Introduction

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This book brings together contributions from both academics and practitioners assessing the operation and efficacy of directors’ duties and shareholder litigation in the wake of the financial crisis and its aftermath. It is striking that no significant litigation has yet emerged against the directors of banks and financial institutions for breaching their duties, despite the disastrous management that was uncovered by the crisis. What could be the reason for this? Does it reveal inadequacies in the law on directors’ duties and shareholder litigation? During the period up to and after the start of the financial crisis, the duties of directors, and the right of shareholders to take action on the company’s behalf against directors for breach of their duties was governed by the common law. If that was deficient then does the Companies Act 2006, which replaced the common law with codified directors’ duties and a new statutory derivative action, address those deficiencies? Given that sufficient time has elapsed since the commencement of the crisis for shareholder litigation to emerge, and given that enough is now known about the crisis in the UK from various public reports, it seems timely to assess directors’ duties and shareholder litigation with these questions in mind. This is what the contributions in this collection set out to do.

The story of the global financial crisis is well-known. The first signs of trouble emerged in the US sub-prime markets but by early 2007 in the UK the Bank of England and the Financial Services Authority (FSA) were raising concerns about the possibility of liquidity problems in the wholesale markets.1 In September 2007 there was the first run on a British bank for over 100 years at Northern Rock plc (Northern Rock). In 2008, in the US, Lehman Brothers went bankrupt, following which there was a massive loss of confidence and the money markets froze worldwide. In the UK, by the end of 2008, Northern Rock, Bradford and

Directors' duties and shareholder litigation after the crisis

Bingley plc, the Royal Bank of Scotland Group plc (RBS), Lloyds TSB Bank plc, and HBOS plc had been bailed out by the Government and entered full or part-public ownership. HBOS plc was taken over by Lloyds TSB Bank plc in January 2009 while Alliance & Leicester disappeared in 2010, having been taken over by Santander plc, as were parts of Bradford and Bingley plc’s business. The problems that were initially confined to the financial sector ultimately had an impact on the real economy, ushering in the deepest recession in the UK for 70 years. At the time of writing many of the world’s economies, including the UK’s, remain weak and the future is uncertain.

The question of what caused the financial crisis has been extensively discussed and no consensus has been reached other than that it was the product of the interaction of different factors. It is generally accepted that macro-economic factors such as global imbalances played a significant part. While countries such as the US, UK, Ireland and other countries had large current account deficits others such as Japan and China had accumulated large current account surpluses and developed large foreign currency reserves which they sought to invest in, inter alia, overseas securities, particularly in the US and the UK. In the US this took the form of investment in government bonds or government-guaranteed bonds and in the UK, investment in mortgage-backed securities. This resulted in large capital flows into both the UK and the US and allowed both countries to keep their interest rates at artificially low levels. The low interest rates led to the availability of easy credit, the growth of the sub-prime market in the US and, in the UK, the extension of high-risk mortgages to low-income groups. As a result there was a property and credit bubble in both countries. At the same time, the low rates of return

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6 Ibid at 12, 32.
7 Ibid at 13.
8 Ibid at 13, 29–30.
on government bonds led investors to seek higher returns on riskier investments and this demand was met by new financial products.\(^9\)

This financial innovation has been identified as a key factor in either causing or exacerbating the crisis for several reasons. First, the products became so complicated that the risks they presented were not understood.\(^{10}\) Second, because executives erroneously believed that these products dispersed risks,\(^{11}\) they took even greater risks than they might have otherwise taken. Third, because of globalization,\(^{12}\) the products, and the unrecognized risks they carried, were exported across the global financial system through a complex chain of products and relationships. This interconnectedness exacerbated systemic risk, and ultimately led to the economic shock of the financial crisis being transmitted across the world from one economy to another.

Another key factor in the crisis was therefore the failure of risk management. In assessing the risk of complex financial products and the likelihood of adverse events, both regulators and the regulated placed undue reliance on faulty risk models containing erroneous or incomplete assumptions, and complex mathematical formulae that were not properly understood.\(^{13}\) As a result there was a failure to recognize the extent of the risk retained by the institutions.\(^{14}\)

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\(^9\) Ibid at 14.
\(^{10}\) Though it may be that the lack of comprehension among market players of the real value of these products and the risks they presented has been over-stated. For example, the top CDO trader at Deutsche Bank is said to have referred to the assets underlying collateralized debt obligations as ‘crap’ and ‘pigs’: T. Braithwaite, F. Guerrera and J. Baer, ‘Senate Report Says Goldman Misled Investors’ Financial Times, 14 April 2011.
\(^{11}\) FSA, \textit{The Turner Review: A Regulatory Response to the Global Banking Crisis} (March 2009) at 42.
\(^{14}\) FSA, \textit{The Turner Review: A Regulatory Response to the Global Banking Crisis} (March 2009) at 16, 43.
However, the crisis has also been blamed on: financial deregulation and regulatory failure,15 in particular the failure of risk-based regulation,16 and the failure to regulate the new financial products; political pressure to engage in ‘light touch regulation’ so that competitiveness was not impeded;17 and gate-keeper failure, particularly that of the credit rating agencies, who awarded financial products the triple A rating that allowed public bodies to invest in them.18 The crisis has also been blamed on inadequately capitalized financial institutions that were excessively leveraged and that lacked a sufficient buffer to cope with the crisis;19 irrational exuberance in the market followed by a collapse in confidence;20 a misplaced faith in the efficiency and rationality of capital markets and a mistaken belief that these would restrain excessive risk taking and winnow out harmful financial products, coupled with a presumption in favour of deregulation;21 and executive remuneration policies that created perverse incentives to take undue risk.22

In addition, however, a number of policy-makers and commentators have blamed failings in corporate governance in banks and financial institutions,23

15 Ibid at 36–38, 43.
17 FSA, The Failure of the Royal Bank of Scotland (December 2011) at para 672.
22 FSA, The Turner Review: A Regulatory Response to the Global Banking Crisis (March 2009) at 47.
though this claim has been disputed. The FSA, for example, concluded that there were no corporate governance failings at board level in RBS, although closer scrutiny of its findings show that in making this assertion the FSA focused on processes and procedures, rather than the substantive effectiveness of those procedures. In fact, it found that there were questions raised over the board’s effectiveness. In any event it is not disputed that corporate governance problems were revealed by the crisis. Thus the Turner and Walker Reviews concluded that shareholders failed to act as a check on management even when, as the FSA found in the case of the acquisition of ABN AMRO by RBS, they had significant reservations about the strategy adopted by the board, and that boards themselves failed to identify and restrain excessive risk-taking. Problems were also identified in relation to the performance of non-executive directors who lacked relevant industry experience, failed to commit sufficient time to their role and failed to monitor and challenge the executive. Boards also failed to exercise adequate oversight of remuneration policies for senior employees with the result that executive remuneration, including bonuses, was linked to short-term performance.

25 FSA, ‘FSA closes supervisory investigation of RBS’ (2 December 2010).
26 FSA, The Failure of the Royal Bank of Scotland (December 2011) at paras 583–593.
28 FSA, The Failure of the Royal Bank of Scotland (December 2011) at 166–167. Despite a number of shareholders, particularly hedge funds, having concerns, 94.5 per cent of shareholders supported the ABN AMRO acquisition.
30 Although Northern Rock’s board included an experienced fund manager, the former CEO of a bank and a former member of the Court of the Bank of England: F. Guerrera and P. Thal-Larsen ‘Gone by the Board: Why the Directors of Big Banks Failed to Spot Credit Risks’ Financial Times, 26 June 2008.
31 D. Walker, A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations (26 November 2009) at 234.
In the light of these failings this book considers what lessons can be drawn from the financial crisis regarding the operation of directors’ duties and shareholder litigation more generally. It might be suggested that such a project overlooks the fact that banks are quite different from other types of commercial company. The nature of their business means that they are likely to be more highly leveraged than other types of business and more vulnerable. Because they play a central role in the economy, bank crises are far more significant for the real economy and for the taxpayer than other kinds of corporate collapses. Banks and financial institutions may therefore need to be more strictly regulated and have governance arrangements that go beyond those normally required of other types of company. Consequently, one needs to be cautious about drawing conclusions from the banks’ experience during the financial crisis and attempting to apply these more widely.

Nevertheless, the financial crisis has highlighted issues that have ramifications beyond the financial sector. The Walker Review itself concluded that some of its findings and recommendations were equally applicable to other types of UK company, particularly regarding the lack of institutional shareholder engagement and the need to enhance this to facilitate greater monitoring and disciplining of management. The UK Code of Corporate Governance was amended in the light of the Walker Review. It stipulates, inter alia, that all boards need to have a balance of skills, experience, independence and knowledge of the company, that directors should have appropriate knowledge of the company and access to its staff, that non-executive directors should constructively challenge executives, that risk management should be addressed and boards should be responsible for determining the nature and extent of the risks.

36 Ibid at 6.
that the company should undertake.\textsuperscript{40} These responses point to concerns about the role of boards, non-executive directors and institutional shareholders that are common to both banks and other types of company.

Moreover, the law’s capacity to respond to the failings identified in the performance of bank directors in the run up to and during the crisis holds lessons that go wider than the financial crisis and the banks. Given the level of shareholder anger at the scale of the losses incurred by institutions during the crisis, and given that various inquiries into the crisis identified missteps by bank directors, then arguably if ever there was going to be shareholder litigation against directors for breaching their duties to their companies, it would have materialized against the directors of banks. Generally though, this has not occurred. Instead, shareholders have attacked on other fronts, including a claim against the Government by the shareholders of Northern Rock in respect of the compulsory acquisition of their shares during nationalization,\textsuperscript{41} litigation or threatened litigation against various institutions for making false and misleading statements in prospectuses preceding rights issues in troubled entities, and claims by investors against banks over the mis-selling of financial products.\textsuperscript{42} Thus although Lloyds directors faced action by shareholders in the US and threatened litigation in the UK, these actions related to the making of misleading statements to shareholders in relation to the takeover of HBOS plc by Lloyds plc, and non-disclosure by Lloyds plc and its directors of the fact that HBOS plc had received emergency liquidity funding from the Bank of England.\textsuperscript{43} In contrast, there has been no litigation by institutions, or by shareholders on their institutions’ behalf, against bank directors for breaching their duties in the run up to and during the crisis. If, even in such extreme circumstances, and with such huge losses, a claim against bank directors was not viable, either because nothing that bank boards did or failed to do amounted to an

\textsuperscript{40} Ibid, Principle C2.

\textsuperscript{41} The shareholders’ claim was dismissed by the Court of Appeal: \textit{R (on the application of SRM Global Master Fund LP) v Treasury Commissioner} [2009] EWCA Civ 788; [2010] BCC 558. See discussion in Chapter 4 of this book.

\textsuperscript{42} These claims have, in turn, generally been unsuccessful see: \textit{Titan Steel Wheels Ltd v Royal Bank of Scotland} [2010] EWHC 211 (Comm); \textit{Camerata Property Inc v Credit Suisse Securities (Europe) Ltd} [2011] EWHC 479 (Comm); [2011] 1 CLC 627; \textit{Camerata Property Inc v Credit Suisse Securities (Europe) Ltd} [2012] EWHC 7 (Comm). RBS shareholders are bringing a similar action in respect of a 2008 rights issue: H. Wilson, ‘Fred Goodwin: we weren’t at fault in RBS failure’ \textit{The Telegraph} 26 June 2012.

\textsuperscript{43} ‘Lloyds faces lawsuit from US investors’ \textit{The Financial Times}, 1 January 2012.
actionable breach of duty, or because the obstacles facing shareholders wishing to bring litigation were too high, or due to problems with the very concept of shareholders as effective monitors, then this has ramifications that go well beyond the financial sector. It raises far broader questions about the efficacy of the law on directors’ duties and shareholder litigation as a means of holding directors to account, particularly in the context of dispersed share-ownership companies.

The purpose of this book is to consider these issues. Although any action against bank directors would be for breach of their common law duties, the book is forward-looking and considers how effective the present law under the Companies Act 2006 would be at addressing the problems flagged up by the financial crisis.

ORGANIZATION OF THE BOOK

The discussion in the book falls broadly into three sections. The first is devoted to directors and directors’ duties. The second part focuses on shareholder litigation and the third part draws together both themes and concludes.

The first section focuses on two duties that are particularly relevant in the context of the financial crisis, namely the directors’ duty of care and skill now contained in the Companies Act 2006 s.174, and the duty to promote the success of the company for the benefit of its members as whole contained in the Companies Act 2006 s.172. As for the first, given the poor quality of board decisions as revealed, for example, in the FSA’s reports into Northern Rock and RBS, it seems self-evident that directors would be vulnerable to claims that they breached their duties of care and skill. Therefore, in Chapter 1 Loughrey examines the directors’ duty of care and skill at common law and under s.174. Through an analysis of the case law, and the various public reports into the crisis, she identifies the obstacles to successful claims against bank directors for breach of their duties of care and skill.

In Chapter 2 Keay analyses the duty under the Companies Act 2006 s.172 which had been heralded as introducing a new model for corporate decision-making based on ‘enlightened shareholder value’, and questions whether it is fit for purpose. The financial crisis highlighted in an extreme fashion the costs to society of reckless corporate behaviour that focuses on the promotion of shareholder value in the short-term and disregards the costs of corporate behaviour to other stakeholders. Keay considers whether s.172 will be successful in discouraging short-term behaviour and in encouraging boards to take a more inclusive approach.
He also considers the prospects for successful claims for breach of the s.172 duty where boards take decisions that do not promote the success of the company.

In the third chapter Villiers turns to the related issue of the obligation under the Companies Act 2006 s.417 for companies and their boards to provide a business review and the manner in which companies are complying with their reporting obligations. Both Villiers and Keay point out that s.417 is closely related to s.172, as the reporting obligations under the former are designed to allow shareholders to assess how directors are performing their duty to promote the success of the company under the latter. It is key therefore to facilitating shareholder monitoring and to promoting the concept of enlightened shareholder value. Villiers assesses the extent to which the reporting obligations under s.417 contribute to these goals, and thus to the success or otherwise, of s.172 and to the objective of more informed shareholder engagement.

While some have argued that the crisis was the product of moral failure and greed, there is evidence that behavioural factors were at work in leading to the short-termist and reckless behaviour exhibited by bank boards. Thus the Walker Review claimed that

> ‘the principal deficiencies in [bank] boards related much more to patterns of behaviour than to organization’

and that behavioural changes were required from boards and senior managers. Campbell’s chapter examines the kinds of cognitive failure that could cause senior managers to make bad decisions and suggests safeguards that could be put in place to reduce the impact of these sub-conscious influences on decision-making. As explained in the Conclusion his arguments give us a different way of thinking about s.172 and its potential to alter directors’ behaviour.

In Chapter 5 the book turns to examine the shareholder role in more detail, with a review by Tomasic and Akinbami of the factors contributing to a lack of shareholder activism in the UK. These factors explain in part the very low levels of litigation involving shareholders in public companies that Tomasic and Akinbami detected in their survey of shareholder

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45 D. Walker, A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations (26 November 2009) at 12.
46 Ibid at 9–10.
litigation in England and Wales between 2000 and 2010. Tomasic and Akinbami also examine one of the few significant shareholder actions that have resulted so far from the crisis, namely the unsuccessful litigation by the Northern Rock shareholders against the Government arising out of the compulsory acquisition of their shares.  

In Chapter 6 Hollington provides a rare example of successful shareholder litigation that has arisen as a direct result of the financial crisis, namely the use of the remedy for just and equitable winding up by members of open-ended investment funds in the Cayman Islands and the British Virgin Islands. The remedy for just and equitable winding up is rarely used now in the UK owing to the availability of the unfair prejudice remedy, but Hollington’s chapter provides an opportunity to consider how an established shareholder remedy can be utilized imaginatively by shareholders to obtain effective redress, provided that they are faced with cooperative courts.

Subsequently in Chapter 7 Loughrey and Keay examine the statutory derivative action under the Companies Act 2006, which replaced the derivative action at common law. The derivative action provides a remedy to the company for breaches by directors of their duties to the company. In the absence of litigation authorized by the company itself through the board, this would be the form of action that shareholders would have to utilize to pursue claims against bank directors on their company’s behalf. However after issuing the claim form shareholders must seek the court’s permission to continue with the claim. Consequently the utility of the derivative action as a remedy for breaches of directors’ duties is contingent on the manner in which the courts perform this gatekeeper function. Loughrey and Keay consider the case law on applications for permission under s.261 and s.263 of the Companies Act 2006 and assess the approach the courts have adopted to date. This chapter was previously published in the Journal of Business Law in 2010 and has been updated to incorporate discussion of the later decisions of Stainer v Lee,

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Langley Ward Ltd v Trevor,\textsuperscript{50} Kleanthous v Paphitis\textsuperscript{51} and Parry v Bartlett.\textsuperscript{52}

To accurately assess the impact of the law and to identify any weaknesses, it is necessary to understand how it operates in practice. Chapter 8 therefore features a debate between academic and practitioner experts regarding, amongst other matters, the efficacy and impact of s.172 Companies Act 2006 and the derivative action in practice. It provides a valuable insight into the practitioner approach to these issues, a matter that will be returned to in the Conclusion.

Finally, the Conclusion draws together the various themes that emerge during the course of the book.

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\emph{Journal of Business Law} for granting permission to include Keay and Loughrey’s material on the derivative action in Chapter 7. Professor Tomasic would also like to thank the British Academy for funding some data collection under the Stakeholders and Gatekeepers in Corporate Governance project funded under Co-Reach Project 64-033. They would also like to thank the Leverhulme Trust for funding on the Tipping Points project. The chapters are up to date as of June 2011, with some chapters incorporating limited consideration of later developments.

\textsuperscript{50} [2011] EWHC 1893 (Ch).
\textsuperscript{51} [2011] EWHC 2287 (Ch).
\textsuperscript{52} [2011] EWHC 3146 (Ch).