directors' incompetence, as the CDDA fails to set effective standards of management for directors as professionals. These deficiencies raise significant questions about the quality of directors who sit on company boards, and these shortfalls require robust measures to improve the way directors run their businesses. The standard of liability to determine unfitness creates confusion and uncertainty. Unfitness is not defined within the act; it leaves a degree of flexibility by which the conduct of directors can be construed. This was evidenced in *Re-Bath Glass Ltd,* where it was stated that a court can disqualify a director on any grounds of misconduct below the standard of unfitness. Such flexibility is not desirable because it brings uncertainty and a lack of clarity to the true meaning of unfitness; consequently, directors are exposed to uncertain liabilities.

6.7 Defining Undesirable Conduct

It is well established that if a court is persuaded that a person's conduct in connection to a firm renders them unsuitable, it may issue a disqualification order against them.[1219] It is imperative to understand what conduct is deemed undesirable and contrary to the public

[1217] ibid.
[1218] *Re Ipcon, Re CU Fittings*, and *Re Cladrose*.

[1219] CDDA (n 89) s 8(2).

interest by the state, as by understanding the case law, it will be easier to establish the effectiveness of the provision.

Dishonesty is not the only element necessary to prove unfitness to be a director. In *Re Dawson Print Group Ltd,* Hoffmann contended that incompetence should be enough to persuade a court to disqualify a director from managing the affairs of the company.[1220] Therefore, a lack of commercial probity, an illustration of dishonest behaviour, that is, behaviour containing an element of intention to misbehave[1221] should not render the director unfit. Lewis J expressed in *Secretary of State v Goldberg & Anor*[1222] the need for a clear approach towards establishing unfitness, among other things, so that the director is aware of what is expected of them by law. The court has made it clear, by using the word 'conduct,' that it is not restricted in finding culpability in situations where a breach of common law or statutory law occurs.[1223]

Norris J[1224] stated that finding directors' conduct unfit should not be restricted to the parameters of directors' duties but should also cover cases of commercial probity. Nor should it be a requirement that the unfit conduct resulted in harm to the company,[1225] as stated in s 8. Norris J was critical, stating that the interpretation of unfitness under s 8 should not be based on any other factors apart from the way it affects business. Its meaning is specified in Schedule 1 of the CDDA. Therefore, when determining unfitness, the court should go beyond predetermined categories of behaviour and encompass conduct that falls below commercial probity and mere incompetence.

Allegations of unfitness can also be made based on non-payment of a Crown debt by a director. A director's conduct can be deemed unfit when a director uses monies meant for the Crown to use to fund the company's continued trading when the business becomes bankrupt. The director is then perceived as deliberately failing to pay sums owed to the

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[1220] [1987] 3 BCC 322.
[1221] ibid.
[1222] *Secretary of State for Trade and Industry v Goldberg & Anor* [2003] EWHC 2843.
[1223] Iris H-Y Chiu, *The Law on Corporate Governance in Banks* (Edward Elgar Publishing Ltd, 2015).
[1224] *Secretary of State for Business Enterprise and Regulatory Reform v Sullman and Another* [2008] EWHC 3179.
[1225] ibid.

Crown and unfairly discriminating against the Crown in favour of other creditors of the company, constituting disqualification for unfitness. Harman J states that failure to pay Crown debts is more ethically reprehensible than paying regular commercial obligations.[1226]

It was further affirmed in *Re Stanford Services Ltd.*[1227] that the Crown is viewed as an involuntary creditor, hence the preference given to Crown debts. For that reason, directors are to refrain from using money owed to the Crown for other trading purposes.[1228] The above cases have proven that directors are now more legally liable than previously, and grounds for holding them personally responsible have been widened. The impact and effectiveness of the disqualification provision are now extended beyond a dishonest director, to irresponsible and incompetent conduct.

6.8 The Conduct in Question Under section 6

(a) Taking Unwarranted Risks with Creditors' Money

When a firm fails to meet its commitments and its liabilities are greater than its assets, it is considered insolvent.[1229] As far as disqualification is concerned, unfitness rests in causing a company to accrue debts leading to insolvent liquidation.[1230] Chadwick J[1231] explained clearly that, if it is for company's good, directors are allowed to trade their insolvent companies out of trouble in the expectation of future profit. They should not be chastised for legitimately holding those beliefs.

However, the regulation exposes directors to the possibility of personal responsibility if they trade while bankrupt. The directors of a corporation are liable for knowingly trading without regard for the future of the corporation and its creditors.[1232] There must be reasonable grounds for their action if they are to escape liability.

[1226] *Re Wedgecroft Ltd* (unreported) 7 March 1986.
[1227] [1987] BCLC 607.
[1228] ibid.
[1229] The Insolvency Act 1986, s123.
[1230] Jason Harris, 'Director Liability for Insolvent Trading: Is the Cure Worse than the Disease?' (2009) 23 (3) Australian Journal of Corporate Law 266.
[1231] *Secretary of State for Trade Industry v Taylor* [1997] I WLR 407.
[1232] The Insolvency Act 1986, s214.

It was stated[1233] that any action that leads a firm to trade while bankrupt, without a realistic chance of satisfying creditors' demands, is likely to represent a high level of incompetence, resulting in a disqualification order. Therefore, taking unjustified risks with creditors' money is likely to warrant unfitness.

It was also confirmed[1234] that it is misconduct for a company director to pursue a policy that exempts their company from paying debts owed to its creditors even when the creditors are not pressing for it. Therefore, a non-payment policy is perceived by the court to be unfitness even without having evidence that a director intended for the creditors never to be paid. A non-payment policy can be regarded as unfitness when taken on even while the company is solvent.[1235]

It was established further[1236] that failure to maintain and produce adequate accounting records constitutes unfitness. Moreover, Re*: Continental Insurance case,*[1237] Chadwick J affirmed that a director who fails to recognise fault is the same as a director who recognises the situation but does nothing. In other words, a director who does not appreciate their duties cannot escape disqualification.

(b) Breaches of Duties

Schedule 1 of the CDDA provides guidance for determining the unfitness of directors; the matters it lists are not exhaustive. There are reported cases, such as *Aberdeen Railway Co v Blaikie,*[1238] where a director was involved in a conflict of interest and fails to disclose. A director who occupies a position of trust must avoid actual or possible conflicts of interests. With such responsibilities to fulfil, no director should be permitted to participate in any obligation that clashes with their personal interest.

As a result, the rule requiring directors to be accountable is not limited to situations in which a commercial opportunity exists; it also covers situations where the director's

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[1233] *Secretary of State for Trade and Industry v Creegan* [2002] 1 BCLC 99.
[1234] *Secretary of State v McTighe (No. 2)* [1996] 2 BCLC 477.
[1235] *Re Hopes Ltd* [2001] 1 BCLC 575.
[1236]*Secretary of State for Trade and Industry v Arif* [1996] BCC.
[1237] [1997] 1 BCLC.
[1238] (1854) UKHL 1.

personal interests collide with those they are obligated to safeguard. In *Re Synthetic Technology Ltd*,[1239] a director was disqualified for unfitness for misusing and misappropriating the company's money. The director had procured the money to pay debts for which they were personally liable. Moreover, they had wrongly claimed ownership of company assets and failed to file accounts at all. This caused the company to trade while insolvent, taking unjustified risks with creditors' money. The director was disqualified for unfitness for seven years and was ordered to pay compensation.

Directors have a responsibility to their companies and a duty to exercise their powers for proper purposes.[1240] Thus, in exercising their powers they must achieve the objectives of the company. For example, in *Howard Smith Ltd*,[1241] it was shown that some directors participated in a takeover bid to dilute the voting power of the majority shareholding of issued shares. The allotment was void, as it was not made in good faith for the organisation`s benefit but for other purposes.

A director can be found unfit because of a breach of duties when making transactions that do not benefit the company. In *J.J Harrison (Properties) case*,[1242] a director acquired land that belonged to the business and was not transparent enough about its future benefits. The director acquired the property below its true value as a constructive trustee for the company and was duly accountable for it. He was sued for knowing receipt.

It can be stated that unfitness, as per Schedule 1 of the CDDA, deprives the company's prospects of successful trading through undesirable conduct. The above cases have proven that the vulnerability of directors to legal responsibilities has increased and that grounds for holding them personally responsible have been widened. The CDDA was reformed with the hope of restoring market trust within the financial sector and business in general. It was hoped this would increase the accountability of company directors. The next section will assess whether the CDDA has achieved its objective, and if not, how best to promote the accountability of directors.

[1239] [1993] BCC 549.
[1240] CA 2006 (n 26) s 171.
[1241] [1974] AC 821.
[1242] [2001] EWCA 1467.

In addition to section 6`s application to insolvent companies. It can be noted also that section 8 of the CDDA encompasses a distinct authority of disqualification. Directors may face disqualification on grounds of unfitness as stipulated in section 8. There exists a distinction between section 6 and the statement, as disqualification is subject to the exercise of judgement and does not necessitate the company's insolvency as a prerequisite.[1243] Court orders or undertakings can be used to disqualify individuals under both sections. However, undertakings have the same effect as disqualification orders.[1244]

The provision grants the Secretary of State the authority to seek a disqualification order against an individual if information regarding their actions in relation to a company is discovered during the utilisation of one or more of the specified statutory investigative powers outlined in section 8(1).[1245] Similar to section 6, if it is deemed necessary in the public interest, the Secretary of State may determine that a disqualification order should be issued. According to section 8(2), the court can exercise its authority to suspend the defendant's ability to manage a company for up to 15 years if it determines that his/her actions in connection with the company render him/her unfit. There is no necessity that the relevant corporation have gone insolvent, unlike section 6.[1246]

Interestingly under section 17, a director has the option to petition the court for permission to continue acting as a director despite being subject to a disqualification order. The court possesses complete and unrestricted authority to provide permission for an individual to act as a director, even if they are subject to a disqualification order, provided that the circumstances warrant such a decision. Hence, it is crucial to ensure that any petition submitted to the court provides a comprehensive account of the

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[1243] Joan Loughrey, Smoke and mirrors? Disqualification, accountability and market trust. Law and Financial Markets Review. (2015) 9(1) 50,62.
[1244] Ibid.
[1245] Adrian Walters, Bare undertakings in directors' disqualification proceedings: the Insolvency Act 2000, Blackspur and beyond. Company Lawyer. (2001) 22 (10) 290-7.
[1246] Ibid.

circumstances pertaining to matters of culpability or other relevant aspects that warrant consideration.

6.9 An Incisive Critique of Disqualification

Following the preceding debate, this section's goal is to ascertain whether the disqualification rule is an acceptable solution for promoting market trust and accountability to directors of companies, considering the Act's improvements. To achieve the goal, the author will conduct a critical analysis of the CDDA. The deterrent effect of the Disqualification Act 1986 is meant to bring confidence to the market. There are, nevertheless, good grounds to doubt the effectiveness of the disqualification regime. Certain factors raise concern regarding the post-effectiveness of disqualifications as a deterrence. Nevertheless, disqualification is plagued by significant vulnerabilities. Firstly, the effectiveness of deterrent and standard raising relies on a director's comprehension of unfitness, however its definition remains ambiguous. In the case of *Re NCG Trading*,[1247] the court declared that it is not useful to examine the details of other cases to determine whether a respondent facing similar or dissimilar charges in relation to different circumstances was deemed unsuitable. The outcome of each of these events is contingent upon the specific circumstances surrounding them. Attempting to establish a comparison, even if it were feasible, would be exceedingly risky.[1248]

This is further intensified by the inadequate understanding of disqualification. A study revealed that 58% of directors lacked knowledge of disqualification, and among those who were aware of the CDDA 1986, 57% had a limited understanding of its method.[1249] However, without clear guidelines on the limitations of directors and the corresponding repercussions, disqualification alone cannot effectively discourage or improve performance. Furthermore, the Insolvency Service operates based on certain

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[1247] [2004] EWHC 3203.

[1248] Yatin Arora's recent article 'What Went Wrong With Wrongful Trading?' (2022) 43(4) Business Law Review 164.

[1249] National Audit Office, Report by the Controller and Auditor General: *The Insolvency Service Executive Agency,* Company Director Disqualification para. 4.3 (1992–1993).

performance goals. Hicks[1250] asserts that, in its attempt to boost its membership, it has neglected to evaluate the actual necessity of disqualifications. As a result, several directors who were not actively involved have been disqualified. However, these disqualifications have not provided any protection to creditors, as these directors were never a threat to begin with.

There have been claims that the Insolvency Service intentionally focuses on easy matters, such as Crown debts[1251] instead of more complex ones, which results in the allocation of resources to low-risk situations. As a result, directors are not discouraged because they are aware that investigations into their actions are rare, and hence they do not feel the need to improve their standards.[1252] This diminishes the level of protection for creditors while disruptive individuals continue to operate in the market. Instead of just reducing the numbers of the Insolvency Service, a more effective strategy would be to focus on identifying and targeting individuals who are likely to commit more offences.[1253] Furthermore, the regime's penalties are ineffective. Practically, only 6% of disqualifications last for a period of ten to fifteen years. On average, disqualifications last for five years and six months.[1254] The absence of a post-disqualification rehabilitative scheme, along with this extended term, implies that directors are not discouraged and are likely to commit more offences.[1255] This situation gets much more challenging due to the prolonged process of securing a disqualification.

Moreover, the majority of orders are placed in opposition to owner-managers. If they are disqualified, they have a shorter distance to descend; they can continue operating as sole traders.[1256] Nevertheless, creditors are still vulnerable as individuals can evade the business's debts by filing for personal bankruptcy.[1257] Therefore, whereas disqualification

[1250] Andrew Hicks, `Director Disqualification: Can it Deliver?' (2001) JBL 433.
[1251] R3, Directors' Disqualification: Room for Improvement (2011).
[1252] Arora (n 1248).
[1253] Ibid.
[1254] Insolvency Service, Enforcement Outcomes: 2020/21.
[1255] Arora (n 1248).
[1256] Ibid.
[1257] Hicks (n 1250).

has a significant effect on a formally certified professional manager, it is merely another setback for small entrepreneurs who already have a damaged reputation.[1258]

Ultimately, the ability for a creditor to receive compensation hinges on whether their case is selected, as only the Secretary of State has the authority to initiate disqualification proceedings. The Insolvency Service has acknowledged that it will pursue compensation in situations that involve several unsecured creditors, vulnerable individuals, and instances of extreme wrongdoing, where the disqualification period exceeds six years.[1259]Nevertheless, the rationale behind the exclusion of less severe instances remains unclear. While some may contend that more severe cases warrant larger amounts of anticipated recompense, it should be noted that the length of disqualification does not necessarily correlate with the magnitude of the loss incurred.[1260] This strategy ultimately implies that not every creditor will receive compensation. Directors can engage in misconduct and evade payment if their action is seen to be of lesser importance.

6.10 Ignorance of Legislation

The Green Paper[1261] consultation on corporate governance highlighted various contributory issues to board failures. Amongst them were board composition, training, and qualifications of the directors. It has been reported that there is limited awareness of the disqualification legislation.[1262] A survey carried out by the National Audit Office reported significantly low levels of awareness, with fifty-eight percent of directors claiming to be oblivious of the legislation.[1263] A similar report followed in 1998, showing an increase

[1258] Ibid.

[1259] Department for Business, Energy & Industrial Strategy, Impact Assessment – Giving the Court and Secretary of State (SoS) a Power to Make a Compensatory Award Against a Director (5 Jun. 2014).
[1260] Arora (n 1248).
[1261] Commission, 'The EU Corporate' (n 78) 164.
[1262] Richard Williams, 'Disqualifying Directors: A Remedy Worse than the Disease' (2007) 7 JCL Studies 213, 218.
[1263] National Audit Office, *Report by the Comptroller and Auditor General: The Insolvency Service Executive Agency: Company Director Disqualification* (HC 1993).

to sixty-six percent of directors.[1264] Considering the statistics above, using disqualification as a way of deterring directors from engaging in undesirable conduct is questionable.

Baldwin stated that the government has introduced policies and legislation to curb undesirable conduct in directors. However, there is evidence that directors are generally not aware of company law regulatory risks.[1265] The deterrent impact of disqualification, according to Williams, is not based solely on awareness of the consequent punishment.[1266] Disqualification and unsuitable behaviour should be understood by directors. Therefore, when directors are unaware of undesirable conduct, it is of no value to try to deter them from it. It could be argued that unfitness is a subject that can be interpreted in a variety of ways based on facts rather than legislation. The effectiveness of this legislation is argued based on its application since most disqualification rulings occur after debts have accrued.

Therefore, the thesis recommends that efficient and swift investigations for disqualification orders be issued whenever there is suspicion and evidence of wrongdoing before grave harm is done to the company. The standard of suspicion used is an objective one. In the interest of fairness, an objective test is used to ensure that the suspicion has a logical and legitimate basis. Due to insufficient oversight, several disqualified directors continue operating on boards of directors. The thesis proposes that effective measures be put in place, such as the tracking of disqualified directors. Companies House would require that all UK directors and new candidates have proof of identity. Under the current law, this is not allowed, which makes forming a limited liability corporation relatively simple.

There are limitations at Companies House that allow persons to register as directors even after having been removed from occupying company directorships. Currently, there are regulated companies that use Companies House data and fail to identify disqualified

[1264] National Audit Office, *Report by the Comptroller and Auditor General: The Insolvency Service Executive Agency: Company Director Disqualification* (HC 1998).
[1265] Robert Baldwin, 'The New Punitive Regulation' (2004) 67 Mod Law Rev 3. 351, 383.
[1266] Williams, 'Disqualifying Directors: A Remedy Worse than the Disease' (n 1262).

directors who assume office work because of a lack of verification when they register. Therefore, the thesis calls for more identity verification and that ongoing due diligence to be conducted to identify and remove disqualified directors. HooYu's research found approximately 800 of the 6,700 presently disqualified directors are still serving as directors.[1267] In addition, over 500 directors have deceptively changed their identity credentials to start in a new role.[1268]

The thesis supports a proposal from the BEIS that would mandate all the UK's active company directors and new applicants to provide proof of identity to Companies House.[1269] Currently, there is no legislation that requires directors to do so. The thesis calls for Companies House to move away from its historical function of recording information to verifying and confirming that the personal information given about directors is true. A range of methods can be applied, ranging from the more basic use of a person's credit history to advanced face recognition and having government-issued identification credentials in the form of a passport or alternatively a driver's licence. An advantage to this approach to identity verification is that it allows technology to be used by companies cheaply, for example, the use of smartphones in banks.

However, there is controversy surrounding the use of facial identification. Many people are concerned about their privacy. Facial recognition databases are not immune to hacking.[1270] Information might fall into the hands of the wrong people and be exploited for nefarious purposes. Moreover, identity documents are prone to be exploited by other organisations. To safeguard all this facial data, cybersecurity methods would need to

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[1267] HooYu, 'The Chameleons in Companies House' (*Hooyu.com 23 May 2019) https://thefintechtimes.com/chameleon-fraudsters/* accessed 23 May 2019.
[1268] ibid.
[1269] BEIS, 'Reforms to Companies House to Clamp Down on Fraud and Give Business Greater Confidence in Transaction' (www.gov.uk 18 September 2020) https://www.gov.uk/government/news/reforms-to-companies-house-to-clamp-down-on-fraud-and-give-businesses-greater-confidence-in-transactions accessed 18 September 2020.
[1270] WGU, 'Facial Recognition: Why Is it So Controversial?' (16 September 2019) https://www.wgu.edu/blog/facial-recognition-why-controversial1909.html#close accessed 16 September 2019.

evolve. Finally, the software is prone to and can make errors, which might result in individuals being wrongly implicated. Negative or positive false identification might occur while using face recognition.[1271] The programme might fail to pair an individual's face or mistake the face.[1272] Such errors could cause issues for the software's users as well as the broader public. With so much controversy surrounding facial identification, it will be necessary to have trained IT professionals who receive regular up-to-date training and information to improve the security and privacy of facial recognition.

6.11 Training and Qualifications of Directors as a Preventative Tool

The number of board failures, in general, is alarming, not to mention banks. The history of unprecedented cases of incompetent directors lacking even the rudimentary skills required for their jobs is great. Northern Rock, HBOS, and RBS are a few examples. For instance, at Northern Rock, Dr Matt Ridley was not a qualified banker, but a zoologist and a science writer.[1273] Such inexperience can raise serious questions concerning the quality of the directors who sit on these boards and thus, robust measures are needed to improve the way directors run their businesses. Firstly, these measures can only be achieved by addressing the qualifications and training of directors as a preventative tool beforehand. Secondly, a director's lack of qualifications must be considered to make directors liable for subpar performance. The thesis argues that for a disqualification regime to be effective, the Secretary of State should extend its powers to deter undesirable conduct and promote market trust by making mismanagement and incompetence a disqualification conduct. It must promote people in management who are fit, appropriate, and have a high level of expertise.

The government's Green Paper[1274] states clearly that companies can have different business models but without quality management are subject to failure. Therefore, it is imperative that directors of companies possess the required skills and knowledge expected of them. No requirement guidelines exist in the legislation of CA 2006 to qualify

[1271] ibid.
[1272] ibid.
[1273] Myners (n 95).
[1274] Commission, `Green-paper` (n 100).

to become a director. Any person can become a director provided they are over the age of 16.[1275] The law also does not require future directors have any credentials prior to taking a post. However, there is more emphasis under the CDDA 1986 to disqualify any director who is incapable of performing their job responsibilities. Conversely, when regarding the issue of proficiency and ability, FCA only considers factors such as if the individual has any necessary FCA training and competency[1276] and is fit to execute the duties regarding the office.[1277] However, it has been argued that it could be challenging for an outsider to evaluate the board`s competency,[1278] as reported that most directors of financial institutions lack a financial degree and business qualification.[1279]

Regarding the collapse of Northern Rock, it was reported that its former chairman Dr Matt Ridley was not a qualified banker, but a zoologist and a science writer.[1280] He was accused of arrogance and incompetence while clinging to the office[1281] and was forced to resign due to his lack of financial understanding and the damage caused to the banking sector.[1282] Sir Cadbury stressed the importance of training directors due to the rise in their job expectations.[1283] In light of unsuitable and unfit directors such as Matt Ridley, the Senior Managers Certification Regime requires anyone taking a senior position to be fit and appropriate for the office.

Zafar Khan was the finance director for Carillion between August 2016 and September 2017 before its collapse. He was an unqualified and incompetent accountant who was

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[1275] CA 2006 (n 26) s 157.
[1276] FCA, FIT Handbook (n 413).
[1277] ibid.
[1278] Demetra Arsalidou, 'The Banking Crisis: Rethinking and Refining the Accountability of Bank Directors' (2010) 4 J Bus Law 284.
[1279] OECD, *Corporate Governance: A Boardroom Perspective* (2008).
[1280] Myners (n 95).
[1281] Julia Finch, 'Ridley Quits as Northern Rock Chairman' *The Guardian* (19 October 2007) https://www.theguardian.com/business/2007/oct/19/4 accessed 19 October 2007.

[1282] Julia Werdigier, 'Northern Rock Chairman Quits after Criticism from Lawmakers' *The New York Times* (19 October 2007) https://www.nytimes.com/2007/10/19/business/worldbusiness/19iht-rock.4.7965470.html accessed 19 October 2007.
[1283] Adrian Cadbury, *Corporate Governance and Chairmanship: A Personal View* (OUP 2002).

accused of failing to control Carillion's substandard accounting methods.[1284] Phillip Green, chairman of Carillion at that time, claimed that Khan was below par with his business accounting.[1285] Khan was deemed an accountant who could not count.[1286] His incompetence was further exposed when it was admitted in the board minutes that accounting irregularities were simply due to his ineptitude.[1287]

A published report[1288] on the failure of HBOS Group establishes a lack of knowledge and qualification within the board of directors. The board's NEDs lacked sufficient banking expertise and understanding. Out of twelve non-executive directors, only one had banking experience.[1289] There were no records of significant board meetings on risk issues the company faced.[1290] It is argued that having experience in banking alone is not enough to fulfil the need for a qualified individual in the position. For instance, Northern Rock had two board members with vast experience in banking but who lacked qualifications and training.[1291] Even though they had notable experience, they were not qualified bankers.

Myners highlighted the need for constant training and development of bank directors as the business of banking is becoming more rapid and complicated than before.[1292] Therefore, directors must be competent enough to meet demands by acquiring recent and relevant banking qualifications and experience.[1293] The above cases have highlighted the requirement to train directors, especially those who work in financial organisations. The Chartered Secretaries body stressed that training plays a pivotal role in revamping

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[1284] Engineering News Record, 'When Carillion's Leaders Missed the Biggest Risk of All' (28 February 2018).
[1285] Letter from Phillip Green to the Chairs (20 February 2018).
[1286] Crace (n 908).
[1287] Carillion plc, Minutes from a Meeting of the Board of Directors (9 May 2017).
[1288] Bank of England, 'Prudential Regulation Authority: The Failure of HBOS plc (HBOS), A Report by the Financial Conduct Authority and Prudential Regulation Authority' (November 2015) https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/publication/hbos-complete-report accessed November 2015.
[1289] ibid.
[1290] ibid.
[1291] Treasury Committee, *The Run on the Rock* (n 633).
[1292] Myners (n 95).
[1293] ibid.

and renewing directors' skills and knowledge of products, strategies, and risks.[1294] Therefore, the thesis recommends a legislative mandate that requires financial organisation directors to undergo yearly training. This will foster directors presiding over those institutions to be up to date with the skills, knowledge, and training necessary to meet the complex demands that come with their duties. In addition, the FCA's FIT for approved persons should promote and commit to annual reviews of the genuine qualifications of directors.

6.12 Failure of Disqualification as a Tool for Restoring Market Trust and Confidence

The norm to have directors with some form of training and qualifications is paramount for restoring public and market trust. The failure to have those requirements should automatically render a director unfit and disqualification inevitable. Arsalidou proposes that a major reason for the collapse of some banks was that their directors were unaware of the hazards they were incurring.[1295] For instance, RBS directors performed an aggressive takeover of ABN Amro before adequately assessing the dangers.[1296] The costly takeover of ABN Amro was described as a wrong deal.[1297] However, directors of companies cannot be penalised for bad business judgement by law. Hence, considering the level of risk taken by the RBS board, it may be appropriate to hold someone accountable to deter other directors of financial institutions from taking such actions.

The collapse of Carillion was a result of its acquisition model, which lacked a coherent strategy, taking on more debt and exploiting suppliers.[1298] The acquisitions were criticised for lacking strategy, although it was effective in outplaying its competitors in the market.[1299] As explained by then Chief Executive Richard Howson, Carillion used an

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[1294] ICSA Governance Institute, 2016.
[1295] Arsalidou (n 1301) 284.
[1296] ibid.
[1297] RBS (n 373).
[1298] HC Deb 12 July 2018, vol 644. Col 75.
[1299] The Construction Index (n 768).

aggressive bidding strategy to generate cash and was forced to use all means necessary to win. [1300]

Carillion's acquisitions were funded by growing debt, which posed future pension issues.[1301] However, its decision to venture into overseas markets was a big mistake, driven by optimism instead of strategic expertise.[1302] It cannot be refuted that it was the directors' actions that led to the collapse of Carillion, which had a knock-on effect on other stakeholders.[1303] Dillion LJ[1304] asserted clearly s 6 (CDDA) objective as to safeguard general people, and especially the prospective creditors of bankrupt firms, against unsuitable directors. Thus, the Disqualification Act seeks to protect from the activities of rogue directors whose undesirable conduct inflicts damage upon the public and companies.

However, it is argued that the CDDA does not foster socially desirable conduct or punish errant conduct. As a result, the act exempts persons who have been deemed incompetent and disqualified from personal culpability. Disqualification orders deal with issues of dishonesty and the lack of commercial probity; however, incompetence is not included in the scope of the remedy.[1305] Without the possibility of blameworthiness, directors cannot be disqualified for company failure caused by 'mere' mismanagement.[1306] Yet, it was the poor decisions of the Carillion board that led to the collapse of the company. Carillion's directors used the privilege of limited liability to take risky ventures at the expense of the company and the public. It is important for the public to be protected from unjustified commercial risks and incompetence by having fit and proper directors in corporations.

The failure of the CDDA to address incompetent conduct effectively is a sign of its weakness. A director cannot be disqualified for cases of ordinary commercial

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[1300] BEIS and Work and Pensions Committees 2017–19 (n 717).
[1301] Carillion plc, *Annual Report and Accounts 2006*.
[1302] Deller (n 830).
[1303] ibid.
[1304] *Re Sevenoaks Stationers (Retail) Ltd* [1991] Ch 164.
[1305] *Re Lo-Line* (n 1205).
[1306] *McNulty's Interchange Ltd* [1989] BCLC 709.

misjudgement.[1307] If commercial misjudgement does not constitute incompetence, it encourages arrogance in directors to act without due care, justifying their actions to be for the company's good. For instance, Carillion collapsed because of its acquisition model, which lacked a coherent strategy but promoted aggressive expansion into new markets.[1308] Section 6 of the Disqualification Act was enacted to safeguard the public, and particularly prospective creditors of insolvent firms, against unsuitable directors.

It is argued that the CDDA does not encourage punishment for misconduct. The court must dismiss unsuitable directors of bankrupt businesses under s 6 of the CDDA.[1309] Moreover, under s 8, a disqualification can occur even before a company becomes insolvent. It was widely accepted that the collapse of banks – for example, RBS, HBOS and Northern Rock – was a result of mismanagement and incompetence.[1310] However, no director was held liable at RBS and Northern Rock, and only HBOS's finance director Peter Cummings was given a penalty of £500,000 and barred from managing any financial institutions.[1311]

It is argued that there is a major gap in the legislation concerning the directors of banks. A director may be dismissed and held personally responsible for unlawful trading if a business fails. However, an incompetent director of a bank can easily escape liability in the event of government intervention to save a struggling bank; see, for instance, Northern Rock, which was considered too big to fail.[1312] The practice is performed by the directors of ailing companies to move assets, for the most part at nominal value, to a new corporate organisation for the purpose of starting a new enterprise, releasing any debt for the new firm that the old one had accumulated.[1313] The move puts the assets beyond the control of creditors as the assets are sold before the first company goes into liquidation.

1307 *Lo-Line Electric Motors Ltd* [1988] Ch 477.
1308 HC Deb (n 1269) Col 75.
1309 *Re Lo-Line* (n 1205).
1310 Tomasic (n 5).
1311 Masters (n 375).
1312 Tomasic (n 5).
1313 Bavoso and Tribe (n 1161).

Individuals participate in the administration of a succession of consecutive limited liability firms that have collapsed under this structure.[1314] A corporation is portrayed as financially sound, while it just manages to acquire debt in order to dump it by selling the viable portion of its business to a new organisation.[1315] It is argued that this is an escape route for directors' liability and their severe problems with respect to the legal system of disqualification. There are several disqualification orders made each year by UK courts; the table below sets out the number of orders made under insolvency and live companies from the period 2008 to 2022.[1316]

Source: Insolvency Service Enforcement Outcomes 2008/2022 [1317]

	2008–09	2009–10	2010–11	2011–12	2012–13	2013–14	2014–15	2016–17	2018–19	2019–20	2020-21	2021-22
Disqualifications under s 6 of the CDDA, following complaints of misbehaviour by company directors due to insolvency.	676	781	794	692	618	1,273	1,210	1,133	1,071	1,196	951	750
Disqualifications resulting from a live company's examination into director misbehaviour under s 8 of the CDDA.	29	10	15	12	4	11	18	27	111	41	8	44

The table above shows statistics on misconduct by directors under ss 6 and 8 of the CDDA. Disqualifications due to misconduct by directors under s 6 seem to increase every

1314 ibid.
1315 ibid.

1317 Insolvency Service Enforcement Outcomes 2008/2022

year, especially from 2014 onwards, contrary to s 8, which allows the Secretary of State to request an order to disqualify only after a particular authority of inquiry has been exercised and the person's behaviour should not necessitate business insolvency. Hence, there were only four disqualifications under s 8 in 2012–2013. However, there was a steadfast increase in 2018–2019, to 111 disqualifications. Changes to laws in 2015 broadened the reach of investigative content, and information from other regulators may have been used to bring a disqualification, resulting in rises in both ss 6 and 8. The number of director disqualification in the fiscal year 2021/22 exhibited a decline compared to the preceding fiscal year of 2020/21. The occurrence of lower numbers in the fiscal years 2021/21 and 2021/22 corresponded with a notable decrease in the frequency of firm insolvencies, which can be attributed to the unprecedented circumstances of the ongoing pandemic within those two years.[1318] Nevertheless, the statistics show the effectiveness of disqualification under s 6 in dealing with unfit directors. However, there is a failure to hold accountable bank directors who are responsible for the almost collapsed companies that are served by government intervention under s 8. Banks are quick to respond to slight changes in the financial market, they are considered vulnerable organisations and any loss that might impact their service is detrimental to overall economic stability.[1319]

However, the author has provided the above statistics relating to disqualification orders, by the courts only because most directors who are disqualified under the CDDA are small business owners. The predominant demographic of directors engaged in disqualification procedures consists of small business owners, specifically self-employed directors or founders of private enterprises.[1320] Thus the CDDA regime is perceived as having a broad focus on directors within this category, and as a result, its

[1318] Commentary- Insolvency Service Enforcement Outcomes 2012/22.
[1319] Tomasic (n 5).
[1320] Blanca Mamutse, Modern Slavery and Directors' Disqualification: A Convergence of Opportunity and Challenge, *Industrial Law Journal*, Volume 51, Issue 4, December 2022, 855,903.

efficacy is primarily evaluated in relation to their level of expertise.[1321] Hence cases of Carillion/RBS mentioned in this thesis appears to have little effect to the disqualification regime. Therefore, the disqualification regime has been strengthened to deter small business owners and directors from liquidating enterprises and evading responsibility for the resulting consequences.[1322]

The recent enactment of law [1323] establishes the possibility of disqualifying former directors after the dissolution of a corporation. Presently, if a company ceases operations without undergoing a formal liquidation procedure, the directors of said company will not be subjected to an inquiry into their conduct by the Insolvency Service under the provisions of the CDDA, provided the corporation is consequently reinstated on the register. The legislation effectively addresses this gap by broadening the authority of the Secretary of State to conduct investigations and disqualify individuals from serving as directors in the future, provided that their conduct fails to meet the anticipated benchmarks.

Additionally, disqualified directors are subject to court orders requiring them to compensate creditors who have suffered losses because of their actions.[1324] It is anticipated that there would be a notable rise in the number of investigations carried out pertaining to the actions of directors of dissolved firms, together with an increase in the issuance of disqualification decisions. Therefore, directors of financially distressed enterprises should exercise significant deliberation when contemplating the dissolution of their company as an alternative to pursuing a formal liquidation procedure. The improper utilisation of the dissolution procedure may result in significant consequences for directors, even after the official removal of their company from the register.

[1321] Ibid.
[1322] Under the new Rating (Coronavirus) and Directors Disqualification (Dissolved Companies) Act 2021.

[1323] Ibid.
[1324] Ibid.

Having established that the predominant demographic of directors engaged in disqualification procedures consists of small business owners, specifically self-employed directors, or founders of private enterprises. It is important to acknowledge that several concerns discussed in this chapter do not have universal applicability to all directors. Directors of publicly traded or privately held corporations, such as Carillion and RBS, are unlikely to partake in the practise of phoenixing or circumventing identity verification protocols. Firstly, this is primarily due to their role as managers rather than owners of the companies.[1325] Furthermore, their trading activities are influenced by their reputations and past business performances. Disqualification is accompanied by the negative perception linked to a violation of ethical standards in business.[1326] The act of depriving an entrepreneur of public acknowledgment for their aptitude to serve as a director of a limited firm removes a desirable characteristic. The presence of ongoing legal actions against a professional director would significantly affect both their reputation and their ability to continue practising their profession throughout this period.[1327] Furthermore, it should be noted that individuals who are barred from serving as directors nonetheless retain the ability to engage in consultancy work.[1328]

This was demonstrated in *Re Barings plc (No.3),*[1329] the director who was disqualified applied for permission under section 17 to serve as a director in a capacity that did not require him to take on any significant executive duties, except for those of a minor nature, and allowed him to engage in consulting activities. The court emphasised the significance of safeguarding the public from the behaviour that resulted in the

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[1325] Blanca Mamutse (n 1320).

[1326] Andrew Hicks, Disqualification of Directors: No Hiding Place for the Unfit? ACCA Research Report 59 (London: Certified Accountants Educational Trust, 1998) 8.

[1327] Blanca Mamutse (n 1320).

[1328] Joan Loughrey, 'Smoke and Mirrors? Disqualification, Accountability and Market Trust' (2015) 9(1) LFMR 50,62.

[1329] [1999] 1 All ER 1017.

disqualification decision, while also highlighting the necessity of maintaining a balance between the applicant's ability to serve as a director of a certain firm. Therefore, the director who was disqualified was found to be of no risk to work as a consultant.

The presented argument highlights a significant divergence from the stance taken towards owner-managers or self-employed directors. In such cases, the court has maintained that permitting a disqualified director to assume the role of the sole proprietor of another company would only be considered under exceptional and extraordinary circumstances. This determination is made considering the possibility for the applicant to continue operating the relevant business in whatever capacity.[1330]

6.13 Too Big to Fail: The Issue and Its Consequences

The issue of ‘phoenixism’ is regarded as an inexpensive and readily accessible recourse to limited liability by which directors may conceal themselves behind the corporate entity's distinct legal personality.[1331] Directors embark on a string of continuous failed limited liability companies, using a name that is often but not always identical to the failed business.[1332] In past years, the government has promoted a business culture that reduces the social stigma associated with corporate failure. For instance, the Enterprise Act 2002 aimed to develop a legal framework that would encourage businesses to engage in responsible risk-taking. Hence, bank directors used these unique characteristics of the financial sector to escape liability. The Treasury Committee concluded, using Northern Rock as an example, that the principal offenders of the difficulties encountered by the organisation were the directors of Northern Rock, who engaged in a high-risk market plan with a focus on the short and medium term.[1333]

It has been asserted that many phoenix directors demonstrated poor managerial and financial competence. However, it was not a requirement for directors to have such

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[1330] Blanca Mamutse (n 1320).
[1331] Bavoso and Tribe (n 1161).
[1332] ibid.
[1333] Treasury Committee, *The Run on the Rock* (n 633).

credentials in order to hold their positions.[1334] Proposals for such requirements were dismissed on grounds that sufficient information regarding director appointments rests with shareholders.[1335] Nevertheless, such logic fell flat, particularly in the circumstances of phoenixism, because in small businesses the same people serve as both directors and shareholders.[1336] Setting minimum qualifications for directorships was seen as a barrier to business.[1337] The Cork Committee made a proposal regarding the same issue of phoenixism, which was later affirmed in s 216 of Insolvency Act 1986. Here, it was stated that whoever causes a company to be liquidated on succession within two years should be held personally liable for their actions, aiming to align the actions of directors to the harsher regime.[1338] However, none of the recommendations were put into practice.

The rescue of RBS from collapse by the government was a result of major weaknesses in RBS's leadership, bad board choices, a culture that rewarded excessive risk-taking, and its acquisition of ABN Amro.[1339] A report of the Financial Services Authority revealed that the chief executive officer had flagged the associated risks.[1340] The due diligence was inadequate, which RBS directors tried to justify by explaining that the merger was hostile.[1341] The FSA claimed in its assessment that the RBS board was overly arrogant and overconfident following the bank's previous successful acquisition of NatWest.[1342] In spite of this, the RBS board advanced with the takeover without properly assessing the dangers. The costly takeover of ABN Amro was described as a wrong deal.[1343] Indeed, the behaviour in the above cases falls under the CDDA for unfitness.

[1334] Imad Moosa, 'The Myth of Too Big to Fail' (2010) 11 Journal of Banking Regulations 319.
[1335] ibid
[1336] ibid
[1337] ibid.
[1338] *Insolvency Law and Practice* (n 1131).
[1339] Treasury Committee, *The FSA's Report into the Failure of RBS* (n 633).
[1340] Lui (n 651).
[1341] ibid.
[1342] McClelland (n 719).
[1343] RBS (n 373).

It is argued[1344] that, had the banks been allowed to fail, it would have introduced a deterrent to the directors. Some banks viewed the bailout of Northern Rock as insurance for their mistakes and incompetence.[1345] It is a problem of moral hazard, the reason for the lack of trust and accountability within the financial sector.[1346] Most disqualification orders deal with issues of dishonesty and lack of commercial probity. However, incompetence is not included in the scope of the remedy.[1347] Cases[1348] have shown that without the possibility of blameworthiness, directors cannot be disqualified for company failure caused by mere mismanagement.[1349] Yet, it was the poor decisions of bank boards of the near collapsing of RBS and Northern Rock. The CDDA`s inadequacy to address such conduct effectively is a sign of its weakness. Penalising incompetent conduct promotes trust within financial institutions by removing incompetent directors from occupying boards. It is argued that courts should find an effective way to protect the public from directors who are unqualified. It's unthinkable that the public should be safeguarded from wrongdoing by professionally trained directors but not by directors in general.[1350]

These incompetent directors fall within blameworthiness and are not fit for the purposes of public protection. The public is at risk regarding unqualified directors who do not meet the relevant requirement level of competence. The courts tend to give importance to conduct that is below the breach of accepted commercial morality. This attitude has been criticised by legal commentators[1351] as lacking effect on the protective purposes of the statute. To creditors who lose their money, it makes no difference whether the directors managing the company were dishonest or merely incompetent. There should not be any difference between excusable and inexcusable incompetence in determining disqualification for incompetence. The persistent use of blameworthiness by the courts for ill-defined issues such as gross negligence, mere incompetence, and total

[1344] Imad Moosa, 'The Myth of Too Big to Fail' (n 1334).
[1345] ibid.
[1346] Loughrey (n 1328).
[1347] *Re Lo-Line* (n 1205).
[1348] ibid.
[1349] *McNulty's* (n 1306).
[1350] Finch (n 1194).
[1351] ibid.

incompetence[1352] allows room for confusion in its interpretation. Harman J in *Re Rolus Properties*[1353] commented that directors use the principle of limited liability to take risky ventures and only truly competent directors would be discouraged.

There must be coherence in the law used to disqualify unfit directors, including those of financial institutions. Although the government bailout of banks is perceived as a way of saving the economy, it could also be argued that, by doing so, it is protecting irresponsible directors of banks from liability for their actions. The idea of rescuing very weak banks has its own disadvantages. Disqualification measures have been underutilised on financial institutions near collapse, with directors escaping liability for their recklessness and risk-taking.[1354] Disqualification is a problem that must be addressed, and the idea that businesses must fail for disqualification orders to be enforced is flawed. To address the above, it is argued that s 6 of the CDDA be amended. It must include failures that cause the near collapse of companies.[1355] Furthermore, s 8 should be used effectively. The above statistics have shown little to hardly any enforcement under the section. Failure to introduce those measures might see another corporate collapse and the escape of reckless directors from accountability.

Disqualification has the potential to be effective, however, its operation in practice makes this unlikely. It is claimed in this chapter that the CDDA neither encourages nor punishes good business behaviour; as a result, directors who have been declared incompetent and disqualified are not held personally liable under the CDDA. The CDDA's inability to properly address inept behaviour reflects its weakness in promoting accountability in company director.

[1352] ibid.
[1353] [1988] 4 BCC 446.
[1354] ibid.
[1355] ibid.

6.15 Conclusion

The author introduced the Company Directors Disqualification Act 1986 (CDDA) in this chapter, hopping to provide the solution to the inadequacies of the derivative action in chapter 5. The CDDA grants authority to the courts to issue orders or accept commitments that prevent persons from serving as directors or participating in any capacity in the establishment, creation, or administration of a business upon disqualification. The author had the implication that the CDDA will be a solution to bridge up directors' duties by removing rogue directors from companies and prevent additional misbehaviour. However, through critical analysis, it was argued that the CDDA does not encourage good corporate behaviour or punish bad behaviour. As a result, those who have been deemed incompetent and disqualified are not held personally liable under the CDDA. Thus, the CDDA's inability to counter incompetent behaviour among other issues is a sign of its weakness. Thus, this thesis turns its attention to the SMCR in chapter 7 as an alternative framework of holding company directors to account for their actions. This thesis will show how the SMRC increases the consistency of governance in institutions by focusing on deterrence. Fines and penalties serve as deterrents to wrongdoing. The thesis will demonstrate how the SMCR is designed to be an enforcement tool for compliance, a way for senior executives to be held accountable for structural failures and severe misconduct that happened when they are in charge.

Chapter 7.

7. Advocating the SMCR as an Alternative Framework of Accountability

This thesis has critically analysed and evaluated the current weaknesses in case law, and legislation relating to the obligations and accountability of directors. Therefore, this chapter will turn its attention to the SMCR on why it should be considered an alternative framework to the inadequacies posed by other regimes in holding directors to account. The objective of the SMCR is to enhance the stability and reliability of regulated financial services companies, minimise negative impacts on consumers, and reinforce the integrity of the market. This is achieved by establishing a framework that allows firms and regulators to hold individuals, especially Senior Managers, responsible for their actions.

The primary objective of the SM&CR is to provide a proactive system that encourages individuals to assume personal accountability for their activities and enhances ethical behaviour across all organisational levels. It also ensures that both firms and employees have a clear understanding of their respective responsibilities and can demonstrate them effectively. Additionally, the SM&CR seeks to enhance corporate governance practices. This chapter will argue that increasing accountability through the SMCR in the non-financial sector will benefit all stakeholders and the corporate entity in general. This chapter will present a workable approach on how the SMCR can be embedded to all companies across the sectors including large and small.

The PCBS stated that the problem with directors of companies was the lack of personal accountability.[1356] The FCA was eager to avoid financial scandals and ensure accountability and responsibility for risk management and wrongdoing from the top down. The PCBS asserted that the problem was having too many bankers at the senior level operating in an atmosphere where personal accountability was lacking.[1357] Senior managers were accused of escaping accountability for their failings by playing a blame

[1356] PCBS (n 384).
[1357] ibid.

game on others and hiding a lack of knowledge. Furthermore, they had little chance of facing financial fines or harsh consequences because of their failings. The SMCR was introduced to enhance regulatory liability for senior persons and employees who recklessly mismanage and harm financial sectors and insurance.[1358] The Financial Services 2013 Act empowers the Secretary of State, FCA and PRA to start criminal proceedings against directors who have knowingly caused business failure by failing to regard the risks.

7.1 The Core Aims of the SM&CR

The overarching goals of the SM&CR are to mitigate harm to customers and enhance market integrity by increasing individual accountability for behaviour and proficiency, as well as to enhance the stability and robustness of the financial services industry[1359]. The regime aims to foster a culture within companies where employees at all levels assume personal accountability for their activities. It also ensures that both companies and employees have a clear understanding of where responsibility belongs and can demonstrate it. By doing so, it fosters a culture of adherence and positive conduct within companies, rather than operating as a responsive system that depends on frequent enforcement measures.[1360]

The regime seeks to facilitate the process by which companies and regulatory bodies can hold individuals responsible. The FCA and PRA frequently utilise the SM&CR in their supervisory actions with firms to ensure accountability for the implementation of important supervisory priorities.[1361] Furthermore, the FCA and PRA possess the authority to initiate enforcement measures against people who violate regulatory norms of conduct. This encompasses the ability to enforce financial penalties, publicly reprimand individuals, and impose limitations or restrictions on approvals for

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[1358] FSMA (n 385) ss 66A, 66B.

Senior Managers & Certification Regime: Call for Evidence, March 2023. Accessed March 2023.https://www.gov.uk/government/calls-for-evidence/senior-managers-certification-regime-a-call-for-evidence.

[1360] Ibid.

[1361] Ibid.

wrongdoing. Additionally, it grants the authority to penalise the performance of a Senior Management Function (SMF) without obtaining clearance.

7.2 The SMCR as an Alternative Framework of Accountability

This section seeks to promote the SMCR as an alternative framework of accountability to the inadequacies posed by other regimes in holding directors to account. The firm's SMCRs cover more ground than does the UK Corporate Governance Code. The SMCR is not just for the board; rather, it applies to a wide range of people. On the board, it is limited to executives and non-executives with duties, like chairman of board committees and Chairmans.[1362] This restriction keeps non-executive directors from having heavy duties because they don't have any daily obligations within the company. The three primary components of the regime are each focused on a different facet of the enacted laws. These components include assigning responsibilities, approving and certifying board and management members, and creating a uniform code of behaviour for all businesses. To varied degrees, directors and senior managers are covered by the sections[1363] as listed below figure 1. [1364].

[1362] Eleanore Hickman. Is the Senior Managers and Certification Regime Changing Banking for Good? *The Modern Law Review*. 2022; 00: 1-23. https://doi.org/10.1111/1468-2230.12752.

[1363] The Bank of England, 'Strengthening the Link between Seniority and Accountability: The Senior Managers and Certification Regime' Quarterly Bulletin Q3, 2018, 3.

[1364] The Extended Senior Managers and Certificate Regime Navigating implementation - insurers January 2018. https://www.lw.com/admin/upload/Documents/Extended-SMCR-Navigation-Implementation-Insurers.2.pdf accessed 27 August 2024.

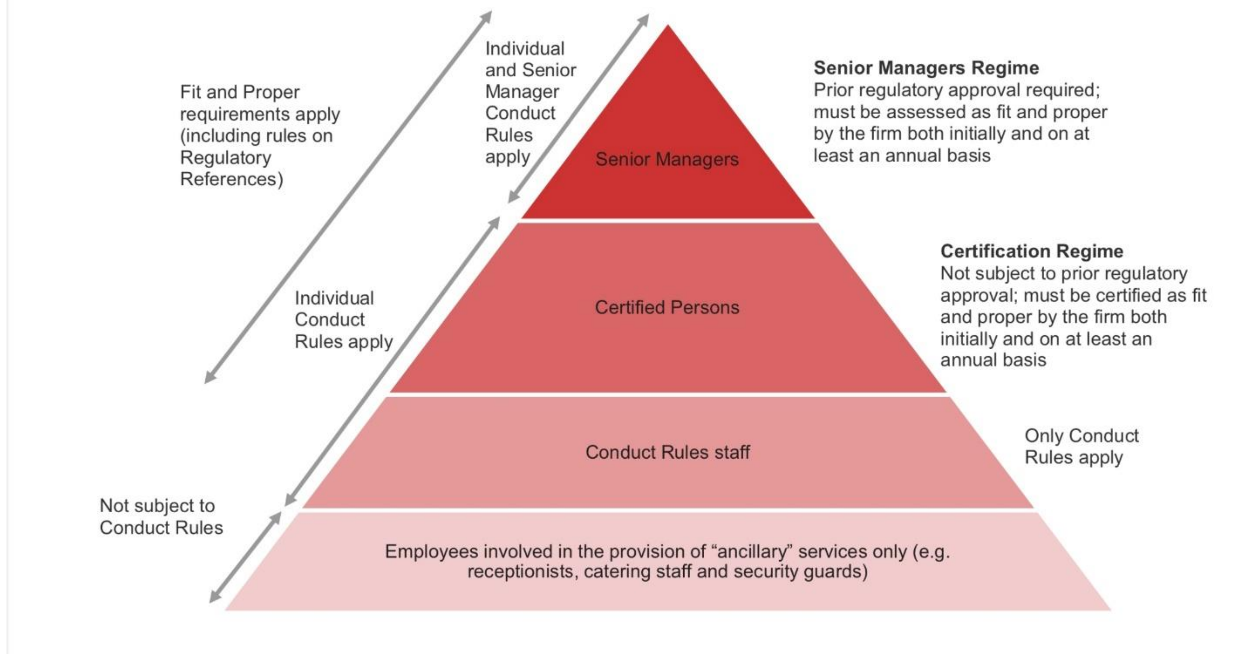

Figure 1: New Senior Managers and Certification Regime

(a)Responsibility Attribution (*The Senior Managers Regime)*

Which wrongs are perpetrated by individuals, and which are done by firms? Mark Steward, the FCA's former director of enforcement and market oversight, posed this question in 2017. Do they contradict, differ from, or are they related to each other?[1365] A successful accountability system requires a response to this question. However, the problem with misbehaviour is that it is typically committed by individuals, and there are corporate cultures where it will thrive more than others.

A conventional interpretation of corporate governance typically assumes that the board of directors has collective responsibility for its acts, making the firm, rather than the people

[1365] FCA, 'The Expanding Scope of Individual Accountability for Corporate Misconduct' 31 March 2017 https://www.fca.org.uk/news/speeches/expanding-scope-individual-accountability-corporate-misconduct.

involved, accountable for any mistakes.[1366] Corporate disasters like those of Carillion, BHS, and Tesco, to name a few, have not been stopped by corporate governance mechanisms. The SMCR deviates from this pattern by placing a strong emphasis on the personal accountability of top management, extending beyond the board. Senior Managers are crucial decision-makers in the company who work at the highest level of authority.[1367]

These persons should have the responsibility, under the supervision of the board, to manage or supervise all the important functions of the firm. Every aspect of a company's operations should be overseen by a competent Senior Manager. As a result, it shifts attention away from the overall governance structure, this would be complementary to the framework of governance codes already in place. This is consistent with Cullen's perspective that penalties for misconduct or taking excessive risks will only have an impact if they are targeted at the individual rather than the organisation.[1368] Individual accountability imposes a higher level of responsibility on managers to govern their own actions, monitor the behaviours they oversee, and seek support for their decisions.[1369] The judiciary has recognised that non-executive directors' responsibilities include overseeing executive management and maintaining judgement independence.[1370] No matter what they are called, these directors haven't stopped several company failures and probably won't be able to stop them from happening

[1366] Model Articles for Public Companies, art 3.
[1367] The Bank of England, 'Strengthening the Link between Seniority and Accountability: The Senior Managers and Certification Regime' Quarterly Bulletin Q3, 2018, 3.

[1368] Jay Cullen, A Culture Beyond Repair? The Nexus between Ethics and Sanctions in Finance (October 5, 2016). Forthcoming in Just Financial Markets: Finance in a Just Society, Oxford University Press, (ed. Herzog 2016), University of Oslo Faculty of Law Research Paper No,2017-19, Available at SSRN: https://ssrn.com/abstract=2848178.

[1369] Eleanore Hickman. Is the Senior Managers and Certification Regime Changing Banking for Good? *The Modern Law Review*. 2022; 00: 1-23. https://doi.org/10.1111/1468-2230.12752.

[1370] Ethical Boardroom (n 982).

again. The SMCR aims to guarantee that there are "no gaps" in the managerial accountability framework covering all facets of the company.[1371]

Essentially, it is necessary for an individual with seniority, trustworthiness, and power to be accountable for overseeing all aspects of the company's operations and managerial tasks consistently.[1372] Under UK law, directors—executive and nonexecutive—have the same obligation.[1373] In terms of the legislation, there is no distinction between executives and non-executives in the UK. Hence, the issue of individual accountability is a problem. Therefore, the SMCR is proposed to cover the gap and bring clarity as demonstrated in the Senior Managers` position. The SMCR strengthens the link between seniority and accountability by clearly assigning tasks to the Senior Managers in a company. Consequently, the link between seniority and accountability would be complementary to the framework of governance codes already in place and the fiduciary obligations of directors. One good example, the collapse of Carillion in 2017 raised questions on what role the non-executive directors played. The Carillion's board paid large sums of money to shareholders while accumulating enormous debts. Under the corporate governance code, it falls under the purview of the NEDs to maintain effective oversight and ensure integrity is practised right across the board.[1374] The NEDs were adamant during the parliamentary inquiry committee that they challenged management consistently on debt issues when debt rocketed to £961 million over a year.[1375] Doubts were cast over whether the NEDs exercised any effective check on the executive management team. The concluding remarks judged that they were hoodwinked as much as anybody else.[1376]

In this context, responsibility is synonymous with accountability because the regulator has the authority to take enforcement action against persons who, based on an objective assessment, have failed to fulfil their expected duties as outlined in the statement of

[1371] Ibid.

[1372] FCA Handbook, SYSC, 26.3.1.
[1373] Companies Act 2006, Part 10 s278.
[1374] The UK Corporate Governance Code 2016, para-A 4.
[1375] Maria Espadinha (n 773).
[1376] Coase (n 155).

responsibilities.[1377] The SMCR enhances the connection between seniority and accountability by clearly assigning tasks to the most senior decision-makers ('Senior Managers') in a company. The CBFG Report suggests that reinstating a feeling of personal accountability among board members has the capacity to enhance the efficiency of board governance and industry standards.[1378] It can be argued from the analysis above that the Senior Managers and Certification regime`s responsibility attribution strengthens the link between seniority and accountability in the company, the missing link in the UK Company law and the Corporate Governance Code.

(b)Approving and Certifying Board and Management Members

The second component of the regime is certification. Companies must evaluate if senior executives have the necessary qualifications and integrity to fulfil their specific roles. [1379] Subsequently, the FCA or Prudential Regulatory Authority (where applicable) must grant its approval for that assessment.[1380] The permission should be granted just once, providing there are no changes in circumstances. This is because one of the objectives of the certification regime is to emphasise that enterprises, not the regulator, are accountable for ensuring that their staff members are suitable and competent.[1381] When determining suitability and propriety, it is important to take into account factors such as qualifications, training, competence, and personal qualities.[1382] This would be complementary to the framework of governance codes already in place and the

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[1377] Financial Conduct Authority, *Final Guidance: The Duty of Responsibility for Insurers and FCA Solo Regulated Firms* PS18/16 (2018) 1.11.

[1378] House of Lords, House of Commons, 'Changing Banking for Good Report of the Parliamentary Commission on Banking Standards' HL Paper 27-I HC 175-I and HL Paper 27-II HC 175-II (2013).

[1379] FSMA 2000, s 61 (A) (1).
[1380] FSMA 2000, s 60A, inserted by Financial Services (Banking Reform) Act 2013, s 21.
[1381] FSMA 2000, s 61 (A) (1).

[1382] FSMA 2000 (n 1379).

fiduciary obligations of directors. The certification has a maximum duration of twelve months, after which it must be renewed.[1383]

Any changes in the conditions of the certified individuals must be promptly reported to the regulator. The objective is to analyse the suitability of individuals in positions where they have the potential to inflict substantial harm. This was the reason for alarming numbers of board failures[1384] (not to mention bank failures). A history of inept directors who do not have even the bare minimum of skills required for their positions. For example, according to a report[1385] produced after HBOS Group's demise, the board of directors lacked knowledge and qualifications. The board's NEDs lacked sufficient banking expertise and understanding. Out of twelve non-executive directors, only one had banking experience.[1386] With the SMCR in force, competence and capability is the main requirement before an individual assumes office,[1387] the missing link in the UK Company law and the Corporate Governance Code.

Suitability evaluations must also be completed for a wide range of positions below senior management, including the general categories of "material risk takers" and "significant management functions."[1388] As part of this procedure, it is necessary to acquire 'regulatory references' from the former employers of candidates. To prevent the occurrence of individuals with a history of misbehaviour who evade accountability by

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[1383] Eleanore Hickman. Is the Senior Managers and Certification Regime Changing Banking for Good? *The Modern Law Review*. 2022; 00: 1-23. https://doi.org/10.1111/1468-2230.12752.

[1384] Tomasic Roman, 'The failure of corporate governance and the limits of law: British banks and the global financial crisis,' *Corporate governance and the global financial crisis*: international perspectives. (Cambridge University Press 2011), pp. 50-74.

[1385] Bank of England, 'Prudential Regulation Authority: The Failure of HBOS plc (HBOS), A Report by the Financial Conduct Authority and Prudential Regulation Authority' (November 2015) https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/publication/hbos-complete-report accessed November 2015.

[1386] ibid.

[1387] FCA, FIT Handbook (FCA 2020) 2.2.1.

[1388] Eleanore Hickman (n 1383).

switching companies without disclosing their past wrongdoings. Individual accountability may be compromised when individuals are able to secure work at another company without revealing their prior misbehaviour. If individuals possess mobility while their conduct history remains static, a crucial protection is compromised, resulting in the issue of persistent problematic persons. Consequently, regulatory references would be complementary to the framework of governance codes already in place, if not the missing link of accountability to the corporate governance code. The behaviour of a director is a matter of concern to themselves both within and outside of the office.

According to Hoo Yu's investigation, almost 800 out of the current 6,700 disqualified directors were still actively working as directors.[1389] Furthermore, more than 500 directors have fraudulently altered their identification credentials to assume a new position.[1390] As part of the SMCR vetting procedure, businesses must do criminal record checks and reach out to previous employers who have hired the individual in question. It is incumbent upon the organisation to ensure that it employs individuals who are both fit and proper for their roles. The behaviour of a director is a matter of concern to themselves both within and outside of the office, as regulated by the Senior Managers and Certification Regime (SMCR).

(c)Code of Conduct

The third component of the system is the conduct requirement, which mandates that the firm consistently uphold values such as integrity, due skill, care, and diligence, as well as demonstrate openness and collaboration with the authorities.[1391] These rules mandate that senior managers must take appropriate measures to ensure effective control over the business they are in charge of, adhere to relevant regulations, supervise delegated responsibilities, and disclose information that the FCA/Prudential Regulatory Authority would expect to be disclosed.[1392]

[1389] HooYu, 'The Chameleons in Companies House' (*Hooyu.com 23 May 2019).* *https://thefintechtimes.com/chameleon-fraudsters/* accessed 23 May 2019.
[1390] Ibid.
[1391] Eleanore Hickman (n 1383).

[1392] Ibid.

The Conduct Rules establish and demand complete personal responsibility and accountability for individuals holding office positions. It fosters positive and conducive corporate culture. Any individual holding a senior management position must possess the necessary qualifications and capabilities as outlined in the SMCR. The Institute of Directors (IoDs) considers a code of conduct for directors to be the essential element lacking in the current corporate structure, which could greatly enhance trust and respect among UK enterprises.[1393] This argument is in line with the ethos of the SMCR`s conduct rules. The IoDs research suggests that directors should be obligated to adhere to a code of conduct, either with their voluntary participation or as a mandatory requirement. It is essential to recognise that a code of conduct for directors is distinct from the UK corporate governance code and the extensive legal responsibilities that directors have according to the Companies Act 2006.[1394]

An effective governance code delineates optimal methods for the structure, makeup, and general functioning of the board of directors.[1395] Moreover, governance rules often apply exclusively to major, publicly listed companies and do not primarily aim to delineate overarching principles of individual behaviour and behaviour that individual directors should demonstrate as corporate leaders.[1396]

Nevertheless, the UK Companies Act 2006 fails to tackle the complexities surrounding the appropriate conduct of directors. The absence of a formal code of conduct for directors, which regulates their conduct as a professional organisation, is very unexpected considering the extensive scope of their responsibilities. An analogous set of standards of conduct is customary in other fields, such as law, medicine, and accounting, and carries repercussions in case of violation.[1397] One such outcome entails the revocation of the legal right to work in the relevant industry. Therefore, this thesis asserts that a crucial component that is absent from the Corporate Governance Code and the Companies Act 2006 is a code of conduct for directors, which may have a

[1393] A Voluntary Code of Directors: A proposal for the UK government, June 2022.
[1394] Ibid.
[1395] Ibid.
[1396] A Voluntary Code of Directors (n 1393).

[1397] Ibid.

substantial impact on fostering trust and respect within the UK corporate community.[1398] Therefore, the code of conduct provides the missing link in the corporate framework which brings effective accountability.

(d)Global Efforts to Ensure Accountability

The need of enhancing governance by promoting accountability, which is based on clear delineation of roles and responsibilities, is reinforced by the efforts of international regulatory organisations and by the adoption of similar practices in other nations.[1399] The Basel Committee on Banking Supervision, in its document titled 'Corporate governance principles for banks', asserts that a board of directors should create and approve a bank's organisational structure.[1400] Additionally, the board should explicitly define the primary duties and obligations of both the board and senior management.[1401] In the "Insurance Core Principles," the International Association of Insurance Supervisors asserts that the governance framework of an insurer should clearly outline the duties and responsibilities of individuals who are responsible for managing and overseeing the insurer.[1402]

Several foreign jurisdictions are now contemplating implementing reforms that include elements of the Senior Managers and Certification Regime or have already done so. The Manager-in-Charge Regime was established by the Hong Kong Securities and Futures Commission in 2017, while Australia's Bank Executive Accountability Regime started operational in July 2018[1403]. Both models necessitate the attachment of responsibilities to designated senior managers. In February 2018, the Central Bank of Malaysia published

[1398] Ibid.
[1399] The Bank of England, 'Strengthening the Link between Seniority and Accountability: The Senior Managers and Certification Regime' Quarterly Bulletin Q3, 2018, 3.
[1400] Basel Committee on Banking Supervision (2015).
[1401] Ibid.
[1402] International Association of Insurance Supervisors (2017).
[1403] The Bank of England, 'Strengthening the Link between Seniority and Accountability: The Senior Managers and Certification Regime' Quarterly Bulletin Q3, 2018, 3.

a Discussion Paper on accountability, referring to aspects that are comparable to those found in the SM&CR.[1404] Furthermore, in April 2018, the Monetary Authority of Singapore put forth guidelines to enhance the individual responsibility of senior management and elevate the levels of ethical behaviour in financial organisations.[1405]

The Senior Managers and Certification Regime offers a versatile method of ensuring individual accountability, which supports collective accountability of the board and executive committees. Where components of the system have already been put into effect, empirical evidence indicates that it is exerting a beneficial control over companies and their primary decision-makers.[1406] The increasing global interest in encouraging individual accountability indicates that others recognise the value of adopting this approach.

7.3 The Effectiveness of the SMCR

This section analyses the functioning and the implementation of the SM&CR since its inception in 2016. An assessment will be conducted to investigate the objectives of the SM&CR and analyse the degree to which the system has achieved those objectives. The section will conclude by discussing the reasons for extending the Senior Managers and Certification Regime (SM&CR) to the non-financial sector.

The implementation of the Senior Managers and Certification Regime (SM&CR) in 2016 provided a favourable occasion to tackle the issues related to the behaviour of high-ranking executives in recognised institutions. Past attempts to combat wrongdoing by high-ranking firm executives through legislation, regulations, civil actions, and criminal prosecutions have been insufficient. The implementation of the SM&CR was significantly shaped by the suggestions put forth by the Parliamentary Commission on Banking Standards (PCBS), which was tasked with examining ways to enhance standards in the aftermath of the LIBOR and FOREX market manipulation scandals. As such, *The*

[1404] Bank Negara Malaysia (2018).
[1405] Monetary Authority of Singapore (2018).

[1406] PRA, Evaluation of the Senior Managers and Certification Regime, December 2020.

Independent commented that directors of banks looked untouchable.[1407] Following the financial crisis, the scandal, was termed 'an accountability firewall.'[1408] In particular, the commission highlighted two hindrances to accountability. First, it was reported that ignorance was being used by directors as an excuse to escape accountability. These directors were very much aware they wouldn`t be held accountable for something beyond their imagination.[1409] This strategy proved to be successful, as not many directors were held legally accountable for their actions. Second, the PCBS learned that directors normally relied on collective decision to escape liability.[1410] The SM&CR introduced a method of rectifying certain deficiencies by holding senior management accountable for their actions. The Financial Services 2013 Act gives the Secretary of State, the FCA, and the PRA the authority to prosecute directors who have deliberately caused a company to collapse by failing to consider risks.[1411] The threshold for liability is higher than recklessness.

The primary goals of the SM&CR are twofold: to promote accountability among all personnel in the financial services industry and to establish a clear framework for licenced firms and workers to demonstrate their respective areas of responsibility.[1412] Hence, the Senior Managers and Certification Regime (SM&CR) seeks to foster a culture where employees at every level assume personal accountability for their conduct.[1413] This

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[1407] James Moore, 'FCA Must Act in Wake of Judge's Criticism' *The Independent* (London, 21 June 2018) https://www.independent.co.uk/news/business/comment/fca-upper-tribunal-criticism-ubs-libor-rigging-traders-arif-hussein-senior-managers-regime-a8410381.html accessed 21 June 2018.

[1408] PCBS (n 384).

[1409] ibid.

[1410] ibid.

[1411] FSMA ss 66A and 66B (n 385).

[1412] Financial Conduct Authority, 'Senior Managers and Certification Regime' (7 July 2015) <https://www.fca.org.uk/ firms/senior-managers-certification-regime> accessed 5 June 2023.

[1413] Financial Conduct Authority, 'FCA Outlines Proposals to Extend the Senior Managers and Certification Regime to all Financial Services Firms' (Press Release, July

facilitates the matter of identification by clearly delineating the roles of senior managers. Consequently, if any mishap occurs within their designated scope of responsibility, they can be held individually liable.[1414] This means that if something goes wrong in an area, they are responsible for, the regulators will consider whether reasonable steps were taken to stop that fault from occurring. The reasonable test being an objective test, it is very difficult for one to escape liability. Second, senior executives are bound by a code of conduct.[1415] If a senior executive is intentionally involved in a regulatory violation, they may be in violation of the code of conduct rules.[1416]

The PRA and FCA are granted powers to bring cases over managers who act knowingly and without regard for the risk of failure. This behaviour is deemed to be well below that of a rational person in their role. [1417] Furthermore, whether directly involved or not, a senior official would be responsible for monitoring a region where a violation occurred.[1418] Where senior persons are in breach, they are liable for severe fines and disqualification from conducting similar functions in the financial sector. The disqualification part has detrimental effects on the career and livelihood of senior persons, as they are barred from working or undertaking the same position in the financial sector.

Under the Senior Managers and Certification Regime (SM&CR), organisations are required to submit evidence to the Financial Conduct Authority (FCA) that demonstrates the responsibilities of senior managers and their aptitude for their roles.

The certification regime applies to individuals who, although not senior managers, have positions that have the potential to cause substantial harm to the organisation or its consumers. A company must not authorise an employee to perform certain tasks unless they have been provided with a certificate confirming their suitability and competence for

2017) <https://www.fca.org.uk/news/press-releases/fca-outlines-proposals-extend-senior-managers-certification-regime-all-firms> accessed 5 June 2023.

[1414] Financial Services (Banking Reform) Act 2013, Part 4, s.29.

[1415] PRA and FCA (n 951).

[1416] FSMA ss 66A and 66B (n 385).

[1417] ibid.

[1418] ibid.

that role.[1419] Certified persons must be assessed annually by firms to ensure they uphold the requirements for fitness and propriety standards.[1420]

The Conduct Rules enforce total individual responsibility and accountability in the position of the office. Doing so, it promotes a good culture in companies. It is mandatory for anyone in the position of senior management to be fit and proper under the SMCR.[1421] These individuals are assessed continuously, a minimum of once per year. The person's honesty, integrity, and credibility would be the most critical factors, followed by competence, capability, and financial soundness.[1422] It is the company's responsibility to have fit and proper employees. One way a firm can determine the fit and proper test is through criminal convictions. Jonathan Burrows' case is a clear example. He was a director of a firm that cheated a train company out of £43,000 in out-of-court settlements.[1423] He was banned from his position because his conduct demonstrated a lack of honesty and integrity for the fit and proper test under the FCA.[1424]

The effectiveness of the SMCR is demonstrated further through the following cases. The deterrence of enforcement was exercised in 2012 at HBOS, where its finance director, Peter Cummings, was accused of pursuing an aggressive growth strategy without due care, skill and diligence.[1425] The bank suffered losses of £7 billion and needed government rescue. Cummings was handed a £500,000 fine and barred for the rest of his life from working in financial institutions.[1426] In 2023, Jes Staley, the former CEO of Barclays, was banned by the U.K.'s financial regulator from assuming high-ranking

[1419] Olly Jackson, 'Primer`: the Senior Managers Certification Regime' [2018] International Financial Law Review 1.
[1420] Morris (n 957).

[1421] Walker Morris, 'Fitness and Propriety of Senior Managers and Certified Person' (14 November 2019) https://www.walkermorris.co.uk/publications/extension-of-the-senior-managers-and-certification-regime-part-1/fitness-and-propriety-of-senior-managers-and-certified-persons/ accessed 14 November 2019.
[1422] FCA, *FIT Handbook* (FCA 2020) 1.3.1B.
[1423] ibid.
[1424] ibid.
[1425] Masters and Goff (n 375).
[1426] ibid.

positions in the financial services industry. Jes was held personally accountable for misleading statements in his relationship with convicted sex offender Jeffrey Epstein. Additionally, he was fined over $2 million due to his shown lack of integrity under Conduct Rule 1.[1427]

Carlos Abarca received a fine of £116,600 for violating Senior Manager Conduct Rule 2. This violation occurred because he failed to guarantee that TSB effectively managed and oversaw its outsourcing of the IT migration programme.[1428]

The Financial Conduct Authority (FCA) imposed a prohibition and disqualification on Richard Adam in October 2023, who served as the group finance director of Carillion plc from 2007 to 2016, for a period of 12 and a half years. The individual in question deliberately manipulated the company into depending on inaccurate and deceptive financial data to create the company's consolidated financial statements for 2015 and 2016, as well as to report the progress of significant building projects. The auditors were not made aware of the true extent of the contracts' degradation.[1429]

Richard Adam was disqualified after Zafar Khan, another former finance chief of Carillion, was banned from being a company director for eleven years in early July 2023. Khan faced allegations of deceiving the markets regarding Carillion's financial performance and position. Additionally, he approved a dividend payment of £54.5m to shareholders in June 2017, which would have been deemed inappropriate if the

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[1427] Paul Clarke, Ex-Barclays CEO Jes Staley banned by FCA for misleading statements on Jeffrey Epstein relationship *Financial News* (London,12 October 2023) https://www.fnlondon.com/articles/jes-staley-fca-ban-barclays-20231012 accessed 12 October 2023.

[1428]Bank of England, 'Final Notice' (13 April 2023) available from <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/regulatory-action/final-notice-from-pra-to-former-tsb-bank-plc-cio.pdf> accessed 5 June 2023.

[1429] https://witansolicitors.co.uk/carillion-director-disqualification/ accessed 12 September 2023.

company's financial statements had accurately reflected its financial position.[1430] Lastly but not least, Richard Howson, who served as the CEO of Carillion Plc until 2017, was also banned from operating as a director for a period of eight years in 2023. Mr. Howson was held accountable for a sequence of accounting misrepresentations throughout his term. Mr. Howson was responsible for the inaccurate reporting and accounting of payments from Wipro, which resulted in a violation of several international accounting standards (IAS) and the IFRS framework for financial reporting. Consequently, Carillion experienced substantial exaggerations of its profit and underestimations of its net debt. He neglected to bring these inconsistencies to the attention of the company's auditors. [1431]

This thesis reasons and argues that the SMCR improves the quality of governance in institutions, as financial and non-financial misconduct are now on an equal footing. The willingness of the SMCR and FCA to extend the spectrum of fitness to deal with the behaviour of people even outside of their jobs demonstrates its efficacy. The SMCR seeks to strengthen the ability of regulators to hold the individual, not just the firm, to account, thereby bringing a complete change of culture within financial services.

This thesis argues that the SMCR improves accountability and enhances regulatory liability for senior managers more effectively than the company law`s directors' duties. This was revealed aftermath of the worldwide economic collapse in 2008, which saw the likes of RBS and Northern Rock collapse, but no director was held accountable. Smith and Walter[1432] had serious concerns in the years before the worldwide financial catastrophe about the need to reform director liability to enhance the personal liability of directors. The ability of the SMCR to extend liability not only to financial misconduct but

[1430] Ibid.

[1431] Former Carillion CEO disqualified for eight years https://www.scottishfinancialnews.com/articles/former-carillion-ceo-disqualified-for-eight-years accessed 5 October 2023.

[1432] Smith and Walter (n 363).

also nonfinancial misconduct, under the breach of the Conduct Rules, makes it even more effective in promoting accountability.

7.4 Critical analysis of the SMCR

This section will critically analyse the progress and impact the SMCR has since it was rolled out eight years ago, in 2016. The SMCR was created because of the 2008 economic crisis with one goal of strengthening responsibility and accountability in the financial industry sector.[1433] It was primarily designed as a tool for enforcing the law. A framework for senior executives to be held accountable for system failures and serious misbehaviour that happened while they were in charge.[1434] However, eight years on there`s debate whether the SMCR has had an impact on the financial sector as was originally envisioned. The SMCR`s agenda was to address and improve the root cause of the collapse of companies in the financial sector. Hence areas of accountability, certification, conduct rules, and the impact on culture were of great concern.

7.5 Accountability

The SMCR identified accountability as one of the problems in the financial sector and implemented personal accountability. Personal accountability is emphasised for all employees, senior managers now have a legal obligation under SMCR to take great concern to prevent rule violations. Individual responsibilities are described separately in the task descriptions.[1435] For before SMCR came into force, the financial crisis of 2008-2009 was dubbed 'an accountability firewall'.[1436] The Parliamentary Commission briefing highlighted two hindrances to accountability.[1437]First, it was revealed that directors were using ignorance as a justification to avoid accountability. These directors understood they would not be penalised for what they couldn't see, so they quickly put on their

[1433] David Rundle, The SMCR, Five Years On (8 April 2021) https://www.wilmerhale.com/en/insights/blogs/wilmerhale-w-i-r-e-uk/20210408-the-smcr-five-years accessed 8 April 2021.
[1434] Ibid.
[1435] FCA, FIT Handbook (FCA 2020).
[1436]PCBS (n 384).
[1437] Ibid.

blindfolds.[1438] This method worked, as just a few directors were held legally responsible for their acts. Second, the PCBS discovered that directors regularly employed ignorance to their failures, arguing that the offence was committed as a group decision to avoid accountability. Now under SMCR individuals cannot escape personal liability. The SMCR aims to strengthen the ability of regulators to hold the individual (and not just the firm) accountable which is the complete transformation of the culture of the firm.

7.6 Certification

Before the SMCR came into force, there were alarming numbers of board failures[1439] (not to mention bank failures). A history of inept directors who do not have even the bare minimum of skills required for their positions. For example, during the collapse of Northern Rock, it was reported that its former chairman Matt Ridley was not a qualified banker, but a zoologist. In another case of Carillion`s collapse, it was reported that Zafar Khan, the finance director was an unqualified and incompetent accountant.[1440] According to a report[1441] produced after HBOS Group's demise, the board of directors lacked knowledge and qualifications. The board's NEDs lacked sufficient banking expertise and understanding. Out of twelve non-executive directors, only one had banking experience.[1442] With the SMCR in force, competence and capability is the main requirement before an individual assumes office.[1443] The introduction of SMCR has deterred unfit individuals to occupy the position of directorship. We now have qualified and proper individuals in the office who goes through annual re-certification of fitness and propriety. Now the SMCR is slightly better than used to be in the financial sector, because

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[1438] Ibid.

[1439] Tomasic Roman, ‘The failure of corporate governance and the limits of law: British banks and the global financial crisis,’ *Corporate governance and the global financial crisis*: international perspectives. (Cambridge University Press 2011), pp. 50-74.

[1440] Engineering News Record, ‘When Carillion’s Leaders Missed the Biggest Risk of All’ (28 February 2018). https://www.enr.com/articles/44058-when-carillions-leaders-missed-the-biggest-risk-of-all accessed 28 February 2018.

[1441] Bank of England, ‘Prudential Regulation Authority: The Failure of HBOS plc (HBOS), A Report by the Financial Conduct Authority and Prudential Regulation Authority’ (November 2015) https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/publication/hbos-complete-report accessed November 2015.

[1442] ibid.

[1443] FCA, FIT Handbook (FCA 2020) 2.2.1.

without the SMCR we had directors who were not qualified, and not up to the job and now there is a far more detailed procedure for recruiting directors and holding them accountable.

7.7 Conduct Rules

The SMCR has brought total individual responsibility and accountability to the position of office.[1444] It is now mandatory for anyone in the position of senior management to be fit and proper under the SMCR.[1445] Honesty, integrity, and reputation are used to determine whether someone is fit and proper. Before SMCR came into force, issues of transparency were a problem in the selection and appointment of directors in the office and effective deterrence mechanism. Hence, problems of honesty, integrity, and credibility were a problem among company directors. Hoo Yu's research found approximately 800 of the 6,700 presently disqualified directors were still serving as directors.[1446] In addition, over 500 directors have deceptively changed their identity credentials to start in a new role.[1447]

As part of the SMCR vetting procedure, organisations are required to look for criminal records and contact past employers who have employed that candidate.[1448] The firm will consider the offence`s nature, the circumstances surrounding it, and its relevance to the proposed function.[1449] The firm will also consider the amount of time that has passed when the crime was done, as well as proof of the person's recovery.[1450] It is now the

[1444] FCA, FIT Handbook (FCA 2020) 1.3.1B.
[1445] Walker Morris, 'Fitness and Propriety of Senior Managers and Certified Person' (14 November 2019) https://www.walkermorris.co.uk/publications/extension-of-the-senior-managers-and-certification-regime-part-1/fitness-and-propriety-of-senior-managers-and-certified-persons/ accessed 14 November 2019.

[1446] HooYu, 'The Chameleons in Companies House' (*Hooyu.com 23 May 2019). https://thefintechtimes.com/chameleon-fraudsters/* accessed 23 May 2019.
[1447] ibid.
[1448] Clifford Change: Non-Financial Misconduct in Financial Services Regulation- Where do we Stand? December 2020.
https://www.cliffordchance.com/content/dam/cliffordchance/briefings/2020/12/non-financial-misconduct-in-financial-services-regulation-where-do-we-stand.pdf accessed December 2020.
[1449] Ibid.
[1450] Ibid.

company`s responsibility to have fit and proper employees under SMCR. A company can determine the conduct of its directors through criminal convictions. For example, the case of Jonathan Burrows, a director of a firm that cheated a train company out of £43,000 in out-of-court settlements. His conduct revealed a lack of honesty and integrity for the fit and proper test under FCA, and he was terminated from his post.[1451] The SMCR's readiness to broaden the scope of fitness and propriety to include behaviour outside of the workplace proves its effectiveness. A director`s conduct is now a cause of concern to him/herself in and out of office under the SMCR.

7.8 The impact on culture

The SMCR has broadened its influence on misconduct oversight to include concerns such as lack of diversity and inclusion, as well as non-financial misbehaviour such as discrimination, harassment, victimisation, and bullying.[1452] These cultural values serve as a litmus test for determining whether someone is appropriate for the job. To avoid malpractice, these values are critical in any firm. Groupthink is significantly less likely in companies with diverse workforces and management where everyone feels comfortable raising concerns.[1453] Under the SMCR, culture is now employed as an instrument of change to broaden the oversight to include non-financial issues, removing real barriers to strong corporate cultures. [1454] Similarly, the FCA cited non-financial wrongdoing as

[1451] Walker Morris (n 423).

[1452] FCA, Non-financial Misconduct in Wholesale General Insurance Firms, Dear CEO Letter (6 January 2020) https://www.fca.org.uk/publication/correspondence/dear-ceo-letter-non-financial-misconduct-wholesale-general-insurance-firms.pdf accessed 6 January 2020.

[1453] Akshaya Kamalnath, "Gender Diversity as the Antidote to 'Groupthink' on Corporate Boards" (2017) 22(1) Deakin Law Review 67,85.

[1454] Anat Keller and Andreas Kokkinis, The Senior Managers and Certification Regime in Financial Firms: An Organisational Culture Analysis (April 4, 2022). Journal of Corporate Law Studies 2022, Available at SSRN: https://ssrn.com/abstract=4083001 or http://dx.doi.org/10.2139/ssrn.4083001 accessed 4 April 2022.

important core causes of firm collapse in the Dear CEO letter.[1455] It stand in the way of developing a culture where one can express him/herself, where the greatest talent is maintained and where better risk judgments are made.[1456] However, the weakness of SMCR has been relatively little enforcement.

Only 34 investigations were conducted between 2016 and 2020, with only 23 enforcement actions taken.[1457] In most cases, enforcement action has taken the form of a ban on acting as a senior manager in the regulatory sector.[1458] In 2018, only one case resulted in a monetary punishment being imposed on a top executive (Barclays CEO James Staley).[1459] Commentators[1460] have questioned the SMCR's effectiveness due to a lack of enforcement, because that was its primary goal for replacing the Approved Persons Regime which was previously scarce.[1461]

To date, most enforcement proceedings have been based on senior executives' direct personal misbehaviour. Based on their professional or personal capacity, rather than their inability to supervise and prevent others' wrongdoing, which is a crucial feature of the SMCR.[1462] A good example is, James Staley, was punished for failing to follow Barclay's whistle-blower procedures after receiving a letter that revealed difficulties that implicated

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[1455] FCA: 'Dear CEO' letter to Insurance Firms, 6 January 2020 https://www.fca.org.uk/publication/correspondence/dear-ceo-letter-non-financial-misconduct-wholesale-general-insurance-firms.pdf accessed 6 January 2022.
[1456] ibid

[1457] PRA, Evaluation of the Senior Managers and Certification Regime, December 2020.

[1458] Anat Keller & Andreas Kokkinis (n 432).
[1459] PRA, (n 435).
[1460]Rachel Mortimer, Warning Sounded Over Lack of SMCR Teeth (14 December 2020) https://www.ftadviser.com/regulation/2020/12/14/warning-sounded-over-lack-of-smcr-mettle/ accessed 14 December 2020.
[1461] PCBS (n 384).
[1462] FCA, FIT Handbook (FCA 2020).

him.[1463] It may be argued that the regulator's goal of improving financial business culture based on non-financial misbehaviour, enforcement cases[1464] does not show any signs of hope. Some commentators, such as Adam Brown and others,[1465] argue that non-financial misconduct is easier to pursue than financial misconduct. For that reason, the danger is that the SMCR will target softer areas than the fundamental problem of financial misconduct. We need to see more of the FCA enforcing such crimes, and offences in relation to financial conduct. There are few cases up to date. However, in principle, non-financial misbehaviour enforcement under the SMCR might be a formidable weapon for intervening and sanctioning failure of management to promote a sound culture. Hence this thesis calls for the SMCR to be expanded to the non-financial sector.

7.9 Extending the Senior Managers and Certificate Regime to Non-Financial Companies as a Means of Enforcement

According to the evidence provided so far, this thesis has shown that the conduct rules, certificate regime, and regulatory references of the SMCR are effective mechanisms for promoting individual responsibility and personal accountability. The analysis offers compelling evidence supporting the implementation of the Senior Managers and Certification Regime (SMCR) to non-financial sectors, highlighting its practical efficacy in promoting accountability within organisations.

This thesis argues that the SMCR should be extended to non-financial institutions to promote individual accountability throughout all UK companies. For instance, some

[1463] FCA, Final Notice to Mr James Edward Staley (11 May 2018).

https://www.fca.org.uk/publication/final-notices/mr-james-edward-staley-2018.pdf

accessed 11 May 2018.

[1464] FCA Final Notice to Frank Cochran (4 November 2020); FCA Final Notice to Mark Horsey (4 November 2020) and FCA Final Notice to Jon Frensham (4 November 2020). https://www.fca.org.uk/news/press-releases/fca-bans-three-individuals-working-financial-services-industry-non-financial-misconduct accessed (5 November 2020).

[1465] Adam Brown and others, 'Turning Tides in FCA SMCR Enforcement: Easier Targets, Non-Financial Misconduct, Changing Priorities' (26 November 2019). https://www.jdsupra.com/legalnews/turning-tides-in-fca-smcr-enforcement-31201/ accessed 26 November 2019.

directors were using ignorance as an excuse.[1466] Directors used their ignorance as a shield to avoid taking responsibility. These directors quickly put on their blindfolds, knowing that they would not be blamed for what they could not see.[1467] Some directors used collective responsibility defence, arguing that everyone was involved in deciding to avert liability.[1468] The extension of the SMCR to non-financial institutions should see a rise in more director probes and successful directors` arrests who have long been evading liability for company collapse. Furthermore, the thesis argues that the extension of the SMCR will also have an impact on small firms. When small enterprises are included in the regime the likelihood of more investigations and enforcement is higher, since it would be simpler to trace decisions done by a smaller firm than a larger one with a complex structure.

However, it could be argued that the application of the SMRC regime to smaller firms would be challenging in terms of assessing and certifying fitness and propriety because of the workload involved. Nevertheless, the FCA indicated that the SMRC regime is a prescriptive guide, leading the way in which firms should assess fitness and propriety.[1469] The FCA believes that firms should decide the best way to conduct their internal employee assessments. The FCA promotes the SMRC as versatile enough to support a variety of business models.[1470]

This thesis argues that the SMRC improves the quality of governance in institutions by placing deterrence as its main objective. Fines and punishments serve as deterrents to wrongdoing. Penalising incompetent conduct promotes trust within institutions by removing unfit and improper directors from occupying boards. The fundamental premise of the SMCR is to promote accountability and responsibility. An individual director must be accountable for the actions under their supervision.[1471] The SMCR establishes the

[1466] PCBS (n 384).
[1467] ibid.
[1468] ibid.
[1469] FSMA (n 385).
[1470] ibid.
[1471] FCA, 'Financial Conduct Authority Investigation Statements in Relation to RBS GRG' (*Financial Conduct Authority*, 2018) https://www.fca.org.uk/news/press-releases/statement-further-investigative-steps-relation-rbs-grg accessed 31 July 2018.

roles and responsibilities of senior managers in approved businesses with deterrence as the primary goal. It is dedicated to achieving equal and just results in the aftermath of wrongdoing by keeping the offender responsible.[1472] Under the SMCR, fines and punishments are used to discourage wrongdoing, as illustrated in the table below.

Year	Fines (£ million)	Number of fines	Prohibitions
2011/12	76.4	59	47
2012/13	423.2	51	45
2013/14	425	46	25
2014/15	1,409	43	26
2015/16	884.6	34	24
2016/17	181	15	23
2017/18	66.9	16	19
2018/19	227.3	16	20

Source: Christopher Hodges, 'Science-Based Regulation in Financial Services: From Deterrence to Culture' OLS Research Paper No 19/2020 SSRN: https://ssrn.com/abstract=3590176 accessed 1 May 2020. [1473]

The FCA imposes heavy fines, as shown above.[1474] A total of 263.5 final notices were issued – I6 financial penalties totalling £227.3 million against firms and 20 against individuals. In recent years, however, the number of penalties and restrictions has decreased. The overall number of fines levied peaked and tripled in 2014/15 compared to the previous year and had a sharp rise in 2018/19 compared to the year before. The amount of fine levied increased, because of ongoing wrongdoing perceived to include serious behaviour. Sanctions are crucial for fostering the proper banking culture, but they won't guarantee compliance if there are greater incentives to violate the rules.[1475]

[1472] FCA, 'FCA Mission: Our Approach to Enforcement' (*Financial Conduct Authority,* 2018) https://www.fca.org.uk/publications/corporate-documents/our-approach-enforcement accessed 21 March 2018.
[1473] Christopher Hodges, 'Science-Based Regulation in Financial Services: From Deterrence to Culture' OLS Research Paper No 19/2020 SSRN: https://ssrn.com/abstract=3590176 accessed 1 May 2020.
[1474] ibid.
[1475]Ibid.

Looking at the aforementioned challenges with enforcement, it might be reasonable for people who have a propensity for wrongdoing or excessive risk-taking to think that the FCA won't go after them.[1476] The fact that the regulator would pursue businesses over people for practical reasons is a contributing factor in the problem.

When a regulatory action is taken against them, people take it personally and realise how important it is to their livelihood and careers. As a result, they are more willing to fight back than a bank with a strong public reputation would be. Therefore, for the SMCR to be successful, the FCA must remove this barrier. Its effectiveness will unavoidably suffer if enforcement isn't maintained since people will start to take it less seriously. The FCA must uphold the accountability message with greater vigour and consistency on behalf of the SMCR.[1477] The SMCR was meant to address the ineffectiveness of its predecessor the FSA, which had failed to 'penetrate an accountability firewall of collective responsibility'.[1478]

It is fair to wonder whether the Parliamentary Commission's critiques of the previous framework have been answered.[1479] It was supposed to be a system that would not only recognise the person who was responsible for a failure but also the failure itself, enabling the regulator to act effectively.[1480] Nevertheless, it could be fair to say the SMCR is making progress by that measurement, looking at past cases of Jes Staley, the former CEO of Barclays in 2023, was banned by the U.K.'s financial regulator from assuming high-ranking positions in the financial services industry and fined £2 million[1481], Carlos Abarca received a fine of £116,600 for violating Senior Manager Conduct Rule 2.[1482] The Financial Conduct Authority (FCA) imposed a prohibition and disqualification on

[1476] Ibid.
[1477] Ibid.

[1478] PCBS (n 384).
[1479] PCBS (n 384).
[1480] ibid.
[1481] Clarke (n 1427).
[1482] Bank of England (n 1428).

Carillion`s former directors Richard Adam respectively 12 and half years, Zafar Khan 11 years and Richard Howson 8 years in 2023.[1483]

However, the tables in the preceding section clearly demonstrate that the sanctions imposed on persons for violating the SM&CR are often of a minor magnitude. Hence, it is advisable for the regulators of the SM&CR regime to augment both the frequency of enforcement proceedings against top managers implicated in financial misconduct and the magnitude of fines imposed upon establishing such wrongdoing. By augmenting the sanctions enforced under the SM&CR, the disincentive to engage in financial misconduct will be heightened, thereby enhancing the integrity of the financial services industry through a reduction in such misconduct. However, it can be argued that the SMCR improves the rigor with which it is implemented. The SMCR is a step forward, and it has proven to be successful in promoting a higher degree of responsibility and transparency in the industry.

7.10 Past Assessments of the Regime

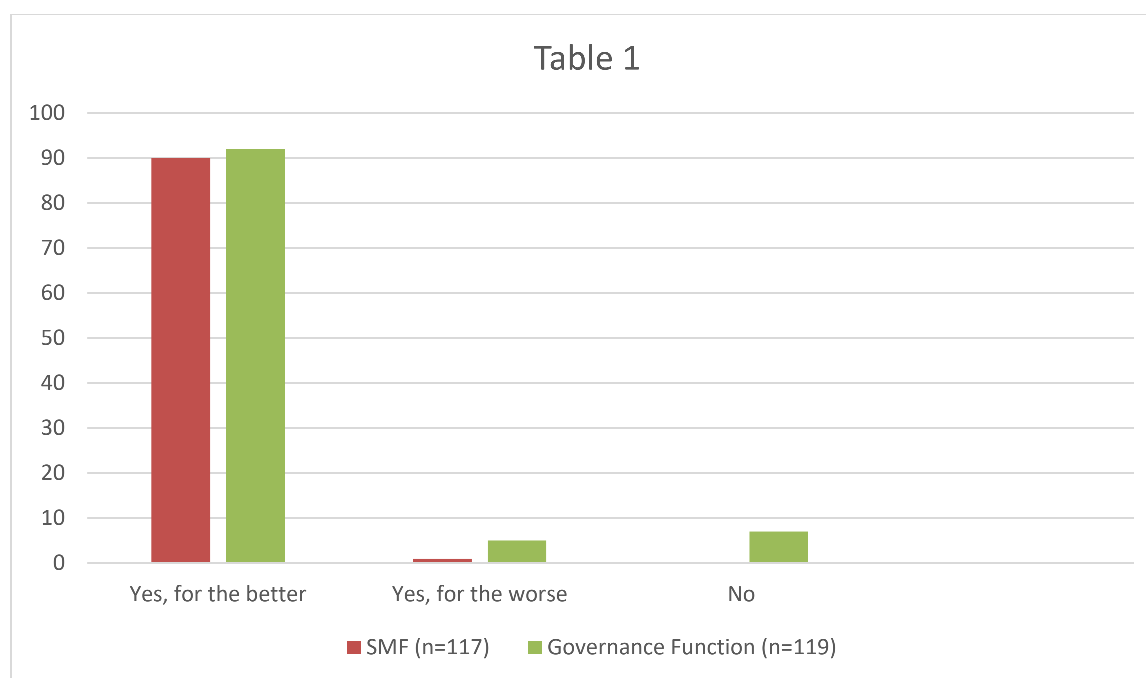
The SMCR promotes values, including honesty, integrity and reputation and the regulatory references necessary for a senior position, and the application of the SMCR to non-financial sectors proves to be the most effective way. This is supported by recent credible past assessment reports. This section will make a past assessment of the SM&CR and draw conclusions based on credible reports whether the system has achieved its objectives. The results from the PRA evaluation in 2020, HM Treasury's Call for Evidence in March 2023, and The Bank of England's DP1/23- Review of the Senior Managers and Certification Regime 2023, all show strong support for the aims of the SMCR.

According to findings results,[1484] the SMCR's implementation has ensured greater accountability on individuals within the financial institution. According to the poll findings of the financial institutions, 94 percent of management and 96 percent of the financial

[1483] (n 1355).

[1484] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/report/evaluation-of-smcr-2020.pdf accessed December 2020.

businesses believed the SMCR changed company behaviour for better.[1485] As shown below table 1.



Source: Bank of England 2020.[1486]

Before SMCR came into force, issues of transparency were a problem in the selection and appointment of directors in the office and effective deterrence mechanism, hence problems of honesty, integrity, and credibility were a problem among company directors.[1487] It is now the company`s responsibility to have fit and proper employees under SMCR. A company can determine the conduct of its directors through criminal convictions. A director`s conduct is now a cause of concern to him/herself in and out of office under the SMCR. Moreover, under the certification regime, with the SMCR in force, competence and capability is the main requirement before an individual assumes office.[1488] The

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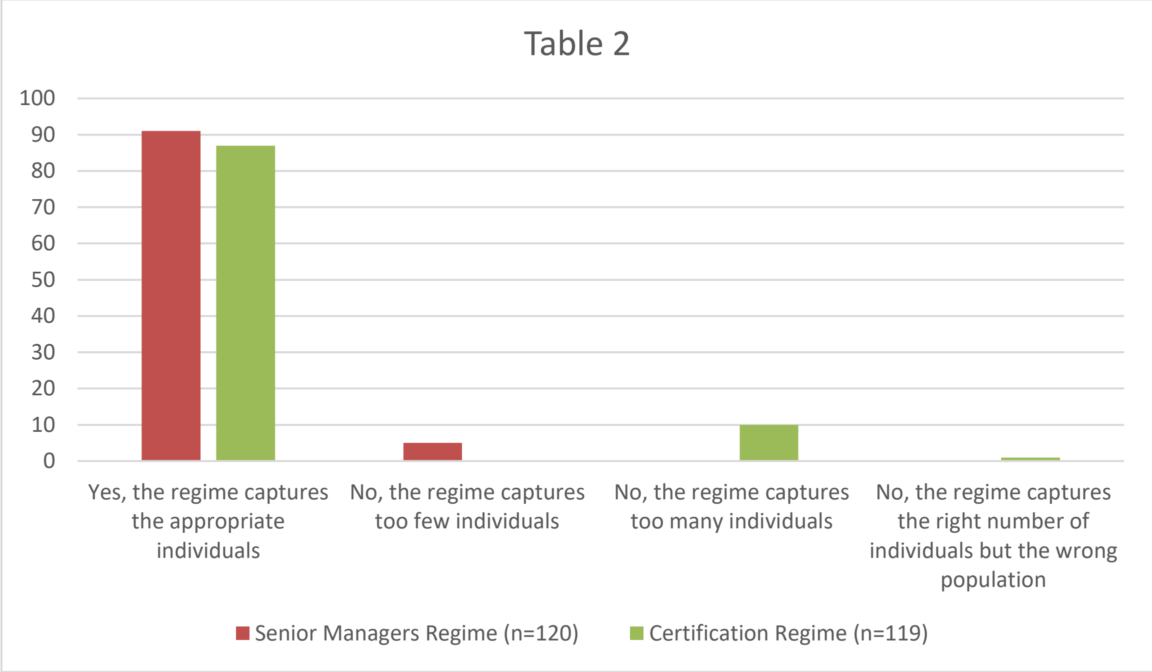
[1485] ibid

[1486] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/report/evaluation-of-smcr-2020.pdf accessed December 2020.

[1487] ibid

[1488] FCA, FIT Handbook (FCA 2020) 2.2.1

introduction of the SMCR has deterred unfit individuals to occupy the position of directorship. We now have qualified and proper individuals in the office who goes through annual re-certification of fitness and propriety. In accordance with the findings,[1489] the SMCR and CR were viewed as adequately capturing the right people for financial organisation, at 95 percent and 89 percent, respectively as shown at the table 2 below:



Source: Bank of England (2020) [1490]

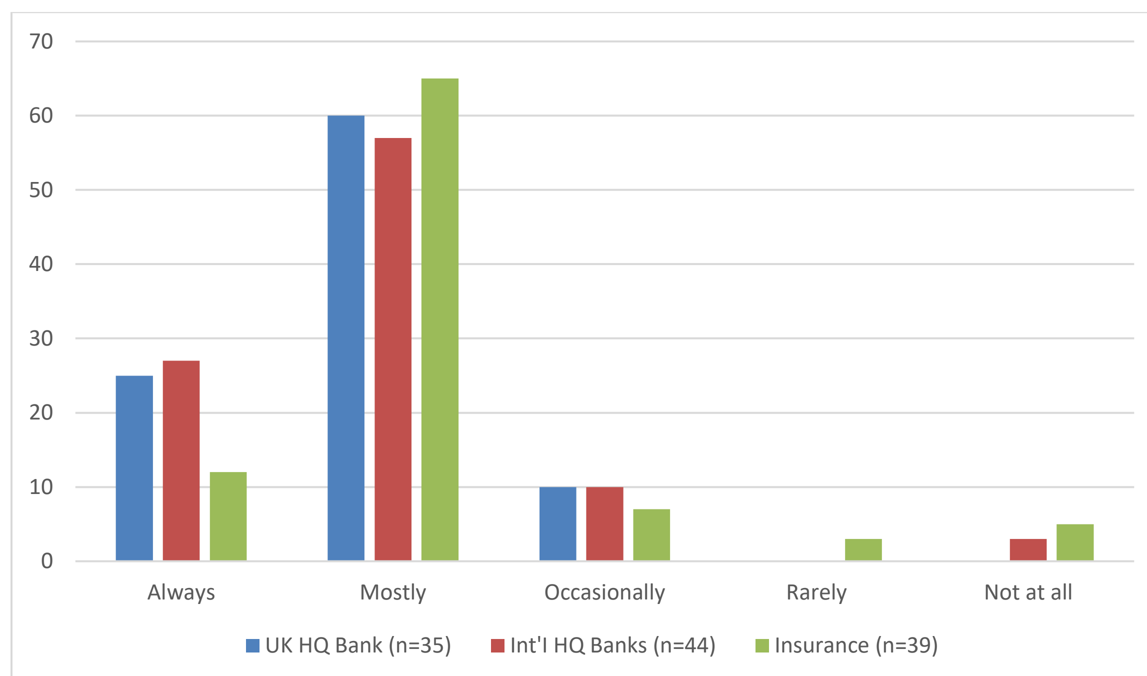
Under the SMCR, companies are required to request regulatory references from candidates when hiring for specific senior jobs.[1491] It is the goal of regulatory references to assist employers in making knowledgeable hiring decisions. An individual`s good practice is demonstrated through regulatory references. It`s a widely accepted method of due diligence. Consequently, it is a better method of strengthening personal accountability

1489 https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/report/evaluation-of-smcr-2020.pdf accessed December 2020.

1490 ibid

1491 https://www.handbook.fca.org.uk/handbook/SYSC/22.pdf / Accessed 22 August 2022.

in directors. According to survey data,[1492] a sizable number of financial organisations, 85% thought the regulatory references were of adequate calibre to support their judgments about a candidate's eligibility. As shown below table 3, despite considerable differences in how different financial organisations operate.



Source: Bank of England (2020).[1493]

The previous annual surveys conducted by the Financial Services Culture Board, gathered employees' impressions of their firms' organisational cultures, offering evidence of enhanced responsibility inside the firms. The percentage of employees who believed that senior managers in their organisation assumed accountability, particularly in times of failure, increased from 58% in 2016 to 68% in2022.[1494]

Furthermore, the regulatory references have consistently received generally positive comments on the system from various enterprises and stakeholders over the years. Many

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[1492] ibid

[1493] Ibid.

[1494] Bank of England's DP1/23- Review of the Senior Managers and Certification Regime 2023 https://www.gov.uk/government/calls-for-evidence/senior-managers-certification-regime-a-call-for-evidence.

individuals perceive significant benefits in the regime's ability to enhance behaviour, administration, and personal accountability, hence facilitating more streamlined company operations. Specifically, companies have stressed the significance of the system amid the operational upheaval caused by the Covid-19 pandemic and have underscored how the SM&CR has aided them in handling the disruption and guaranteeing business continuity.[1495]

In general, the government received feedback from stakeholders indicating that the overall objectives of the regime are acknowledged and comprehended. In addition to comprehending the wider context surrounding the implementation of the regime, companies have also indicated that the regime has resulted in enhanced transparency for their internal frameworks and obligations, hence enhancing their management practices and yielding favourable results for both the companies and their clients.[1496]

However, the FCA and PRA acknowledged that certain stakeholders have previously expressed concerns over the time it takes to secure regulatory approval for Senior Manager appointments.[1497] Notable enhancements have already been implemented, resulting in decreased delays at both the FCA and the PRA.[1498] There has been a notable decrease in the total number of pending applications, as well as those that have been pending for over three months.[1499] The regulators will engage in additional efforts to remedy this issue in conjunction with the ongoing review.

However, the FCA flagged other issues, the FCA commented that firms sometimes fail to adequately customise training on the Conduct Rules to align with specific job

[1495] Ibid.

[1496] HM Treasury's Call for Evidence in March 2023 https://www.bankofengland.co.uk/prudential-regulation/publication/2023/march/review-of-the-senior-managers-and-certification-regime.

[1497] Bank of England's DP1/23 (n 1428).

[1498] Ibid.

[1499] Ibid.

responsibilities.[1500] The FCA also found little evidence of firms effectively aligning the Conduct Rules with their own principles, and many firms were unable to articulate the specific indicators of a breach of conduct within their business setting. Through the regulatory referrals' procedure, firms have discovered that other firms are not consistently registering breaches of the Conduct Rules. Therefore, companies should seize this chance to assess their execution (or intended execution) of the Conduct Rules, specifically their training initiatives for employees subject to the Conduct Rules but not covered by the Senior Managers Regime or the Certification Regime. It is imperative for companies to ensure that this training is suitably customised and provides personnel with a comprehensive comprehension of what constitutes "excellent" and "poor" performance within the framework of their specific job.

The FCA acknowledges that firms generally have strong systems in place to supervise their certified staff, but it has observed a lack of major modifications to performance evaluation procedures in relation to the Certification Regime.[1501] The majority of organisations were unable to provide evidence of the efficacy of their assessment methodology, utilisation of subjective evaluation, or methods employed to maintain uniformity across the entire population. An example provided by the FCA is that enterprises are not necessarily utilising the Certification Regime to assess the managerial competence of certified staff. Therefore, companies should reassess their evaluation procedures and determine if they encourage a strong and efficient approach. Companies should specifically focus on how they can guarantee a consistent method for certification, and that evaluations genuinely consider the essential talents and qualities needed for a certain position. However, from the past assessment analysis above, this thesis argues that the SMCR`s conduct rules, certificate regime and regulatory references is proven effective instrument of promoting individual responsibility and personal accountability which lead to collective responsibility and has

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[1500] FCA Warns of 'Significant Weaknesses' in Firms' Implementation of the Conduct Rules 05 August 2019. https://www.latham.london/2019/08/fca-warns-of-significant-weaknesses-in-firms-implementation-of-the-conduct-rules. Accessed 05 August 2019.
[1501] Ibid.

worked so far. Therefore, this thesis argues that the SMCR should be extended to all non-financial sectors in the UK, as an effective way to increase director accountability and transparency as proving effective within financial institutions.

7.11 Embedding the SMCR to All Companies Across Sectors

This chapter looked at why the SMCR was introduced, to address the accountability 'fire wall' in bank directors. This chapter so far has showcased why the SMCR is effective and why it should be extended to the non-financial sector. The chapter has painted a picture with past assessment reports to support the success of the SMCR. This section will now try to format how the SMCR can be embedded to large and small companies for effectiveness.

Corporate disasters like those of Carillion, BHS, and Tesco, to name a few, have not been stopped by corporate governance mechanisms. However, despite these corporate tragedies, greater expectations towards business boards are growing. Due to their participation in the failure of organisations, calls have been made to eliminate non-executive directors as they are deemed to be unfit for their intended purpose.[1502] Under UK law, directors—executive and nonexecutive—have the same obligation.[1503] In terms of the legislation, there is no distinction between executives and non-executives in the UK.

The judiciary has acknowledged that the duties of non-executive directors encompass supervising executive management and preserving the independence of judgement.[1504] Undoubtedly, regardless of their designation, these directors have failed to prevent multiple corporate collapses and are unlikely to prevent their recurrence. The weaknesses of the board to instil the proper culture across the firm have been blamed for the demise

[1502] Ethical Boardroom, 15 February 2019. https://ethicalboardroom.com/time-to-abolish-non-executive-directors/ accessed 15 February 2019.
[1503] Companies Act 2006, Part 10 s278.
[1504] Ethical Boardroom (n 982).

of Carillion, BHS, and Tesco.[1505] Allegations of ineffective board oversight have occurred in several situations. Occasionally because to a lack of knowledge.

The collapse of Carillion has been characterised as the result of a systemic breakdown of company accountability. The board of Carillion was held accountable for the business's failure. Weak corporate governance was the primary reason that BHS entered administration in 2016, according to a report by a parliamentary committee. A systemic breakdown of corporate accountability was also reflected by the FCA in the TESCO scandal of 2014.[1506] Which saw a high level of falsifying accounts by the board. The aforementioned case studies show the shortcomings of the current legal framework/mechanisms, including corporate governance standards, in spite of their concerns with accountability and transparency.[1507] To pre-empt and avoid additional pressure on the government to impose prescriptive regulatory responsibilities linked to directorship, the Institute of Directors (IoDs) has specifically released a paper on a voluntary code of conduct for directors.[1508] The paper calls for increased accountability of business to society at large. In the paper, a strident argument is made in favour of a written code of conduct that governs the conduct of directors as a profession. This argument is in line with the thesis proposal of expanding the SMCR to all the companies in UK for effective accountability.

The SMCR has a code of conduct.[1509] The Conduct Rules enforce total individual responsibility and accountability in the position of the office. It promotes good culture in companies. It is mandatory for anyone in the position of senior management to be fit and proper under the SMCR.[1510] A code of conduct for directors, which may significantly contribute to fostering trust and respect among UK businesses, is seen by the Institute of

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[1505] Ibid.

[1506] Ibid.

[1507] For instance, the UK CG Code 2016 and the 2018 Combined Code, which included certain revisions regarding directors' discharge of their responsibility under S. 172 (1) CA 2006, both declared that transparency and accountability were the fundamental principles of good CG.

[1508] A Voluntary Code of Directors: A proposal for the UK government, June 2022.

[1509] FCA, *FIT Handbook* (FCA 2020) 1.3.1B.

[1510] Ibid.

Directors as the crucial component missing from the current corporate structure.[1511] The IoDs study recommends that directors be subject to a code of conduct, either voluntarily or on a required basis.[1512] It's crucial to understand that a code of conduct for directors differs from the UK corporate governance code and the broad legal obligations that directors have under the Companies Act 2006.

A governance code outlines best practices for the make-up, composition, and overall operation of the board of directors.[1513] Furthermore, governance standards are sometimes only applicable to large, publicly traded firms and are not primarily focused on articulating high-level principles of individual conduct and behaviour that individual directors should exhibit in their conduct as corporate leaders.[1514] On the other hand, the UK Companies Act 2006 does not address the intricacies of how directors should behave. It may come as a surprise that directors lack a written code of conduct that governs their behaviour as a professional organisation given their wide range of duties.[1515] A similar code of behaviour is typical in other professions, such as law, medicine, and accounting and comes with consequences upon breach. One such consequence involves revoking the legal privilege to work in the relevant field. The conduct of directors holds equal significance for society as the conduct of doctors, lawyers, accountants, and other professionals. Therefore, we assert that a crucial component that is absent from the corporate framework is a code of conduct for directors, which may have a substantial impact on fostering trust and respect within the UK corporate community.[1516]

Nonetheless, the Companies Act of 2006's general legal duties and other regulatory requirements serve as the main means of regulating the conduct of UK directors.[1517]

[1511] A Voluntary Code of Directors (n 1508).
[1512] Ibid.
[1513] Ibid.
[1514] Ibid.
[1515] A Voluntary Code of Directors (n 1508).
[1516] Ibid.
[1517] Ibid.

Consequently, a code of conduct would be complementary to the framework of governance codes already in place and the fiduciary obligations of directors.

7.12 Embedding the SMCR to Large Companies

The SMCR can be integrated so that it regulates both the biggest and smallest businesses across all industries, whether they are publicly traded. The Wates Corporate Governance Code Principles is a formal code that is applicable to large private businesses (more than 2000 people, £200 million in annual revenue, and a balance sheet exceeding £2 billion).[1518] The Companies (Miscellaneous Reporting Regulations 2018) apply to these companies. The requirements mandate that privately held businesses with sizeable scale of employees publish their CG arrangements in their directors' reports and on their websites, as well as whether they adhere to a formal code like the Wates CG Principles. The Wates CG, regarding directors` responsibilities state clearly that, the board and every director should understand exactly what they are responsible for and who is responsible for what.[1519]

The SMCR can be embedded effectively in large companies across all sectors. Under the UK law, directors who are either executive or non-executive have the same obligation. In terms of the legislation, there is no distinction between executive directors and non-executive directors in the UK. The judiciary has recognised that non-executive directors' responsibilities include overseeing executive management and maintaining judgement independence. No matter what they are called, these directors haven't stopped several company failures and probably won't be able to stop them from happening again. Consequently, the SMCR strengthens the link between seniority and accountability in the company, the missing link in the UK Company law and the Corporate Governance Code. Therefore, this thesis calls for a distinction between executive directors and non-executive directors. The SMCR distinguishes clearly and enhances the division of responsibilities for each Senior Management Function manager (SMFs) stating what that person is accountable for. Senior Managers perform one or more Senior Management Functions

[1518] The Wates Corporate Governance Principles for Large Private Companies, December 2018.
[1519] Ibid

(SMFs) positions. The most senior members of the company are those who hold these positions. Some of these are executive positions like chief executive officers and finance directors, while others are oversight positions like chairman of boards and their subcommittees and senior independent directors. There is a clear link between seniority and accountability.

The SMCR divides people into three categories, roughly based on seniority. Senior managers (SMF) are the most senior people in charge of handling business affairs that could have major repercussions for the company. Certified Persons are not senior managers but whose position puts them in a position where they can seriously harm the business or its clients. Every other employee within a company must abide by the conduct rules. Individuals in any of these three categories may face disciplinary action if knowingly complicit in the firm's violation of the regulatory regime. Where the senior manager oversaw the company's operations where the breach happened and lastly where a senior management should have taken action to stop or prevent the breach but did not.

Senior managers are subject to a duty of responsibility, which increases the significance of how they carry out their responsibilities. Therefore, a link with 'seniority' should be established within the corporate governance framework to distinguish clearly and clarify the division of responsibilities between executive directors and non- executive directors. Secondly, there must be a distinction between executive and non-executive directors in the corporate structure to make disciplinary action against specific employees easier and to enhance the behaviour of every employee. Companies should improve their hiring and HR procedures to clearly state that non-executive director roles, such as the chairman, senior independent director, and chairs of the risk, audit, remuneration and nominations committees, must meet the SMCR. All Board Members will get thorough, customised training sessions on SMCR obligations both individually and collectively.

Training requirements can be met in several ways, which rely on factors such as the firm's size, business, and number of staff. [1520]Big corporations may choose to collaborate

[1520] https://www.rbcompliance.co.uk/post/2018/12/04/what-conduct-rules-training-is-required-under-smcr. Accessed 26 August 2024.

with external providers to develop training programs or may find value in customised training programs developed by their own internal training departments. When companies seek to collaborate with external service providers, they could choose a provider that has extensive expertise with the Financial Conduct Authority (FCA) and can equip their workers with comprehensive knowledge about how the Conduct Rules will affect their job.[1521]

7.13 Embedding the SMCR to Small Companies

The conduct in the small and medium-sized enterprise (SME) banking sector has been under constant examination, particularly by the Treasury Committee.[1522] Some prominent instances of inadequate treatment of small and medium-sized enterprise (SME) clients include the mis-selling of hedging products, the mistreatment of SME customers at RBS's Global Restructuring Group (GRG), and the fraudulent activities carried out at HBOS Reading.[1523] During the course of the investigation, the Committee analysed the attributes of the SME banking sector that facilitated the presence of these instances of wrongdoing, and contemplated the potential modifications that may be required to future prevent similar conduct.[1524] In addition, the Committee has undertook rigorous examination of the events that occurred at RBS GRG, as well as the regulatory reaction.[1525]

The activities of RBS and Carillion, which were allegedly engaged in dishonest behaviour, had a highly negative impact on small businesses. The collapse of Carillion brought to light the difficulties many small suppliers face when it comes to payment conditions. The supply chains of Carillion's small company contractors were impacted, with each losing

[1521] Ibid.
[1522] https://publications.parliament.uk/pa/cm201719/cmselect/cmtreasy/805/80505.htm accessed 31 August 2024.
[1523] Ibid.
[1524] Ibid.
[1525] Ibid.

an average of £141,000 in revenue.[1526] Carillion owed its suppliers a total of £2 billion. The great majority of the suppliers were never paid anything at all. Payment terms on suppliers` invoices were stretched over long periods.[1527] According to estimates, the fall of Carillion directly caused 780 small construction companies to declare bankruptcy in the first quarter of 2018.[1528]

It was well documented in the parliamentary report that the way Global Restructuring Group of the Royal Bank of Scotland treated small and medium-sized businesses (SMEs) strongly worried the House, who also observes that there have been broader claims of malpractice in the financial services and allied industries.[1529] According to the House, this demonstrates a systemic failure to adequately protect firms. The House also called for an independent investigation into how financial institutions treat small and medium-sized enterprises (SMEs) and the protections offered to them since it considers that a solution requires the coordinated and cooperative efforts of regulators, Parliament, and the Government.[1530] RBS came under fire for its "extraordinarily aggressive" litigation strategy and for intimidating SMEs.[1531] Ad hoc compensating remedy offered by RBS was compared to a "burglar... [picking] the jury for his trial," which prompted concerns.[1532] Let customers hang themselves," the "horrifying" "Just Hit Budget" memo from GRG served as incriminating proof of the "profoundly sick culture" that existed within that bank.[1533]

[1526] Debbie Abrahams (Labour MP) I Rise to Speak to My New Clause 12. 23 June 2023: House of Commons. https://www.theyworkforyou.com/debates/?id=2023-06-13b.205.0

[1527] Ibid.

[1528] Ibid.

[1529] UK Parliament, RBS Global Restructuring Group and SMEs, Hansard, Volume 634, 18 January 2018. Accessed 18 January 2018. https://hansard.parliament.uk/commons/2018-01-18/debates/662C3FBE-7CAA-47F9-A63A-D01564E21B44/RBSGlobalRestructuringGroupAndSmes.

[1530] Ibid.

[1531] Lexlaw, HM Parliament condemns RBS GRG`s Parasitic Treatment of SMEs, 26 January 2018. https://lexlaw.co.uk/solicitors-london/uk-parliament-condemns-rbs-grg-mistreatment-sme-bank-misconduct-litigation-solicitors-london. Accessed 26 January 2018.

[1532] Ibid.

[1533] Ibid.

Taking advantage of a customer's payment protection insurance to get additional money is one thing, but "deliberately bringing down, crashing, and destroying someone's business... is a league beyond anything we can comprehend" as per the parliamentary report.[1534] This behaviour is clearly unlawful, and it ought to be treated as such. The Parliamentary Committee on its investigation sought for evidence on questions on management capability: How well-funded and readily available are training programmes geared towards SME managers? What else can be done to give high-quality, coordinated support to raise management capability across the UK?[1535]

In the interest of completeness to the question above, how readily available are training programmes geared towards SMEs managers? The answer could be found in the rolling of SMCR to all SMEs. For instance, the sole shareholder/director companies, is one of the business categories that fall within the SMCR guidelines' definition of a Core Firm. A Core Firm is regarded as a company with a single director. Senior Management Functions, Certified Staff, and Conduct Rules are among the Core Firms for which applications are necessary.[1536] An individual director must be deemed "fit and proper" for any applicable SMF role(s) each year.[1537] Any actions the person needs to do to keep their competence up to date should be considered, carried out, and certified. The individual director is solely responsible and liable for the actions taken on behalf of the company.

Any employee of the company who is in any way associated with the operations is subject to the conduct rules. The sole director is accountable for informing and training the necessary personnel on how the conduct rules apply to their positions. Each

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[1534] Ibid.

[1535] Enterprise Nation, MPs to Investigate Unfair Treatment of Small Business by Big Firms Paying late, 7 February 2018. https://www.enterprisenation.com/learn-something/mps-to-investigate-unfair-treatment-of-small-businesses-by-big-firms-paying-late/.

[1536] https://news.ateb-group.co.uk/smcr-sole-traders-and-single-directors. Accessed 6 January 2020.

[1537] Ibid

employee who falls under one of the conduct rules will need to get training on how to comply with the rules and how they affect their daily activities. This calls for developing a customised education and training programme. Alternatively, a director can engage in collaboration with external service providers and select a provider with profound proficiency in the Financial Conduct Authority (FCA) to ensure that their employees possess thorough understanding of how the Conduct Rules will impact their job.[1538] The current fee for external service providers is GBP £25.[1539] It is argued that the sole director should bear the cost of the training. There would unquestionably be resistance to this. Instead of perceiving it as a burden, the fee can be viewed as a strategic investment that enables individuals to operate a firm with greater efficiency and accountability. If individuals lack the financial means to buy this, it raises doubts about how they will finance the company itself. The costs in question would be far lower than the minimum capital needed.

For instance, the director would have to annually evaluate the staff members who fall under certification to verify that they are fit and proper.

However, in the event of the business going bankruptcy because of business failure, it has been a matter of discussion and debate from commentaries[1540] whether the director of the SME is realistically able to pay SMCR fines. Regardless of whether insolvent trade took place, it might not be worthwhile for any party to pursue a director for civil recovery if they have experienced severe personal financial loss as a result of company failure.[1541] A substantial body of evidence suggests that directors of smaller companies are significantly more vulnerable to financial risk from the failure of their businesses, either because they provide personal guarantees for corporate debt or because their

[1538] https://www.rbcompliance.co.uk/post/2018/12/04/what-conduct-rules-training-is-required-under-smcr. Accessed 26 August 2024.

[1539] Ibid.

[1540] Richard Williams, What Can We Expect to Gain from Reforming the Insolvent Trading Remedy? (2015) 78(1) MLR 55, 84.

[1541] Ibid.

companies self-finance their operations by making loans, among other methods.[1542] Therefore, any significant fraction of corporate bankruptcy could result in the failure of civil recovery efforts. However, the incentives to penalise insolvent trading in director disqualification procedures are, of course, unaffected by fluctuations in director wealth.[1543]

Nevertheless, calls for a consultation on the SMCR have been made by the government after bankers labelled the rules `burdensome`.[1544] Andrew Griffith (the then Financial Services Minister) proposed narrowing the scope of banker accountability rules.[1545]This thesis justifies the expansion of the SMCR against these challenges. A sound culture in a corporation provides a locus for oversight and accountability against deviant behaviours at multiple levels of the organisation. The global financial crisis of 2007–2009 was blamed in large part on a culture that encouraged excessive risk-taking and short-termism.[1546] A culture that is driven by purpose must start at the top if it is to succeed. There has never been a case of a significant failure in a corporation that did not have a failure of culture in governance, remuneration, risk management, or tone from the top as one of its core causes.[1547] The SMCR assert that culture originates from leadership. Boards must assume accountability for culture and must exercise supervision demonstrating leadership by actions, aligning with the culture they want to implant. The primary objective of the SMCR is to enhance the level of accountability

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[1542] Ibid.

[1543] Ibid.

[1544] https://www.reuters.com/world/uk/britain-wont-scrap-banker-accountability-system-says-minister-2023-01-10/ accessed 10 January 2023.

[1545] Ibid.

[1546] Anat Keller & Andreas Kokkinis, The senior managers and certification regime in financial firms: an organisational culture analysis, (2022) Journal of Corporate Law Studies, 22:1, 299-334.

[1547] https://whartonbc.co.uk/insights/the-role-of-smcr-in-changing-culture-in-financial-services/ accessed January 25, 2018.

among top-level personnel in organisations, fostering personal responsibility for their conduct, and advance the concepts of good culture and governance.

The Conduct Rules are designed to foster a culture that guarantees firms act with honesty, deliver fair results and safeguard the integrity of business. Organisational culture should incorporate values of positivism, honesty, and trust to ensure that staff members behave responsibly and refrain from using the authority granted to them by their position within the business.

In addition, individual accountability ensures that all members of the organisation comprehend and adhere to the set of conduct norms. This ensures that all individuals comprehend their responsibility in guaranteeing adherence to regulations and that their organisation operates in the utmost benefit of the corporation. For Senior Managers, it entails acknowledging their obligation to maintain the corporate culture and guarantee that they proceed with appropriate expertise, caution, and conscientiousness.

Therefore, this thesis justifies the expansion of the SMCR against these challenges. Effective governance within the company levels is a sign of a strong, purpose-driven culture. The most obvious link between the SMCR and culture is that the latter can work as a catalyst for changing cultural norms, which in turn leads to better behaviour and risk management within companies.[1548]

7.14 Director Education (a model of accountability)

The importance of deterrence is well acknowledged, and it hinges on three key factors: certainty, celerity, and severity.[1549] Certainty refers to the strong likelihood of enforcement action, celerity emphasises the need for a swift response to disobedience, and severity entails imposing large penalties for noncompliance.[1550] Currently, the

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[1548] Ibid.

[1549] Nicholas Ryder, Diana Johnson, Samantha Bourton, Demelza Hall, Review of the senior managers & certification regime, 2023 Journal of Economic Criminology, Volume 2, 2949-7914.

[1550] Ibid.

absence of enforcement measures results in a lack of certainty and promptness in the SM&CR regime. The dependence on financial penalties also leads to a lack of seriousness in the imposed punishments, which hinders deterrence and increases the likelihood of persons engaging in misbehaviour. However, to address the challenges with enforcement the author proposes implementing a mandatory pre-appointment director education[1551] as a model of accountability for company directors. This would enhance accountability and enforcement among business directors. This thesis proposes that directors of companies be educated, trained and qualified at induction. The thesis argues that directors of companies should possess the required skills and knowledge expected of them. There are no requirement guidelines in the legislation of CA 2006 to qualify to become a director. Any person can become a director provided they are over the age of 16.[1552] It is not legitimate for future directors to have any credentials prior to taking a post. Therefore, it is imperative for the Secretary of State to mandate directors to have pre-appointment director education.

The Green Paper[1553] consultation on corporate governance highlighted various contributory issues to board failures. Amongst them were board composition, training, and qualifications of the directors. It has been reported that there is limited awareness of the disqualification legislation.[1554] A survey carried out by the National Audit Office reported significantly low levels of awareness, with fifty-eight percent of directors claiming to be oblivious of the legislation.[1555] A similar report followed in 1998, showing an increase to sixty-six percent of directors.[1556] Considering the statistics above, using

[1551] Yatin Arora, What Went Wrong With Wrongful Trading? (2022) Business Law Review 43 (4) 164-177.

[1552] CA 2006 (n 26) s 157.
[1553] Commission, 'The EU Corporate' (n 78) 164.
[1554] Richard Williams, 'Disqualifying Directors: A Remedy Worse than the Disease' (2007) 7 JCL Studies 213, 218.
[1555] National Audit Office, *Report by the Comptroller and Auditor General: The Insolvency Service Executive Agency: Company Director Disqualification* (HC 1993).
[1556] National Audit Office, *Report by the Comptroller and Auditor General: The Insolvency Service Executive Agency: Company Director Disqualification* (HC 1998).

director education as a way of deterring directors from engaging in undesirable conduct is unquestionable.

Therefore, a consistent assessment of education and training during induction is likely to reduce the problem at hand. Hence, the thesis proposes implementing mandatory pre-appointment director education as a model of accountability for company directors as per Arora.[1557]

Prior education before appointments would enhance standards by establishing a fundamental level of understanding. Consequently, this would lead to a drop in misconduct, resulting in a reduction in the number of insolvencies and ultimately safeguarding creditors. The collapses of RBS, Northern Rock, HBOS and Carillion were a result of directors not possessing suitable qualifications and adequate training, amongst other deficiencies. The public needs to be protected from unjustified commercial risks and incompetence by having fit people managing businesses. The failure of the CDDA to address incompetent conduct effectively is a sign of its weakness.
Since this would encompass understanding of the applicable consequences, it would also function as deterrence. However, it is widely acknowledged that "training does not guarantee competence."[1558]

Therefore, just mandating directors to undergo training or exempting those with relevant knowledge will not be sufficient to solve the issue. Undoubtedly, several instances of serious wrongdoing have originated from very competent directors with immaculate credentials from prestigious colleges or specialised expertise. Nevertheless, this plan does not aim to eliminate wrongdoing on its own. The author acknowledges that a director's actions can be influenced by several circumstances, both inside and external to the firm, some of which may be beyond the control of a legal system.

[1557] Arora (n 1551).

[1558] Vanessa Finch, Company Directors: Who Cares About Skill and Care? (1992) 55 Mod. L. Rev. 179, 210.

Hence, this proposal seeks to provide directors with the necessary knowledge to reduce the likelihood of such wrongdoing. The objective is to enhance the existing regime to ensure comprehensive oversight of directors, both prior to and following any wrongdoing. An apt comparison can be drawn to the act of driving.[1559] Since reckless driving can result in death, no one would consent to unskilled drivers operating a vehicle Nevertheless, reckless leadership might result in the demise of a company, yet directors are permitted to navigate the corporate landscape without scrutiny. While training alone may not eliminate unsafe driving, it reduces the likelihood of its occurrence. Additionally, when combined with appropriate post-facto penalties, it provides a level of protection to other drivers on the road.

When formulating this proposal, the author fully considers if this rule should be applicable to all individuals, as not all directors provide a potential danger. Bowles asserts that 20 percent of all enterprises would adhere to any rule without conditions, while 5 percent would try to avoid compliance. The remaining 75 percent are similarly inclined to comply, but only provided there is a credible threat of punishment for the dishonest 5 percent.[1560]

According to Bowles' data, 20% of individuals do not need education. Undoubtedly, they have likely acquired information through aggressive efforts to ensure compliance.[1561]. The 5% intentionally evade the rules and will not gain any advantages from education. Hence, the objective should be to achieve a 75% target. Nevertheless, numerous directors opt not to make an effort when presented with the opportunity. According to the Institute of Directors, fewer than 10% of directors have had any training, less than 25% have any professional qualifications, and only 24% consider training to be 'extremely important'.[1562]

[1559] Arora (n 1551).

[1560] Ian Ayes & John Braithwaite, Responsive Regulation 25 (OUP 1992).

[1561] Ibid

[1562] Ibid.

Therefore, if education is to be implemented, it must be made compulsory. Individuals who argue that this is burdensome have the option to engage in trading without limited liability. Undoubtedly, education is significantly less onerous as compared to the safeguard that limited liability provides. It is argued that prospective directors should bear the cost of such education. There would unquestionably be resistance to this for instance, from SMEs who may perceive this as extra cost. Instead of perceiving it as a burden, the fee can be viewed as a strategic investment that enables individuals to operate a firm with greater efficiency and without assuming personal obligation. Existing SME directors and business owners who believe there may be a trap door waiting to be opened and who are unclear of their official duties and legal responsibilities under UK Company law will welcome this to their advantage. If individuals lack the financial means to buy this, it raises doubts about how they will finance the company itself. The costs in question would be far lower than the minimum capital needed.

To establish a fundamental level of understanding, it is important to address certain subjects. Some examples of topics related to directors' responsibilities include duties, fraudulent and unjust trading, director disqualification, maintaining accounts, and tax liabilities. The appropriate format for this will vary according on several aspects, such as the cost, length, and educational outcome. When considering the available choices on a scale, an MBA programme, with its high cost and long duration, is excessively demanding, even though it offers significant educational benefits.[1563]

On the other hand, accessing material online is efficient in terms of time and money, but it lacks significant educational value, especially when it relies on an individual's personal motivation to study. The author suggests a concept like the driving theory test. This is an in-person computerised examination that persons must pass with a score of forty-three out of fifty to proceed to the practical portion of the driving test. The current price is GBP £23, which is consistent with the other expenses that directors encounter. The fee of incorporation is GBP £12. Similarly, study materials can be acquired inexpensively. The duration of the test is 57 minutes, and it is suggested to allocate 20 hours for studying.

[1563] Arora (n 1551).

This makes it more efficient in terms of time compared to an MBA programme. Additionally, directors have the flexibility to study at their own speed and without the need for in-person attendance.

Testing necessitates active involvement and should not be taken lightly, as seen by the pass rate of 47.3%. Conducting assessments in person ensures that participants are unable to cheat or undermine the integrity of the test.

Mandating the administration of such tests to the present board members would pose significant logistical challenges. Although the syllabus of the driving theory test may change, existing drivers are not obligated to retake the test. Thus, it is proposed that testing should only be mandatory when current directors assume an additional directorship. They can use the knowledge they acquire to all their companies and receive regular legal updates from Companies House.

Therefore, it is submitted that Director education offers a higher level of protection for creditors by preventing misconduct from happening in the first place, when compared to the previously mentioned solutions. Undoubtedly, it will provoke irritation among people who desire to exploit the system and attain a director position without fully assimilating such knowledge. However, in the long term, it guarantees equity as other directors will have taken similar actions, and it removes, or at least significantly decreases, the necessity for retroactive measures in the future.[1564] Based on the concept that it is more effective to prevent problems rather than deal with them afterwards, the author has suggested a novel framework for mandatory pre-appointment director education.

Implementing director education would enhance standards by creating a fundamental level of understanding. Consequently, this would lead to a drop in misconduct, a reduction in the number of insolvencies, and ultimately, the protection of creditors. Having knowledge of the applicable consequences would act as a deterrent. Since the other regimes of accountability discussed in this thesis are considered ineffective, director education can effectively prevent troublemakers and therefore reduce or eliminate the need to rely on SMCR. Companies can have different business models,

[1564] Ibid.

but without the quality management of directors who are subject to robust education and training, they are subject to failure.[1565]

The need of enhancing governance by promoting accountability, which is based on clear delineation of roles and responsibilities, is reinforced by the efforts of international regulatory organisations and by the adoption of similar practices in other nations.[1566] The concept of director education is not novel. For decades, institutions in Europe such as Belgium, Luxembourg and Monaco have provided training (Institute of Directors).[1567] Registration in the programmes offered by the Institute of Corporate Directors in Canada has been increasing by 25 percent annually since 2006.[1568] The need to have trained and qualified directors in companies is paramount on a global scale, on which no company should be without.

The thesis contends that education plays a pivotal role in revamping and renewing directors' skills and knowledge of products, strategies, and risks.[1569] In addition, the thesis argues that it will foster directors presiding over these institutions, keeping them up to date with the skills, knowledge, and training required to meet the complex demands that come with their duties. A mandatory requirement could be an effective tool to ensure robustness by having competent, trained, and qualified directors in companies. This approach shows promise as a potential solution.

[1565] Commission, 'The EU Corporate' (n 100) 164.

[1566] The Bank of England, 'Strengthening the Link between Seniority and Accountability: The Senior Managers and Certification Regime' Quarterly Bulletin Q3, 2018, 3.

[1567] Michael O'Neill, State-owned enterprise director training: a review of Canadian experiences. *Teaching Public Administration*, (2015) *33*(1) 62-73.

[1568] International | Regional Locations | Institute of Directors (iod.com) accessed 28 August 2024.

[1569] ICSA Governance Institute (n 129).

Chapter 8

8.1 Restating the Key Arguments

This thesis has conducted research concerning improving directors' accountability and enforcement under the CA 2006. The doctrinal content of company law regarding the company`s goal was assessed in line with the position of directors, shareholders, and stakeholders. This served as the foundation for the thesis's recommendations on necessary changes in response to the question 'for whom should the firm be run?'

To better comprehend the issue and potential remedies mentioned in Chapter one, Chapter two examined significant literature in the fields that serve as the basis of the thesis and provide theoretical and conceptual justification. To understand the issue with the question that was addressed in Chapter one regarding the question 'in whose interest should company directors run the company and to whom should they owe their duties?' the thesis provided justification and an explanation of how and why organisations operate the way they do. Therefore, an analysis of business theories was undertaken to achieve the goals. The thesis argued that corporations do not exist purely to profit their shareholders.[1570] For by doing so, it has no regard of other parties affected by the company. The thesis argued that the shareholder theory is too narrow. As a result, it is stated that shareholders should have a wider vision beyond pure profit maximisation. Therefore, the thesis contends whether a company does well without caring about various constituencies. Stakeholder theory is a central tenet of the discussion.

The thesis analysed the stakeholder theory and contended that shareholders do not have a privileged place in business enterprises.[1571] It was therefore argued in this thesis that corporations cannot maximise shareholder interests at the expense of other stakeholders

[1570] Berle (n 146).
[1571] Lynn Stout, *Shareholder Value Myth* (Berrett-Koehler Publishers Inc 2012).

because doing so is not economically efficient. Thus, directors must consider all stakeholders' interests that would be affected by their decisions. This means that for the business to succeed, directors must strike a balance between conflicting stakeholders' interests and shareholders' interests.[1572]

The thesis argued that the stakeholder approach is not practical and workable due to its competing interests as it contradicts the beliefs of corporate governance.[1573] The thesis contends, the director's accountability to shareholders is paramount in corporate governance, while with the stakeholder approach, the corporation is compelled to be accountable to all. It was therefore argued in this thesis, that stakeholder theory does not align with corporate governance.[1574] The stakeholder theory, according to the thesis, eliminates business responsibility since a company that is accountable to everyone is answerable to none.[1575]

The thesis went further to argue that organisations are formed for explicit purposes and require the inclusion of directors to execute those obligations. It was therefore argued that the choice and maintenance of company directors who are equipped for guaranteeing corporate targets should be the principal and central component of the corporate governance process. The UK CGC 2018 reaffirmed in its preface that company directors are accountable for managing their corporations. However, the thesis's analysis of directors' duties in chapter three found regulatory gaps in the company law's directors' duties under s172 and s174 in dealing with decisions that concern financial sector misconduct. These were argued to be the main causes for the collapse of banks and other corporations such as Northern Rock, HBOS, RBS, and Carillion. Yet, as far as the author is aware only few individuals reported to incur legal obligations. HBOS's finance director Peter Cummings and Tom Hayes, a former UBS, and City group executive. Cummings was struck with a penalty fee of £500,000 and barred from performing any activity in the financial sector,[1576] while Tom Hayes was given a 14-year prison term for

[1572] Blair and Stout, 'A Team Production Theory' (n 204).
[1573] Sternberg (n 224).
[1574] ibid.
[1575] Keay, 'Ascertaining the Corporate Objective' (n 4).
[1576] Masters (n 374).

his part in rigging the LIBOR rate.[1577] In Carillion, Richard Adam was disqualified and banned for 12 and half years after Zafar Khan, another former finance chief of Carillion, were banned from being a company director for eleven years in early July 2023.

Therefore, this thesis argued that the legal structures are incapable of functioning as deterrents for directors. The lack of personal consequences for directors was argued to be the cause of repeated bad behaviour at institutions.[1578] In Chapter four, the thesis critically argued directors' liability under the CA 2006 of s 172 and s 174, regarding the case studies of RBS and Carillion as weak and of a low standard. Therefore, it was argued that the current statutory framework does not provide deterrence. It was argued that although the legislative framework is well designed, it is prone to be exploited by company directors because of the loopholes. Chapter four also looked at what could have looked different on Carillion and RBS under the entity maximisation approach and how this approach could have served both companies from collapsing.

In Chapter five, when introducing the derivative action, the author was predictably implying that the derivative action will be a solution to bridge up directors' duties. However, it was argued that the derivative action hasn't been up to the job because of the uncertainty and complexities of Part 11 of the CA 2006, lack the potential to have an impact on directors' duties. It was proven ineffectual in enforcing directors' duties, due to its procedural difficulties.[1579] However, even if the derivative action works would it have worked in Carillion and RBS circumstances. Could the statutory derivative action have solved the problems in Carillion and RBS cases. Why couldn't the shareholders bring a claim out of these crises? The thesis argued that there is not much within the statutory provision to persuade rational shareholders to use the derivative action. Therefore, the thesis argued that using shareholders' private litigation as a means of enforcement under directors' duties does not provide effective governance of directors. Shareholders often

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[1577] Lucy McNulty, 'Here's Who Will Decide on Tom Hayes's Final Battle to Quash His LIBOR Conviction' (*Financial News* 19 February 2021) https://www.fnlondon.com/articles/heres-who-will-decide-on-tom-hayes-final-battle-to-quash-his-libor-conviction-20210219 accessed 19 February 2021.
[1578] Stuart McWilliam (n 360).
[1579] Arad Reisberg, *Derivative Actions and Corporate Governance: Theory and Operation* (Oxford University Press 2007).

use derivative litigation against directors to pursue personal financial interests rather than the company`s interests.

Therefore, the author introduced the Company Directors Disqualification Act 1986 (CDDA) in chapter six, hopping to provide the solution to the inadequacies of the derivative action. The CDDA grants authority to the courts to issue orders or accept commitments that prevent persons from serving as directors or participating in any capacity in the establishment, creation, or administration of a business upon disqualification. The author predictably implied that the CDDA will be a solution to bridge up directors' duties by removing rogue directors from companies and prevent additional misbehaviour. However, after critical analysis, it was argued that the CDDA does not encourage good corporate behaviour or punish bad behaviour. As a result, those who have been deemed incompetent and disqualified are not held personally liable under the CDDA. Thus, the CDDA's inability to counter incompetent behaviour is a sign of its weakness.

8.2 Restating Key Proposals

(a) *The Entity Maximisation Approach as a Replacement to Shareholder Approach*

The thesis has critically argued the effectiveness of the two main theories discussed as inadequate for corporate purposes. According to the thesis, no firm can maintain the abstract objective of maximising the shareholder or stakeholder value model.[1580] In light of management's power and influence, as well as its relationships with various stakeholders other than shareholders, the former is unrealistic and unreachable.[1581] The thesis critically asserts that shareholder wealth maximisation does not bring effectiveness to directors in managing firms, although it might be considered realistic and achievable. It does provide more validity than the stakeholder theory but is frequently overlooked because of its unpredictability. This is because there are occasions when acting in shareholders' interests does not always imply acting for the company's good. While

[1580] Keay, 'Ascertaining the Corporate Objective' (n 4).
[1581] ibid.

stakeholder theory has attracted attention because of how it holds values of trust and fairness, it is still not feasible. It does not state how directors can achieve this objective.[1582] Hence, main issue is that successfully juggling multiple competing interests is challenging because no one group of interests takes precedence over others.[1583]

Therefore, the thesis advocated for the entity maximisation approach, which was established by Keay,[1584] as a replacement for the shareholder approach. The corporation is treated as an entity, not a collection of shareholders, according to English law.[1585] The thesis has established that much emphasis in the literature is on whom directors should operate the firm. This has created debates over the shareholder versus stakeholder theory. The debate allowed the emphasis to centre on groups than on the company. It was asserted that focusing on groups or people gives way to partisan interests.[1586]

However, the thesis did not reject the importance of such groups, nor does it centre on them, as it has proved difficult for a model other than those currently mentioned to develop. The entity concept attempts to maximise the entity and ensure that it is sustained as an ongoing concern.[1587]

The thesis argued that the entity centred approach exists on its own apart from its investors and does so even when the investors' identities change.[1588] The thesis contends that directors should run the organisation as a legitimate business. Managing the corporation as a separate organisation gives directors a straightforward path to behave in circumstances where interests conflict.[1589] If the board of directors should promote whichever interest group's priorities, the business would most certainly profit. For instance, directors may decide against paying high dividends to shareholders and instead give workers a bonus and ensure employee loyalty. This can be evaluated considering

[1582] Andrew Keay, 'Stakeholder Theory in Corporate Law: Has It Got What It Takes?' (2010) 9 Rich J Global L and Bus 249.
[1583] Ibid.
[1584] Keay, 'Ascertaining the Corporate Objective' (n 4).
[1585] Ibid.
[1586] Mukwiri (n 29).
[1587] Keay, 'Ascertaining the Corporate Objective' (n 4).
[1588] Suojan (n 245) 391.
[1589] keay (n 4).

the company's economic and financial stability.[1590] The balance of interests will be determined by what will maximise and sustain the entity.[1591] As a result, handling competing interests is not a problem with the company-centred approach, as one interest takes precedence over the others.[1592] It was argued that the entity as an organisation is distinct from its members. It was well affirmed by Brown that a company is not a myth but a genuine person in the eyes of those who recognise its existence, which is an objective fact.[1593] However, critics[1594] argue that it is only through incorporation that a corporation is born, which is not the case. It was well affirmed that an entity can be made without being incorporated.[1595]

The proposal of a company-centred approach is even affirmed during derivative action. Though members have access to present a claim, the law considers the company as the victim.[1596] The thesis argued that a company-centred approach promotes the maximisation of a company by requiring that directors enhance the firm's market value over time, thereby creating wealth for the company.[1597] The thesis argued that allowing directors to concentrate on the sustainability of the company reduces the appetite for unwarranted risks to maximise the entity's wealth. The explanation behind the company maximisation proposal is to benefit all the stakeholders, including investors. Moreover, it is the shareholders who benefit from the company because the company itself will develop, survive and be successful. The thesis has argued that the more effective and productive the company is, the more shareholders will benefit. As such, it was argued that the ideal approach to accomplish shareholder value is by maximising the entity instead of always prioritising shareholders to the detriment of stakeholders.

The influence of the Covid-19 epidemic on establishing a corporation's mission was also addressed in the thesis. The recent pandemic has put stakeholders' interests into

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[1590] Ibid.
[1591] Ibid.
[1592] Ibid.
[1593] Brown (n 250).
[1594] Peter Drucker, *Concept of the Corporation* (Routledge Press 1993).
[1595] Keay, *The Corporate Objective* (n 4).
[1596] Tang (n 928).
[1597] Keay, *The Corporate Objective* (n 4).

perspective. In recent months, companies have engaged in various activities and initiatives on a not-for-profit basis to deal with the devastating impact of the virus. For instance, MG Motor Company gave away 100 eco-friendly vehicles free of charge to help with the dwindling transport capacity in NHS Trusts. Breas Company UK, the sole existing company that builds ventilators in Britain, placed staff on a seven-day working week to triple its capacity in dealing with the impact of the virus. Google funded a joint project of £646 million to produce millions of face masks. Unilever Company, the world's biggest soap maker and producer of British-Dutch consumer goods increased production and donated goods worth £88 million.[1598] The impact of all these activities highlights the broader purpose of the corporation. This involves a shift from the norms of profit maximisation to the perspective of the stakeholders' interests. The contributions from these companies reflect the importance of helping the community during a global pandemic.

Due to the coronavirus pandemic, some companies on the London Stock Exchange stopped paying dividends to shareholders in 2020.[1599] But from a legal standpoint, one can question whether this represents the new normal. Will companies continue to operate in this way or move back to shareholder primacy and profit maximisation once the pandemic is over? The thesis contends that the current legal system of having regard for different stakeholders under s 172 (1) is efficient, and when it was needed in a crisis, directors acted accordingly for the company's good. Directors have shown to be resilient in the face of adversity when the pandemic has proved it is urgent and required. Thus, when the situation demands it, directors will pursue a long-term sustainability approach. Therefore, it is argued in this thesis that what can be learned from the Covid-19 pandemic crisis is that directors of companies can adopt a company-centred approach by focusing on its long-term sustainability.

[1598] Paine (n 307).
[1599] Sangster (n 314).

8.3 The Duty of Good Faith: As a Measure of Accountability for Directors

(b) Proposed Approach

The thesis has argued for and proposed an objective test under s 172. An analysis of this issue evaluated the objective test as a standard measure to hold directors accountable and deter misconduct when the director completely fails to act for the company's good. It was argued that the courts interpret s 172 in a similar way as under common law. This is confirmed in the case *Hellard v Carvalho* in which s 172 'codifies the pre-existing common law' [1600] as a subjective element that requires assessing the director's mental state.

It was asserted in this thesis that the test for good faith investigates a director`s honesty regarding what`s best for the company.[1601] Those opposing the directors must show their credibility by demonstrating that the choice made was not for the company's good. However, evaluating whether a director was honest in supporting the company's success is a difficult process, such as in *Regentcrest*,[1602] which confirms that the court will not go against a director's decision made in good faith.

A subjective test has its own criticisms, as stated in the *Hutton case,* in that the firm may be run by a madman who spends the company's money with both hands in a completely bona fide but totally illogical manner.[1603] Therefore, it is not surprising that there are incidents where courts have introduced some objective elements into the duty of good faith.[1604]

As a result, it was contended that the subjective test requirement placed on directors under s 172 is inadequate. If a director can demonstrate that they behaved in good faith, they can escape liability. There is no standard by which to judge their intentions. It was asserted that the subjective test's parameters under s 172 are reasonableness and corporate harm.[1605] The thesis demonstrated that though honesty is perceived in a

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[1600] *Hellard* (n 531).
[1601] Quinn, 'The Duty of Good Faith' (n 534).
[1602] [2001] 2 BCLC.
[1603] *Hutton* (n 454).
[1604] *Charterbridge* (n 63).
[1605] Hannigan, *Company Law* (n 553).

subjective way, the law on dishonesty is an objective one. The definition of dishonesty is explained in terms of breach of trust's culpability. The explanatory notes for s 172 (1) state clearly in interpreting the new directors' responsibilities that the law of trusts will be used.

Lord Nicholls explained the meaning of dishonesty in *Royal Brunei* as acting without any regard to conscience, which is an objective element.[1606] The thesis submitted and affirmed the *Ivey* test [1607] as the leading case when dishonesty is in question. Lord Hughes asserted that it is applicable across both criminal and civil law.[1608] It was asserted that dishonesty is by no means a defined concept and should be more recognisable, even if it cannot be defined.[1609]

Under the *Ivey* test, dishonesty is based on facts and standards rather than a legal issue. When it comes to dishonesty and collecting information, a tribunal must first assess (subjectively) the individual's real state of awareness or belief about the evidence.[1610] The fact that the conviction is rational is not an additional prerequisite, rather, the question is whether or not it is held in good faith.[1611] The factfinder can assess the actual mindset of knowledge or belief by applying the (objective) criteria of ordinary decent citizens.[1612] The offender is not expected to acknowledge that what they have done is unethical by certain standards.[1613]

Setting a clear norm of good faith, according to the thesis, might have a declarative influence on directors' decision-making, thereby ensuring that directors exercise caution in the management of their companies. To achieve this goal, directors should be held accountable whenever they do not behave or fail to act for the company's good, and the objective element is the best remedy. This objective criteria for good faith, for example, might be utilised in cases where directors have failed to advance the company's interests. Furthermore, determining whether a director was honest in supporting the organisation's

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[1606] *Tan* (n 558).
[1607] *Ivey* (n 65).
[1608] ibid.
[1609] ibid.
[1610] Griffiths (n 587).
[1611] ibid.
[1612] Griffiths (n 587).
[1613] ibid.

success is a difficult process.[1614] This case demonstrates that a court will not overrule a judgement made in good faith by the board of directors.

As a result, it was asserted in this thesis that adding an objective test under s 172 would open the courts' scrutiny and lead us in a new direction. Such subjective criteria make all but the most egregious violations of a director's responsibilities unassailable, which is both regrettable and inconsistent with s 172's modest goals.

8.4 Extending SMCR to the Non-financial Sector.

This thesis showcased why the SMCR is effective and why it should be extended to the non-financial sector. The chapter has painted a picture with past credible assessment reports to support the success of the SMCR. The thesis provided a workable approach on how the SMCR can be embedded to all companies across the sectors including large and small. This thesis argues that the SMRC improves the quality of governance in institutions by placing deterrence as its main objective. Fines and punishments serve as deterrents to wrongdoing. Penalising incompetent conduct promotes trust within institutions by removing unfit and improper directors from occupying boards. The fundamental premise of the SMCR is to promote accountability and responsibility. An individual director must be accountable for the actions under their supervision.[1615] The SMCR establishes the roles and responsibilities of senior managers in approved businesses with deterrence as the primary goal. It is dedicated to achieving equal and just results in the aftermath of wrongdoing by keeping the offender responsible.[1616] Under the SMCR, fines and punishments are used to discourage wrongdoing. Reports from credible sources[1617] of the past assessment of the SMCR evidenced that the system has achieved its objectives, and all show strong support for the aims of the

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[1614] *Regentcrest* (n 15).

[1615] FCA, 'Financial Conduct Authority Investigation Statements in Relation to RBS GRG' (*Financial Conduct Authority*, 2018) https://www.fca.org.uk/news/press-releases/statement-further-investigative-steps-relation-rbs-grg accessed 31 July 2018.

[1616] FCA, 'FCA Mission: Our Approach to Enforcement' (*Financial Conduct Authority,* 2018) https://www.fca.org.uk/publications/corporate-documents/our-approach-enforcement accessed 21 March 2018.

[1617] The PRA evaluation in 2020, HM Treasury's Call for Evidence in March 2023, and The Bank of England's DP1/23.

SMCR. This thesis argues that the SMCR`s conduct rules, certificate regime and regulatory references has proven effective instrument of promoting individual responsibility and personal accountability which led to collective responsibility and has worked so far. Therefore, this thesis argues that the SMCR should be extended to all non-financial sectors in the UK, as an effective way to increase director accountability and transparency as proving effective within financial institutions.

8.5 Director Education

This thesis has advocated for a mandatory pre-appointment director education as a model of accountability for company directors. This thesis proposes that directors of companies be educated, trained and qualified at induction. The thesis argues that directors of companies should possess the required skills and knowledge expected of them. Therefore, it is submitted that Director education offers a higher level of protection for creditors by preventing misconduct from happening in the first place, when compared to the previously mentioned solutions. Undoubtedly, it will provoke irritation among people who desire to exploit the system and attain a director position without fully assimilating such knowledge. However, in the long term, it guarantees equity as other directors will have taken similar actions, and it removes, or at least significantly decreases, the necessity for retroactive measures in the future.

Based on the concept that it is more effective to prevent problems rather than deal with them afterwards, the author has suggested a novel framework for mandatory pre-appointment director education. Implementing director education would enhance standards by creating a fundamental level of understanding. Consequently, this would lead to a drop in misconduct, a reduction in the number of insolvencies, and ultimately, the protection of creditors. Having knowledge of the applicable consequences would act as a deterrent. Since the other regimes of accountability discussed in this thesis are considered ineffective, director education can effectively prevent troublemakers and therefore reduce or eliminate the need to rely on SMCR. This approach shows promise as a potential solution.

8.6 Originality and Contribution to the Literature

This thesis provides an essential contribution to prior knowledge and offers new discoveries or ideas. The specific contribution of this work begins with the benefits of the entity maximisation approach. How an accountable board can create value and success for the company. The directors see continual wealth creation for company groupings as the optimum way for shareholders' ability to profit from their investments on a regular basis.

The thesis recognises the advancement of the ESV and the obligation of directors to examine long-term commitments regarding other stakeholders. However, the thesis contends that the ESV has not gone far enough to hold directors accountable. It is a shareholder-oriented paradigm, as opposed to common law. It measures the success of a firm in terms of shareholder value.[1618] Therefore, it is extremely difficult to enforce the ESV to ensure directors will consider stakeholders' interests.

(a) Proposition 1

This thesis offers an alternative approach to the ESV considering the respected academic insight of Keay.[1619] The entity maximisation is favoured instead. The corporation is treated as an entity, not a collection of shareholders, according to English law.[1620] The entity approach is built from Keay's model of entity maximisation and sustainability.[1621] Keay emphasises what should be done to maximise an entity's wealth and create its long-term sustainability, the company-centred approach adds further to how value creation of the entity can be achieved and increased. The entity maximisation approach focuses on accountability as a component of increasing value for company success in the following:

(b) Employees' interests in the company

[1618] CA 2006 (n 26) s 172.
[1619] Andrew Keay, *Board Accountability and The Entity Maximisation* (n 12).
[1620] Mukwiri (n 29).
[1621] Andrew Keay, `*Board Accountability and The Entity Maximisation*` (n 12).

This thesis considered all criteria stated in s.172 as assets[1622] because they either directly or indirectly contribute to the company's long-term sustainability.[1623] It was stated[1624] that a company with regular employee strikes, customer dissatisfaction with its products, or suppliers who favour its competitors is unlikely to benefit its stockholders. Directors who are accountable to the entire company foster good employee relations and encourage long-term loyalty to the organisation. As a result, when company directors are held accountable to the company, employees will see the company as more than just a source of revenue, but as an organisation to which they can commit to improving via the development of personal abilities and constructive criticism. .[1625] This is a bonus that a firm receives when its directors have regard of its employees` interests. Employees must be viewed as persons with whom a shared mission must be formed.

(c)Productive Business Relationships

When shareholders promote accountability in their firms, it creates strong and productive business relationships with their suppliers, customers, and other stakeholders. Stakeholder relationships, corroborations, and reputation-building variables will be fully exploited possible by the organisation. [1626] These assets (stakeholders) are an important part of wealth creation of the corporation, which is through the maintenance of secure customer and supplier relationships.[1627] Customer loyalty to brands and businesses, according to some observers[1628], lowers marketing expenses and stabilises production and sales volume.

[1622] Garth Saloner, Andrea Shephard, Joel Podolny, *Strategic Management* (1st edition, Wiley Publishing 2001).
[1623] Luca Cerioni, The Success of The Company in s.172(1) An Enlightened Directors` Primacy, OLR (2008) vol 4 (1).
[1624] Ibid.
[1625] Ibid.

[1626] Jim Post, Lisa Preston and Sybille Sachs, Redefining The Corporation: *Stakeholders Management and Organizational Wealth* (Stanford University Press 2002).
[1627] Cerioni (n 271).
[1628] Ibid.

(d)The Company's Operations Have a Social and Environmental Impact

A corporation with effective accountability procedures reaps community advantages that improve the firm's wealth. The corporation will have the freedom to operate[1629] which means that its commercial activity will be supported by the people and will not cause public outrage. When directors are held accountable, the company enjoys positive community connections, which bodes well for its long-term future. Any business that has a detrimental influence on the community or the environment is under constant attack. Even if the company is profitable, its bad reputation will harm its operations, and competitors will prosper in this climate. For that reason, it is advantageous to have a positive standing for ethics as a business. Maintaining strong ethical standards benefits the company's long-term credibility and trustworthiness. Therefore, a company with an effective accountability framework will not only benefit individual factors prescribed under s 172 (1) (a-f) but the company as a whole and an optimum way for shareholders' ability to profit from their investments on a regular basis.

This thesis argues that the shareholder value model views the purpose of corporations as the maximisation of shareholder wealth. Moreover, it does not provide concrete guidelines about how the company should be managed. It is narrowly focused on shareholder wealth and economic efficiency and ignores values other than efficiencies, such as fairness, equality, and justice.[1630] As with the stakeholder theory, the shareholder value model lacks clarity about who constitutes stakeholders, the nearly impossible task of balancing conflicting interests among stakeholders, and the difficulties implementing and enforcing the model in the real world.[1631]

This thesis fills a void in the legal literature. Many of the questions have concentrated on the question 'in whose interest should directors act?' This has created the debates between shareholder and stakeholder values. The focus has been put on people instead of the company. Even though the importance of such groups in the company cannot be

[1629] Ibid.
[1630] Stout (n 204).
[1631] ibid.

refuted, centering on them would make coming up with a different model a daunting task. Mukwiri asserted that focusing on groups or people gives way to partisan interests.[1632] Two arguments are offered for an entity maximisation approach against the existing models. Firstly, it is distinct from both shareholder and stakeholder values as a separate entity. Secondly, an entity maximisation approach is more desirable, as it focuses on value creation for company success. Long-term objectives are made easier by treating the corporation as a separate legitimate business. [1633] This is a significant improvement and contribution to the existing literature.

For the entity maximisation approach to be a feasible model, directors should be accountable for their failures. The duty of good faith brings a significant contribution to the literature and can be used to bring clarity to the test when a director completely fails to act for the company's good. Directors must behave honestly in accordance with Section 172. A director must operate sincerely and genuinely to their best to enhance the organisation`s success.[1634] In *Re: Fawcett Ltd case* it was decided as a matter of the directors' sincerity to define what company interest is against the court. The test used in this case is subjective, requiring the directors' mental condition. The subjective test standard imposed on directors under s 172 is low[1635] by interpretation, as no director can be brought to justice by demonstrating to have behaved in good faith. There is no measure by which to judge their action. Without a meaningful good faith requirement, the core duty of loyalty is subject to abuse and is without a suitable standard of liability.

Setting up a criterion of good faith might have a declarative influence on directors' decision-making, thereby ensuring that directors exercise caution in the management of their companies. The objective test for good faith could be the ideal solution. For example, in cases where directors have failed to advance the company's interests, this objective criterion for good faith might be employed. For instance, the near collapse of RBS demonstrated a major weakness in its leadership, which was comprised of the board's

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[1632] Mukwiri (n 29).
[1633] Stout (n 204).
[1634] CA 2006 (n 26) s 172.
[1635] *Hutton v West* (n 454).

poor judgement and the environment's promotion of greediness.[1636] The House of Commons produced a damning report concerning the behaviour of Carillion's board of directors. Carillion's board was accused of acting ignorantly unaware of its corrupt culture.[1637] Moreover, the directors depicted themselves as victims of unanticipated misfortunes.[1638] These behaviours exhibited an element of risk with serious effect and yet few individual directors were held accountable under the law.

The thesis provides significant clarity to the field of study by providing a logical analysis and evaluation of the test. The work contributes to the literature by defining the obligation to act honestly. The proposed suggestion aims to demonstrate that although honesty is perceived subjectively, the law regarding dishonesty is objective.[1639] An analysis within this contribution looks at the objective test as a standard measure of holding directors to account for their failures. The problems surrounding the issue of dishonesty were resolved and affirmed in *Ivey,*[1640] which this thesis submits as the leading case to determine the duty of good faith. This case is a criminal law case, which states that dishonesty is not limited to criminal cases.

An objective test, as Lord Hughes declared, represents the reasoning of 'successive cases at the highest level.'[1641] The decision in *Ivey* demonstrates an improvement by abandoning the subjective test. The problem with a subjective test is that any reckless director can claim their actions to be in good faith.[1642] Setting up a transparent criterion might have a significant influence on directors' conduct, as most breaches confuse the statement of law.[1643]

This thesis promotes the introduction of an objective test by the Supreme Court – as in the *Ivey* case – for s 172 to define the duty of good faith. If s 172 is not clarified, then it will simply imitate its predecessor, the old Companies Act 1985, which failed to oversee

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[1636] Lui (n 625).
[1637] BEIS and Work and Pensions Committees (n 718).
[1638] ibid.
[1639] *Barlow Clowes v Eurotrust International* [2002] UKHL 12.
[1640] *Ivey* (n 65).
[1641] ibid 141 para 62.
[1642] *Hutton v West* (n 454).
[1643] Keay, 'The Corporate Objective' (n 4).

any case law. By introducing an objective test, directors will be exposed to more scrutiny than under the subjective test.[1644]

Proposition 2

The thesis contributes originality and robustness to the literature by proposing that the SMCR be extended to non-financial institutions to promote individual accountability across UK companies. The thesis provided a workable approach on how the SMCR can be embedded to all companies across the sectors including large and small. The extension of the SMCR will bring a rise in probes and successful directors` arrests who have long been evading liability for company collapses. Furthermore, the thesis argues that the extension of the SMCR will have an impact on small firms. When looking into breaches, the FCA will find it simpler to pinpoint shortcomings in these smaller corporations' decision units. This will result in more measures being taken against these companies.

Moreover, these firms will not have many resources available to fight enforcement actions against them. However, it could be argued that the application of the SMCR to smaller firms could be challenging in terms of assessing and certifying fitness and propriety because of the workload involved. Nevertheless, the FCA indicated that the SMCR is a prescriptive guide, showing how firms should assess fitness and propriety.[1645] The FCA believes that firms should decide how to best conduct its internal employee assessments. The thesis argues that the SMCR could be used as a preventative tool through the training and qualifications of directors. Moreover, the thesis proposes that directors of companies be qualified and trained in areas such as strategic risk management before assuming office.

The SMCR places deterrence as its main objective and is committed to bringing justice by holding the wrongdoer accountable. Fines and punishments serve as deterrents to wrongdoing, which is followed by using director disqualification as a successful method

[1644] ibid

[1645] FSMA 2000 (n 385).

of holding directors responsible for their poor performance. Penalising incompetent conduct promotes trust within institutions by removing unfit and improper directors from occupying boards.

Proposition 3

The thesis provides further significant knowledge to the field of study through creative innovation in its application. The thesis identifies legal gaps and solutions to deal with the issue of unfit and improper directors who continue to serve in companies. Because of power oversight, firms with disqualified directors continue to operate. The BEIS identified loopholes at Companies House, which allow individuals to register as directors even after having been removed from occupying company directorships.[1646] Currently, regulated companies that use Companies House data fail to identify disqualified directors who assume office work because of a lack of verification when they register.

Recommendations are proposed for more identity verification and ongoing due diligence to identify and remove disqualified directors. Recent research by Hoo Yu found that too many disqualified directors continue to serve as directors on boards,[1647] including some who disguise their identities.[1648] Therefore, robustness is likely to be achieved by mandating all the UK's active company directors and new applicants provide proof of identity to Companies House. Companies House will need to move away from its historical function of recording information to verifying and confirming that the personal information given about directors is true.

Identification verification methods range from the more basic use of an individual's credit history to more advanced face recognition techniques. An advantage to this approach to

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[1646] BEIS, 'Reforms' (n 718).

[1647] Joanne Atkin, 'One in Eight Disqualified Directors Sneak Back into Companies House' (*Mortgage Finance Gazette* 16 May 2019) https://www.mortgagefinancegazette.com/market-news/fraud/one-eight-disqualified-directors-sneak-back-companies-house-16-05-2019/ accessed 16 May 2019.

[1648] ibid.

identity verification is that it is a less costly technology that can be used by companies, for example, the use of smartphones in banks. Smith and Walter[1649] expressed serious concerns regarding the need to reform director liability to increase the personal liability of directors. Therefore, the current legal framework is not adequate, as it does not significantly improve accountability among directors. There is a need for immediate redress, which could be achieved through extending the SMCR to non-financial institutions to promote individual accountability across UK companies.

Proposition 4

The thesis contributes originality and robustness to the literature by proposing the implementation of a mandatory director education as a model of accountability for company directors. The importance of deterrence is well acknowledged, and it hinges on three key factors: certainty, celerity, and severity.[1650] Certainty refers to the strong likelihood of enforcement action, celerity emphasises the need for a swift response to disobedience, and severity entails imposing large penalties for noncompliance.[1651] Currently, the absence of enforcement measures results in a lack of certainty and promptness in all regimes. The dependence on financial penalties also leads to a lack of seriousness in the imposed punishments, which hinders deterrence and increases the likelihood of persons engaging in misbehaviour. However, to address the challenges with enforcement the author suggests implementing mandatory pre-appointment director education as a model. This would enhance accountability and enforcement among business directors. Additionally, when combined with appropriate post-facto penalties, it provides a level of protection for company insolvencies and creditors.

Prior education before appointments would enhance standards by establishing a fundamental level of understanding. Consequently, this would lead to a drop in

[1649] Smith and Walter (n 362).
[1650] Nicholas Ryder, Diana Johnson, Samantha Bourton, Demelza Hall, Review of the senior managers & certification regime, 2023 Journal of Economic Criminology, Volume 2, 2949-7914.
[1651] Ibid.

misconduct, resulting in a reduction in the number of insolvencies and ultimately safeguarding creditors. Since this would encompass understanding of the applicable consequences, it would also function as deterrence. The collapses of RBS, Northern Rock, HBOS and Carillion were a result of directors not possessing suitable qualifications and adequate training, amongst other deficiencies. The public needs to be protected from unjustified commercial risks and incompetence by having fit people managing businesses. The failure of the CDDA to address incompetent conduct effectively is a sign of its weakness.

This thesis proposed robustness in education and training through implementing mandatory pre-appointment director education as a model of accountability for company directors. This robustness can only be achieved by addressing the education and training of directors as a preventative tool beforehand. Companies can have different business models, but without the quality management of directors who are subject to robust education and training, they are subject to failure.[1652] The thesis argues that for a disqualification regime to be effective and deter undesirable conduct and promote market trust, a mandatory pre-appointment director education model should be implemented. Thus, it will promote people to management that have strong business ethics and a high degree of knowledge and ability.

The thesis contends that education plays a pivotal role in revamping and renewing directors' skills and knowledge of products, strategies, and risks.[1653] In addition, the thesis argues that it will foster directors presiding over these institutions, keeping them up to date with the skills, knowledge, and training required to meet the complex demands that come with their duties. A mandatory requirement could be an effective tool to ensure robustness by having competent, trained, and qualified directors in companies. The UK is based on soft law (codes) and thus this might be viewed as a departure from its norm.

The Code is often recognised as the most significant set of standards worldwide due to the flexibility it gives to organisations. However, despite the undeniable advantages of its

[1652] Commission, 'The EU Corporate' (n 100) 164.
[1653] ICSA Governance Institute (n 129).

flexibility, the code has received harsh criticism in recent decades, prompting calls for change in this area of legislation. Some argue that the theory has fallen short of its expectations because no substantial change in the standard has been brought about in practice.[1654] For instance, the Walker Review 2009[1655] was brought in to improve the standards of directors because of the financial crisis. The Walker Review called for changes to the Combined Code to enable directors to engage more effectively in the monitoring of business issues. However, the Walker Review declined to adopt the higher standards of statutory form, opting for the voluntary model of complying and explaining that they existed.[1656]

The Walker Review opted to reinforce the existing structures of corporate governance with the belief that non-legal mechanisms are superior at dealing with governance issues.[1657] However, this view is only partially correct, as scholarly research[1658] has demonstrated that reliance on private regulatory enforcement alone cannot guarantee improved regulatory goals. The central issue here is whether the alternative to soft law is adequate in corporate governance and likely to avoid the future failure of another corporation. The thesis asserts that there is more potential for change in mandatory requirement to deal with conduct than in soft law, as demonstrated in the Walker Review.

The falls of RBS, HBOS and Carillion illustrated significant shortcomings in the internal and external regulation of companies. These failures were partially due to non-commitment to market regulation factors. By reasoning, it was generally perceived, that corporate governance voluntary codes were more successful than statutes.[1659] Even though it could be argued that formal legal rules and government regulations alone have limits, it is not sufficient to merely follow and rely on self-regulatory or soft law

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[1654] George Hadjikyprianou, 'The Principle of Comply or Explain Underpinning the UK Corporate Governance Regulation: Is There a Need for a Change?' (2015) 7 Corporate Governance Law Journal 33.
[1655] Walker (n 123).
[1656] Ibid.
[1657] Ibid.
[1658] Doreen McBarnet and Others, *The New Accountability: Corporate Social Responsibility* (Cambridge University Press 2007).
[1659] Tomasic (n 368).

frameworks.[1660] The thesis argues that fiddling with codes of conduct will not bring robustness to corporate governance. The lesson has been illustrated by a history of the consecutive bank and other corporate failures. Hence, there is a call for a more radical approach to corporate governance. Therefore, this thesis contributes originality and robustness to the literature by proposing the implementation of a mandatory pre-appointment director education as a model of accountability for company directors.

8.7 Limitations and Further Research

The thesis proposed a clear interpretation of the meaning to act in an organisation`s interest based on the distinct legal personality doctrine supported by the relevant literature and cases. Implementing a company-centred approach in the UK, however, would entail substantial legislative change, which is quite unlikely. It was made clear by the Company Law Review Committee that they were not willing to propose any Enlightened Shareholder Value changes, which prioritise the interests of shareholders.[1661] The proposed ESV reform, however, has recently sparked renewed interest., which would reinforce the voice for broader interests within the organisation.[1662] The proposed company-centred approach indicates that the interpretation of acting in the company's interest could be altered in the future. This calls for further research in the interpretation of the ESV.

Moreover, the assumption that the company-centred approach is more advisable than shareholder value or stakeholder theory based on their limitations is not the strongest rationale to introduce a new model. This can occur only if it can be shown to be a substantial improvement over the alternatives. Furthermore, the thesis proposed the extension of the SMCR to all UK companies due to its effective design of accountability and enforcement. However, it could be argued that relying on the use of fines and sanctions as deterrents is ineffective and narrow-minded. Addressing the problem of

[1660] Ibid.
[1661] House of Commons, 'The White Paper` (n 391).
[1662] BEIS, 'Corporate Governance Reform' (Green Paper) November 2016.

misconduct risk requires a multifaceted approach.[1663] In order to punish misconduct, penalties are necessary and have a major deterrent impact, but depending solely on ex-post sanctions from organisations is inadequate and inefficient.[1664] The funds paid in fines might have better-helped companies if they had been kept as capital. Therefore, there is a need for further research on a multifaceted approach in response to misconduct.

[1663] Christopher Hodges, 'Science-Based Regulation in Financial Services: From Deterrence to Culture (14 May 2020) OLS Research Paper 19/2020' 44.
[1664] Ibid.

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