Corporate Governance Reforms Post 2008 Global Financial Crisis:

An Exercise in Futility?

By

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<tr>
<td>AIB</td>
<td>Allied Irish Bank</td>
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<td>AIG</td>
<td>American Insurance Group</td>
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<td>AGM</td>
<td>Annual General Meeting</td>
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<td>AMEX</td>
<td>American Stock Exchange</td>
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<td>ARRA</td>
<td>American Recovery and Reinvestment Act</td>
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<td>BAP</td>
<td>Bank Administration Procedure</td>
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<td>BoE</td>
<td>Bank of England</td>
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<td>BIS</td>
<td>Bank for International Settlements</td>
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<td>BIP</td>
<td>Bank Insolvency Procedure</td>
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<td>CUP</td>
<td>Cambridge University Press</td>
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<td>CALD</td>
<td>Council of Australian Law Deans</td>
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<td>CDS</td>
<td>Credit Default Swaps</td>
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<td>CDCI</td>
<td>Community Development Capital Initiative</td>
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<td>CDFI</td>
<td>Community Development Financial Initiative</td>
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<td>CEO</td>
<td>Chief Executive Officer</td>
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<td>CFO</td>
<td>Chief Finance Officer</td>
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<td>CBO</td>
<td>Congressional Budget Office</td>
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<td>CGI</td>
<td>Corporate Governance Institute</td>
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<td>COP</td>
<td>Congressional Oversight Panel</td>
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<td>Abbreviation</td>
<td>Full Form</td>
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<tr>
<td>CPP</td>
<td>Capital Purchase Programme</td>
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<td>CRS</td>
<td>Congressional Research Service</td>
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<td>CRA</td>
<td>Credit Rating Agency</td>
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<td>EC</td>
<td>European Commission</td>
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<td>ECB</td>
<td>European Central Bank</td>
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<td>ESA</td>
<td>Economic Stimulus Act</td>
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<td>EESA</td>
<td>Emergency Economic Stabilisation Act</td>
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<td>EU</td>
<td>European Union</td>
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<td>EC</td>
<td>European Commission</td>
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<tr>
<td>FCA</td>
<td>Financial Conduct Authority</td>
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<td>FCIC</td>
<td>Financial Crisis Inquiry Commission</td>
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<td>FDIC</td>
<td>Federal Deposit Insurance Corporation</td>
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<td>FDICA</td>
<td>Federal Deposit Insurance Corporation Act</td>
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<td>FDI</td>
<td>Foreign Direct Investment</td>
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<td>FDR</td>
<td>Federal Reserve Board</td>
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<td>FRC</td>
<td>Financial Reporting Council</td>
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<td>FHA</td>
<td>Federal Housing Administration</td>
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<td>FHFA</td>
<td>Federal Housing Finance Agency</td>
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<td>FSA</td>
<td>Financial Services Authority</td>
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<td>FSF</td>
<td>Financial Stability Forum</td>
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<td>FSMA</td>
<td>Financial Services Market Act</td>
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<td>Abbreviation</td>
<td>Full Form</td>
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<tr>
<td>FSCS</td>
<td>Financial Services Compensation Scheme</td>
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<td>FSOB</td>
<td>Financial Stability Oversight Board</td>
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<tr>
<td>GAO</td>
<td>General Accounts Office</td>
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<td>GCGF</td>
<td>Global Corporate Governance Forum</td>
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<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>GFC</td>
<td>Global Financial Crisis</td>
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<td>GM</td>
<td>General Motors</td>
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<td>GNP</td>
<td>Gross National Product</td>
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<tr>
<td>HHF</td>
<td>Hardest Hit Fund</td>
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<tr>
<td>HAMP</td>
<td>Home Affordable Modification Programme</td>
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<tr>
<td>HBSO</td>
<td>Halifax Bank of Scotland</td>
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<tr>
<td>HCTC</td>
<td>House of Commons Treasury Committee</td>
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<tr>
<td>HPS</td>
<td>Home Preservation Scheme</td>
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<td>ICGN</td>
<td>International Corporate Governance Network</td>
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<td>IFLR</td>
<td>International Finance Law Review</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>NAMA</td>
<td>National Asset Management Agency</td>
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<td>NAO</td>
<td>National Audit Office</td>
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<td>NAPF</td>
<td>National Association of Pension Funds</td>
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<td>NED</td>
<td>Non-Executive Directors</td>
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<td>PRA</td>
<td>Prudential Regulation Authority</td>
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<td>Abbreviation</td>
<td>Full Form</td>
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<tr>
<td>NRAM</td>
<td>Northern Rock Asset Management</td>
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<td>NYSE</td>
<td>News York Stock Exchange</td>
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<tr>
<td>IoD</td>
<td>Institute of Directors</td>
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<tr>
<td>OFS</td>
<td>Office of Financial Stability</td>
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<td>OIG</td>
<td>Office of Inspector General</td>
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<td>OSM</td>
<td>Office of Special Master</td>
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<tr>
<td>OECD</td>
<td>Organisation for Economic Cooperation and Development</td>
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<td>OUP</td>
<td>Oxford University Press</td>
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<tr>
<td>PEA</td>
<td>Prompt Corrective Action</td>
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<td>S &amp; P</td>
<td>Standard and Poor’s</td>
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<tr>
<td>SEC</td>
<td>Securities and Exchange Commission</td>
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<tr>
<td>SEO</td>
<td>Senior Executive Officer</td>
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<td>SRR</td>
<td>Special Resolution Regime</td>
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<td>TAAP</td>
<td>Troubled Asset Auction Programme</td>
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<tr>
<td>TARP</td>
<td>Troubled Asset Relief Programme</td>
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<tr>
<td>TFEU</td>
<td>Treaty on the Functioning of the European Union</td>
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<td>UK</td>
<td>United Kingdom</td>
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<td>UKFI</td>
<td>United Kingdom Financial Investment Limited</td>
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<tr>
<td>USA</td>
<td>United States of America</td>
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Dedication

This thesis is dedicated to the blessed memory of Nnaa Yaa Bosuo (My Late Grandmother), Nomoa Kwabena Gyinde (My Late Father) and Hankoro Akua Jugboi (My Late Mother) who instilled in me the virtues of hard work, duty to my community and taught me that what makes me human is my recognition of the humanity in others.
Abstract

The financial crisis which began in 2007/2008 remains the most severe since the Great Depression of the 1930s.\(^1\) It exposes the inherent dangers of unregulated markets and highlights the weaknesses of the corporate governance system that has been constructed and determined by the shareholder primacy theory.\(^2\)

The crisis sparked an intense debate on the causes and the reforms needed to correct the largely dysfunctional governance, legal and regulatory regime that has characterised the pre-crisis corporate governance landscape. In response, governments in the US and the UK embarked on different governance and regulatory reforms ostensibly to contain the damage and possibly prevent future occurrence.

This Thesis argues that corporate governance failures merely triggered the crisis and that the underlying cause of the crisis is the idea that the sole purpose of the corporation is shareholder value maximisation. The reforms merely provide immediate and temporary solutions but leave intact the problem of how to deal with the issue of shareholder primacy in the long-term. Thus, the thesis contends that the reforms in the US and UK are at best ad-hoc and cosmetic measures that only treat the symptoms and not the causes of the crisis.

An original contribution of this thesis is that it may lead to a reconceptualization of the nature and purpose of the corporation and the emergence of a more long-term governance model. It has wider implications as it will be useful not only for students and researchers but also provide insights for policy makers and business managers to enable them make informed decisions.

---

\(^1\) Thomas Clarke and Jean-Francois Chanlat, *European Corporate Governance: Readings and Perspectives* (Routledge 2009) 1

\(^2\) Lynn Stout, *The Shareholder Value Myth* (Berret-Koehler Publishers) 7
Declaration of Originality

This Thesis and the work to which it refers are the result of my own efforts. Any ideas, data, images or text resulting from the work of others (whether published or unpublished) are fully identified as such within the work and bibliography or in footnotes. This Thesis has not been submitted in whole or in part for any other academic degree or professional qualification. I agree that the University has the right to submit my work to the plagiarism detection service TurnitinUK for originality checks. Whether or not drafts have been so assessed, the University reserves the right to require an electronic version of the final document (as submitted) for assessment.

Signature of Candidate

[Signature]

Date: 30 October 2016
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*Blight v. Brent* (1837) 2 Y & C Ex. 268


*David v. Old Colony Railway Company*, 131 Mass, 258 [1881]


*Mun v. Illinois* 94 U.S.113 (1877)

*Paramount Communications Inc. v. QVC Network Inc.* (1994), 637 A (2d) 34 (Del. SC)

*Paramount Communications Inc. v. Time Inc.* (1989), 571, A (2d) 1140 (Del. SC)

*Peoples Department Stores Inc. (Trustees) v. Wise* 2004 sec 65[2004] 3 SCR 461

*R v (on the application of Kaupthing) HM Treasury* (2009) EWHC 2542 (Admin) [16] [28]

*Revlon Inc. v. Mac Andrews & Forbes Holdings Inc.* (1986), 506 A (2d) 173 (Del. SC)


*Shlensky v. Wrigley* (1968), 237 NE (2d) 776

*Steinway v. Steinway & Sons*, 40 N.Y.S, 718 [1896]

*S v Mankwanyane* 1995 (3) SA 391 (CC)

*Port Elizabeth Municipality v Various Occupiers* 2005 SA 217 (CC)

*The City of Johannesburg v Rand Properties Ltd* 2007 (1) SA 75 (W)

*Dikoto v Mokhata* 2006 (6) SA 235 (CC)
## Table of Legislative Materials

### US

- The American Recovery and Reinvestment Act 2009
- The Banking Supervision Act 1991
- The Emergency Economic Stabilisation Act 2008
- The Economic Stimulus Act 2008
- The Federal Deposit Insurance Corporation Improvement Act 1991
- The Sarbanes-Oxley Act 2002
- The Securities Act 1933
- The Securities and Exchange Act 1934
- The Special Provision Act 2008
- The Credit Rating Agencies Reform Act 2006
- The Dodd-Frank Act 2010
- The New York Stock Exchange Listing Rules
- The Shareholder Bill of Rights Act 2009
- The Graham-Leach Bliley Act 1999
- The Garn St German Depository Institutions Act 1982
- The Commodity and Futures Modernisation Act 2001
- The Glass-Steagall Act 1933
- Joint Stock Companies Act 1886
- The Shareholder Bill of Rights 2009
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The Internal Revenue Code 1986

The Private Securities Litigation Reform Act 1995

**UK**

The Banking Act 2009

Credit Rating Agencies (Civil Liability) Regulations 16/2013.

The Companies Act 2006

The European Communities Act 1975

The Enterprise Act 2002

The Financial Services and Market Act 2000

The Human Rights Act 1998

The Insolvency Act 1986

The Pension Act 1995

**EU**

European Convention on Human Rights

Capital Requirements Directive (Governance and Remuneration)-Directive 2013/36/EU


Treaty on the Functioning of the European Union- Articles 101 & 102

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Regulation (EC) No.513/2011
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Michael S. Barr, Testimony before the Sub-Committee on Oversight and Government Reform on Domestic Policy (*US House of Representatives*, 14 November 2009)


Congressional Budget Office, ‘Did the 2008 Tax Rebates Stimulate Short-Term Growth?’ (Economic and Budget Issue Brief, 10 June 2009)


Table of Other Materials


CHAPTER 1

1.1 Introduction

The prolonged Global Financial Crisis (GFC) which began in 2007/2008 is seen by many as having been triggered by corporate governance failures.³ It is considered the most severe financial crisis since the Great Depression of the 1930s exposing the inherent dangers of unregulated markets and undermined the reasoning behind the efficient market hypothesis. Above all, it raises important questions about the long-held assumptions regarding the shareholder primacy theory. The crisis calls into question the way the public corporation is conceived, its nature and purpose in society.⁴ The United Kingdom (UK) Turner Review characterises it as ‘the greatest crisis in the history of financial capitalism’.⁵ According to Davis, it remains the greatest shock to the world financial system for nearly eight decades.⁶

Financial crisis is here defined as ‘a disruption to the financial markets in which adverse selection and moral hazard problems become much worse, so that financial markets are unable to efficiently channel funds to those who have the most productive investment opportunities’.⁷ Arguably, the effects of financial crisis go beyond those resulting from bank panics. It also interferes with the process of long-term economic growth.⁸

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³ Thomas Clarke and Jean Francois Chanlat, European Corporate Governance: Readings and Perspectives (Routledge 2009) 1.
⁸ ibid
Although the crisis originated in the United States of America (US), its repercussions are widespread and in fact global.\textsuperscript{9} It led to the collapse of financial markets and institutions worldwide, triggered a dramatic fall in industrial output, an increase in unemployment, a reduction in foreign direct investments (FDI) and a sharp economic decline.\textsuperscript{10} Obviously, all these have serious political, economic, social and security implications for countries around the world. Nearly eight years after the crisis, the effects are still evident in various shapes, forms and at multiple levels.\textsuperscript{11}

The GFC has impacted both the developed and emerging economies albeit in different degrees. Several financial institutions including some of the world-renowned corporations have either collapsed or have been bailed out by governments across the world. In the United States (US) for instance, the Treasury Department was compelled to initiate a rescue package for Fannie Mae and Freddie Mac in July 2008 and intervened on March 10 the same year to save the US investment bank, Bear Stearns from imminent collapse.\textsuperscript{12} Similarly, in the United Kingdom (UK), the crisis led to the collapse of Bradford & Bingley, Alliance & Leicester and the subsequent nationalisation of Northern Rock Plc and the Royal Bank of Scotland.\textsuperscript{13}

The International Monetary Fund (IMF) estimates that worldwide losses arising from the crisis, measured in terms of write-downs on assets in the US, Japan and Europe could be as high as $4.1 trillion while global gross domestic product (GDP) contracted to its lowest in 2009 since World War II.\textsuperscript{14} In its 2009 report, the IMF further reveals that the total cost of the GFC

\textsuperscript{10} Stavros Vourloumis, ‘Reforming the EU and the Global Financial Regulation: Crisis, Learning and Paradigm Shifts’ (A Paper Presented at the 4\textsuperscript{th} Biennal ECPR Regulatory and Governance Conference, 27-29 August 2012)
\textsuperscript{12} ibid
\textsuperscript{13} ibid
including cash injections into failing banks, bank guarantees and the purchase of toxic assets amounted to $11.9 trillion. This represents one-fifth of the world’s annual economic output.

Europe did not escape the devastating effects of the GFC. The European Central Bank (ECB) reveals that the write-downs on securities and loans by banks in the Eurozone amounted to $649 billion between 2007 and 2010. Similarly, the European Commission admits that Gross Domestic Product (GDP) across the European Union (EU) dropped by an estimated 4 per cent, making it the first recession in the EU since the early 1990s and the worst performance on record.

The GFC highlights the weaknesses in the edifice of the corporate governance system that has been constructed and determined by the shareholder primacy theory. According to Vourloumis, the crisis has exposed the ‘flaws and fault lines’ of the pre-existing architecture of corporate governance. It is an architecture in which the dominant paradigm has been one of shareholder primacy, over-emphasis on profit maximisation and a misguided over-reliance on the superiority of the efficient market hypothesis. The underlying assumptions of the current corporate governance model not only proved faulty and inadequate in dealing with the systemic challenges sweeping through the corporate landscape, it also challenges a host of conceptions about the theories of corporate governance.

The crisis sparked an intense debate regarding the causes and possible remedies. Consequently, academics, politicians and journalists have all joined the fray and have been engaged in the

15 ibid
19 Vourloumis (n 10) 23.
20 Mishkin (n 7) 115.
21 ibid
discourse regarding the origins, causes and triggers of the crisis. Many studies examining the causes of the crisis have been undertaken by various writers in different jurisdictions but reaching a consensus has remained elusive. While there is a general agreement on the list of contributory factors, there is less agreement on which of the factors are the most important and the consequent implications for the necessary reforms.22

Following the GFC, countries across the globe have initiated several corporate governance reforms in an attempt to contain the damage and address the defects in the current corporate governance regime to prevent future occurrence. These initiatives, notably in the US and UK entail various corporate governance reform proposals intended to curb excessive risk taking and empower shareholders in the belief that shareholder-empowerment in particular, would constraint reckless risk managers in the future.23 As a result, US authorities introduced significant corporate governance reforms such as the Dodd Frank Act 2010, the American Recovery and Emergency Act 2009, the Economic Stabilisation Act 2008 and the Shareholder Bill of Rights Act 2009. In the UK, authorities embarked on several legislative and regulatory measures to reform the banking sector and the financial markets. Notable among these initiatives are the Banking Act 2009, Financial Services Act 2010, Financial Services and Banking Act 2010 and the Combined Code of 2010 and 2014.


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22 Gamble and Kelly (n 4) 114.
25 EC Transparency Directive (2009/109/EC) was amended in 2013 and is now Directive 2013/50/EU
26 Capital Requirements Directive (Governance and Remuneration) Directive 2013/36/EU
On the face of it, some of the corporate governance reforms that have been initiated and passed into law seem progressive and forward-looking. Ostensibly, they are designed to correct the corporate governance failures and shortcomings that have created the greatest GFC in recent times.\(^{27}\) But the question becomes whether these legislative initiatives, regulatory changes and corporate governance reforms are the appropriate responses in the first place. Second, to what extent do these policy initiatives address the underlying cause(s) of the GFC?\(^ {28}\) The answer is largely unclear, highly contentious and remains unanswered. Against this backdrop, the questions that this thesis intends to address are:

(a) What is the nature of corporate governance reforms that have occurred in the US and UK post the financial crisis?

(b) Do the current reforms differ from previous ones?

(c) To what extent do such reforms address the fundamental issue of shareholder primacy theory that have influenced and dominated corporate governance thinking and practice?

(d) What are the differences and similarities between the reforms in the UK and US?

Therefore, the bigger question that this thesis seeks to answer is ‘Do the corporate governance reforms post the 2007/2008 financial crisis address the underlying cause/causes or are they merely treating the symptoms?’

In answering these questions, the thesis pursues three distinct but inter-related aims. First, it examines the shareholder primacy theory which, this thesis argues, is the underlying cause of the GFC. Consequently, the thesis interrogates the various corporate governance reforms that have been initiated in the US and UK following the GFC. Such a critical examination will help

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\(^{27}\) Bruner (n 23) 37.

\(^{28}\) Franklin A. Gouvurtz, ‘The Role of Corporate Law in Preventing a Financial Crisis: Reflection on In Re Citygroup Inc. Shareholder Derivative Litigation’ in P.M Vasudev and Susan Watson (eds), Corporate Governance after the Financial Crisis (Edward Elgar Publishing 2012) 163.
inform and determine how far and to what extent these reforms are able to resolve the fundamental problem of the shareholder primacy theory. Arguably, these reforms reflect a growing consensus that the current corporate governance system is defective in many respects. The central message therefore, is that the underlying cause of the financial is the unquestioning acceptance of the shareholder primacy theory whose basic assumptions have proved to be fundamentally flawed. Thus, this thesis submits that the role and purpose of the corporation should go beyond the narrow confines of shareholder interests and focus on its long-term survival.29

Secondly, it explores the causes of the financial crisis and situates it within the shareholder primacy context. The central argument is that there is a direct link between recent corporate governance failures and the shareholder primacy theory. From this perspective, the thesis evaluates the theoretical foundations, evolution and assumptions of the shareholder primacy theory and explains how it has influenced and shaped present day corporate governance. Furthermore, the thesis takes a comparative look at the major reforms in the US and the UK. Such a comparative approach facilitates an understanding of the forces driving the differences and similarities and the subsequent reforms that emerged. Although the policy frameworks differ significantly on both sides, there are also important commonalities between the two countries. These differences and similarities are driven by domestic agendas largely because the responses in the two jurisdictions express the interaction of economic preferences and political institutions.30

Finally, it seeks to highlight the lessons that can be drawn from the GFC and makes recommendations that will bring about the necessary legislative and regulatory reforms. These

include a tighter regulatory regime, the introduction of ‘covenant’ banking principles, and more importantly a redefinition and reconceptualization of the ultimate role and purpose of the modern corporation in society.31

1.2 Relevance and contribution

The thesis is particularly relevant for several reasons. First, it contributes to knowledge by offering a systematic framework for analysing the shareholder primacy theory and its role in the current GFC. It contextualises actual policy responses following the GFC and justifies the policy choices using theoretical tools that have shaped and influenced corporate governance discourse and practice in recent times.

Moreover, it provides new perspectives on the long-standing debate regarding the purpose and role of the corporation by questioning the validity of the shareholder primacy theory of corporate governance.32 In so doing, the thesis refutes the mistaken assumptions of the shareholder primacy theory and sheds light on the debate thereby promoting a better appreciation of the critical issues surrounding corporate governance.

Furthermore, it addresses key philosophical and methodological issues in corporate governance thinking and more importantly moves beyond the constraints of traditional mode of thinking. In that respect, a significant contribution of this research is the proposition that reliance on the shareholder theory which is characterised by profit maximization, short-termism and efficiency of the markets is not just flawed but under pines the current financial crisis.33 Therefore, the need to explore alternative governance architecture and make proposals for reforms has never

33 Thomas Clarke, ‘Corporate Governance Causes of the Financial Crisis’ in William Sun, Jim Stewart and David Pollard (eds), Corporate Governance and the Global Financial Crisis: International Perspectives (CUP 2011) 31.
been more urgent.\textsuperscript{34} Hence, the proposals and recommendations contained in this research provide insights and direction in the corporate governance debate regarding the causes of the crisis and the appropriate policy responses to be adopted.

Finally, the thesis is policy-relevant as it contributes to policy development in the corporate governance domain particularly post the 2008 GFC. Although, some research work has been done in this area of study, this is the most comprehensive doctrinal work undertaken to compare the legislative, regulatory and governance responses in the US and UK post the GFC. Indeed, the more forensic approach provides a deeper and clearer understanding of the power relations and struggles fuelled by different perceptions of the role and purpose of the public corporation in society. It is envisaged that the outcome and subsequent recommendations will be of immense benefit policy makers, practitioners and business managers as it provides them with the vital tools to make informed decisions.

1.3 Research Methodology

Basically, research is a systematic, thorough and rigorous process of investigation that increases knowledge.\textsuperscript{35} This process of investigation requires a research methodology- which is defined here as a set of rules about the way research is conducted and the rules governing their application and validity. This thesis adopts a mixed methodological approach that is mainly doctrinal, partly socio-legal and to a lesser extent comparative. This mixed approach has become necessary because focusing exclusively on the doctrinal approach cannot adequately explain the theoretical foundation and evolution of the shareholder primacy theory and the governance model that emerged from it.

\textsuperscript{34} P.M. Vasudev and Susan Watson, \textit{Corporate Governance After the Financial Crisis} (Edward Elgar Publishing 2012) 5.

\textsuperscript{35} Maggie Walter, \textit{Social Research Methods} (2\textsuperscript{nd} edn. OUP) 485.
Moreover, corporate governance systems and models are ‘path-dependent’ and have been shaped and determined by cultural experiences, social norms, and political beliefs within a certain legal, economic and historical context. For these reasons, it becomes imperative to situate the discourse within the socio-legal approach.

The research also adopts a comparative approach by comparing the regulatory and legislative responses in the UK and the US. The object is to investigate whether and to what extent the differences and commonalities are due to domestic considerations and local circumstances or a specific governance model. Therefore, this study justifies the need to employ a combination of doctrinal, socio-legal and comparative research methodology to ensure relevance and cure some of the inherent weaknesses of doctrinal research.

1.3.1 Doctrinal Research

Doctrinal research is defined as research that aims to give systematic exposition of the rules, principles and concepts that govern a particular field or institution.\textsuperscript{36} It analyses the relationship between these principles, rules and concepts in order to resolve the uncertainties and gaps in the existing law.\textsuperscript{37} According to the Council of Australian Law Deans (CALD), ‘Doctrinal research involves rigorous analysis and creative synthesis, the making of connections between seemingly disparate doctrinal strands and the challenge of extracting general principles from an inchoate mass of primary material’.\textsuperscript{38}

\textsuperscript{37} ibid
Chapter 1

Therefore, doctrinal research concerns itself with textual analysis of documents, legislations, rules and regulations. In effect, doctrinal research is not merely asking what the law is on an issue, but also concerns itself with the development and application of the doctrine.

Doctrinal research methodology serves three main goals namely; description, prescription and justification. First, it describes the existing law (situation) in a specific field of study or in respect of some institutions. This, however, requires neutrality and consistency to inform audience on how the law operates. While it is difficult to imagine how the law would function without a systematic description, it should also be remembered that in doctrinal research, the law is considered a system and not a mere description of existing legislation and case law. Consequently, this research provides a comprehensive description of the causes of the GFC, the shareholder primacy theory and the policy responses in the US and UK.

Second, doctrinal research is not limited to the mere description and perhaps, understanding of existing law but also entails a search for practical solutions that best respond to the challenges posed. More often, description is complimented by a more prescriptive approach that guides the search for best outcomes. Against this backdrop, the thesis goes beyond the description of the causes and responses to the financial crisis but suggests practical solutions in the form of recommendations.

Doctrinal research, otherwise referred to as pure theoretical research focuses on the analysis of doctrine, its development and application. It can either take the form of a simple research focusing on a specific issue or a more complex one demanding an in-depth analysis and critical examination of the underlying theories behind a substantive issue.39 This thesis justifies the approach from three perspectives. First, it argues that doctrinal research remains the most

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accepted approach to research in law as it helps in systemising the present law.\textsuperscript{40} This systemisation enables the law to accommodate new developments in relation to legislation and case law against the backdrop of societal changes. The ability to respond to such changes makes it ‘a living system capable of achieving both consistency and change in the development of the law’.\textsuperscript{41}

Furthermore, doctrinal research sets the standard in terms of the intellectual and practical skills needed to engage in the critical analysis of primary and secondary sources and provides solutions to challenging questions.\textsuperscript{42} Arguably, the doctrinal approach is in many respects, a prerequisite for undertaking any meaningful legal research and remains the most important type of research in which legal scholars engage.\textsuperscript{43}

But doctrinal research has its own weaknesses and has come under attack for several reasons.\textsuperscript{44} The major criticism is that it tends to over-emphasise normative questions while neglecting substantive issues. Critics argue that the attention seems to focus on ‘shaping legal reasoning and less towards influencing policy and practice’.\textsuperscript{45} As a result, doctrinal research remains largely theoretical and very abstract. According to Hillyard ‘It demonstrates a preponderance of purely theoretical and textual analysis rather than theoretically informed empirical research’.\textsuperscript{46} Thus, it is submitted that doctrinal research is more about theoretical discourse and less about bringing effective policy changes in practice.

\textsuperscript{42} ibid
\textsuperscript{43} ibid
\textsuperscript{44} Terry Hutchinson and Nigel Duncan, ‘Defining and Describing What We Do: Doctrinal Legal Research’ (2012) 17(1) Deakin Law Review 83, 97.
\textsuperscript{46} ibid
Second, doctrinal research is considered too narrow from an interdisciplinary perspective. Arguably, the culture of doctrinal legal research has been characterised by a ‘lone researcher’ working on his/her own and not accustomed to being part of a team. This inevitably, leads to what has been described as ‘silo mentality’ which makes legal scholars both physically and academically isolated from other researchers in the social sciences.

Another methodological pitfall of doctrinal research is that it tends to be too provincial and focuses on just two jurisdictions (UK and US) instead of adopting a transnational approach. Critics further contend that doctrinal research is not creative enough from an academic perspective. In recognition of these methodological challenges, it is submitted that mainstream doctrinal legal research needs to be less national, more interdisciplinary and less old-fashioned in its approach. This explains why this thesis adopts a multi-dimensional approach which combines doctrinal, socio-legal and comparative research to situate the discussion in the right context.

Arguably, such an approach moves the discourse from a purely abstract and theoretical perspective to a more practical level in terms of policy formulation and development. As indicated earlier, the aim of this thesis, among other things, is to make recommendations with the view to marking a radical departure from the present shareholder-oriented model. Against this backdrop, it has become imperative to incorporate socio-legal and comparative research into the overall research methodology so to provide the proper context and ensure a fuller engagement in the discourse.

1.3.2 Socio-Legal Research

Researchers are often inclined to invoke the concept of socio-legal research, but clear definitions tend to be rare and elusive. In practice, however, the definitions tend to fluctuate

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between broader and narrower conceptions. Thus, socio-legal research is defined in this context as an inter-disciplinary approach to analyse law, legal phenomena and the relationships between these disciplines and the wider society.\textsuperscript{48} Patterson defines socio-legal research as ‘theoretical work which leads to the development of grounded theory as well as more policy-oriented study which feed directly into the policy-making processes’.\textsuperscript{49} Similarly, Cottrell defines it as ‘the systemic study of the field of social experience’ and notes that socio-legal research goes beyond the orthodoxy of doctrinal legal commentary and debate.\textsuperscript{50}

Socio-legal research has its theoretical foundation in the social sciences and thus, seeks to understand law as a social phenomenon. In that respect, it considers the law in the context of broader social and political theory by exploring how the law is implemented and enforced, the exercise of discretion, the nature of disputes and disputing.\textsuperscript{51}

A distinguishing feature that binds the socio-legal community together is the multi-disciplinary approach in which the theoretical perspectives and methodologies are informed by research in other disciplines. Traditional socio-legal research has helped bridge the gap between law and sociology, social policy and economics. Indeed, the past two decades have witnessed a growing interaction between law and other disciplines within the field of humanities.

Apparently, recent developments in socio-legal research indicate that the methodology may be predominantly empirical but not necessarily exclusive. This is because socio-legal research has developed and become diverse both in theory and methodology. It has become less empirical as evidenced in recent attempts to define the aims and disciplinary boundaries of socio-legal research.\textsuperscript{52} With this growing diversity, socio-legal study is now defined not so much in relation

\textsuperscript{48} Reza Banakar and Max Travers (eds), \textit{Law and Social Theory} (2\textsuperscript{nd} edn. Hart Publishing 2002) 26.
\textsuperscript{49} Dennis Patterson (ed), \textit{A Companion to Philosophy of Law and Legal Theory} (2\textsuperscript{nd} edn. OUP 2010) 327.
\textsuperscript{51} ibid
\textsuperscript{52} ibid
to empirical research but in terms of academic contribution to the development of law. As Wheeler and Thomas point out, socio-legal study has emerged as an interdisciplinary alternative and a challenge to traditional empirical research.\(^53\) They argue that socio-legal research ‘represents an inter-face with a context within which the law exists’.\(^54\) Indeed, law is after all, a social institution like religion, medicine or education and can be studied by situating it within the context in which it exists. From this standpoint, socio-legal research represents a truly interdisciplinary field open to theoretical diversity and innovation.\(^55\) The theoretical diversity, as already mentioned, involves how best to incorporate the social, political, economic and historical insights into the corporate governance discourse and to encapsulate the origins, existence and consequences of corporate governance theory and practice.

Corporate governance systems are path-dependent and thus reflect the social, legal, political and economic settings in which they exist and operate.\(^56\) Path dependence, according to Pierson, means ‘what happened at an earlier point in time will affect outcomes at later point in time’.\(^57\) Hence, it is difficult to understand the significance of a particular social variable or phenomena without understanding how it got there (the path it took).\(^58\) Consequently, corporate governance models, systems and structures should be seen as politically and culturally unique phenomenon arising out of specific historical circumstances.\(^59\)

In view of the close relations between corporate governance, social norms, history, ideological beliefs and legal traditions, a complex system of laws, rules and regulations have evolved under

\(^{53}\) Sally Wheeler and Phil A. Thomas ‘Socio-Legal Studies’ in David J. Hayton (ed), Law’s Future(s) (Hart Publishing 2001)71.

\(^{54}\) ibid

\(^{55}\) Banakar and Travers (n 48) 27.

\(^{56}\) Mauro F. Guillen, ‘Corporate Governance and Globalisation. Is there Convergence across Countries?’ in Thomas Clarke (ed), Theories of Corporate Governance (Routledge 2008) 223.


\(^{58}\) ibid

different corporate governance models. For instance, the American model of corporate governance is a result of specific legal tradition, economic system and political orientation coupled with its own historical experiences. These past events have eventually influenced outcomes and trajectories as reflected in banking, labour, tax laws and a single tier board of directors. Moreover, the American culture emphasises individualism, entrepreneurship and a strong belief and inclination towards a market-driven economy and minimal government regulation of business. Thus, the shareholder primacy model of corporate governance emerged as the logical outcome and perhaps, the inevitable consequence of specific past events. On the other hand, the corporate governance models in Germany and Japan are characterised by a different set of banking, tax, labour and competition laws. As Guillen explains, these arrangements ‘facilitate routine interactions between managers and owners, promote extensive collaborative ties between financial institutions and firms, or between firms themselves’. The two-tier corporate governance model which allows labour to participate in the supervisory boards of corporation is a distinct feature of the German corporate governance model. It both reflects social and cultural values and defines the society’s understanding and expectation of the role and purpose of the corporate entity. Thus, it may be argued that ‘the choice of corporate governance practices in any country expresses the interaction of economic preferences and political institutions’.

Against this backdrop, this thesis justifies the adoption of the socio-legal research methodology for three reasons. First, it is multi-disciplinary encompassing various fields and open to ‘theoretical diversity’. Indeed, corporate governance is a product of the interaction of diverse disciplines including law, economics, accounting and management among others. It therefore,

60 ibid
61 ibid
62 ibid
63 Gourevitch and Shinn (n 30) 5.
64 Ivaschenko and Koeva Brooks (n 24).
becomes imperative that the study and appreciation of corporate governance theories, principles and models is undertaken from a socio-legal perspective.

Secondly, socio-legal research gives a more balanced view by incorporating different insights and perspectives into corporate governance scholarship. Moreover, corporate governance as a social phenomenon can only be understood within that social context; as such socio-legal research provides that understanding and meaning to corporate governance within the context of the broader social, legal, political and cultural environment.

Another justification is that by contextualising the concept of corporate governance, socio-legal research helps bridge the gap between law, economics, sociology and social policy. Arguably, socio-legal research effectively widens the lens through which diverse factual situations and sources are considered and brought to bear both in theory and practice.65

For these reasons, this thesis recognises the importance of locating research within the social, political, cultural and historical contexts by considering the social construction of these contexts. This is because corporate governance systems and their theoretical underpinnings do not exist in a vacuum.66 In fact, they reflect certain economic, political and ideological positions; as such the inherited instincts, the acquired convictions and the resultant outlook to a large extent determine the corporate governance choices to be made. As Webley rightly notes ‘we may try to see things as objectively as we please, nonetheless we can never see them with any eyes except our own’.67 The import is that ‘we cannot understand the significance of a social variable or phenomenon without understanding how it got there’.68 This thesis, therefore,

65 Hillyard (n 45) 87.
66 Guillen (n 56) 233.
68 Ibid
combines doctrinal, socio-legal and comparative approaches as each approach compliments the weaknesses of the other

1.3.3 Comparative Legal Research

As earlier indicated, the research also adopts a comparative methodological approach by comparing the responses of the US and UK governments to the GFC. Comparative legal research is: ‘an attempt to formulate the presuppositions, the preoccupations, and the frames of action characteristic of one sort of legal sensibility in terms of those characteristic of another’.69

Comparative research is based on similarity and differentiation and does not follow a single exclusive method or route. Rather, it adopts several methods by which the comparisons are carried out. For instance, the comparison could be historical, functional, evolutionary, structural, thematic or empirical. Any of the methods identified can be carried out from the micro or macro point of view depending on the nature and objectives of the research and the research question.70 For the present purposes, this research adopts the functional comparative approach. But before delving into detailed discussion of the functional approach, it is important to justify the need for the comparative methodology.

The need to compare and differentiate phenomena, events and institutions seems pervasive and in some respect, indispensable in decision-making. It would be seriously flawed, if issues had to be analysed and evaluated from a single perspective because such one-sided approach often leads to distortion. Against this background the thesis uses comparative legal research to serve as (a) an instrument of learning and knowledge by providing information and promoting better understanding of law in other jurisdictions (b) instrument of evolutionary change in terms of

common evolutions and legal families (c) contribute to an understanding of one’s own legal system and, (d) a means of harmonising the law.\textsuperscript{71}

In effect, comparative legal research, through the process of comparison, strengthens and expands the role of law in practice. Swanson reaffirms the importance of comparative legal research and argues that ‘thinking without comparison is unthinkable: and, in the absence of comparison, so is all scientific thought and scientific research unthinkable’.\textsuperscript{72}

As mentioned earlier, this research adopts the functional comparative approach in the analysis of the governance, regulatory and legislative responses in the two jurisdictions under study. Functional comparison is defined as: ‘the study of how the same thing may be brought about, the same problem may be met by one legal institution or doctrine or precept in one body of law by another and quite different institution or doctrine or precept of another’.\textsuperscript{73}

Functional comparative method by refers to the context in which problems of society can be resolved and by what legal construction. It is often used on the assumption that the issues giving rise to the problems are likely to be the same everywhere and may be true in many cases in countries with similar historical and socio-economic experiences.\textsuperscript{74} In this context, the functional comparative methodology is justified on the grounds that solutions to the general corporate governance problems and the GFC in particular are largely similar in the US and the UK.\textsuperscript{75} Indeed, the US and UK may diverge in terms of the different legal constructions, historical experiences and the evolution of the corporate governance framework.\textsuperscript{76} That notwithstanding, their responses to the crisis seem similar or even identical. In this respect, it is

\textsuperscript{71} Jan M. Smits, \textit{Elgar Encyclopaedia of Comparative Law} (Edward Elgar Publishing 2006)
\textsuperscript{72} George Swanson, ‘Jhering’s Influence on the Development of Comparative Legal Method’ (1971) 19 AJCL 215
\textsuperscript{73} Roscoe Pound, \textit{Social Control through Law} (Transaction Publishers 1943) 59.
\textsuperscript{74} Palmer (n 70) 13.
\textsuperscript{75} ibid
\textsuperscript{76} ibid
submitted that the functional methodology is a better approach as it is more interested in interrogating the ‘functional equivalence’ at the level of solutions.\textsuperscript{77}

The functional comparative method is characterised by four important elements. First, it is factual and relevant in the sense that it focuses on the effects and outcomes of events and not rules or doctrinal structures. Second, the functional comparative approach combines the factual approach with the theoretical framework that requires the objects to be understood in view of their factual relations to law and society in situations thought to be separable but related in other respects. Third, it provides the basis for comparison by serving as \textit{tertium comparationis}. In other words, legal and non-legal institutions that differ doctrinally can be compared if they are functionally equivalent or fulfil similar functions. From the functionalist perspective, the outcome is what matters; as such the functional approach does not compare primary rules but focuses on offering solutions to practical problems. In that respect, the object of comparing the responses in the US and UK is to investigate the underlying reasons for such responses to the GFC.

The fourth critical element is that functional comparison serves an evaluative purpose and has become what Hoecake calls ‘better-law comparison’\textsuperscript{78} because it fulfils its functions much better than the others for two reasons. First, by looking at developments in other jurisdictions through comparison, the functional approach enables a reconstruction of a better appreciation of one’s own system. Second, it helps in the formulation and evaluation of concepts and their relationships with other disciplines.

The functional comparative approach has been criticised on different grounds. A critique that has been influential within the functional comparison discourse is that each legal culture, regulatory regime or governance model is unique. According to Hecke, these are ‘culturally

\textsuperscript{77} Hoecke (n 41) 4.
\textsuperscript{78} ibid
contingent products”\textsuperscript{79} which can only be understood within the surrounding social context. Thus, the claim by advocates of functional comparison to understand the legal culture, regulatory tradition and governance model of another country or jurisdiction is difficult to validate.\textsuperscript{80}

Further, functional comparison has been strongly criticised for the lack of objectivity. It has been argued that in seeking to compare legal cultures, regulatory traditions or governance models, it is important to first reconstruct their socio-economic origins and the path along which they have evolved. The challenge however, is that more often, the researcher is unable to divest him/herself from his/her own framework of embedded conceptions and adopt an outward-looking approach with a detached eye.\textsuperscript{81} In the end, it allows the researcher to superimpose his/her own values and perceptions on the issue being discussed and thus make it impossible to achieve complete objectivity. To minimise the loss of objectivity, it is suggested that researchers should as much as possible, detach themselves from their own preconceptions.

Finally, the functional comparative method has been described as ‘a triple misnomer.’\textsuperscript{82} First, there is not just one functional method but many and second, not all allegedly functional methods are functional at all.\textsuperscript{83} Thirdly, some research projects that claim to adhere to the functional method cannot be said to be following any recognisable methods. Notwithstanding, these weaknesses, the functional comparative method remains relevant for the purposes of this research.

Having identified the methodological approach, this section now explains how the material is to be gathered and analysed. But before proceeding to analyse the material there is the need to

\textsuperscript{79} ibid
\textsuperscript{80} ibid
\textsuperscript{81} ibid
\textsuperscript{82} ibid
first, find and locate it. Thus, the thesis makes use of the relevant literature on corporate
governance. This includes primary sources such as legislations, case law, policy documents,
parliamentary and congressional documents. Furthermore, secondary sources, especially text
books, journal articles, legal and academic commentary, working papers and press releases by
government institutions and non-governmental organisation will be another important resource
for the thesis.

In addition to the above, the thesis will also make extensive use of online resources. The
challenge associated with the use of such material is the difficulty in ascertaining the reliability
of such literature. This is an important limitation since not all the material published online can
be verified or deemed reliable. In fact, some online material tends to lack credibility and
authenticity, hence needs to be treated with caution. To overcome some of the challenges
identified, the online source will be put under intense scrutiny and proper evaluation by looking
at the currency of the source, author’s credentials and how the source aligns with the research
question.

In evaluating the materials to be included in this research, three parameters, namely, credibility,
relevance and reliability will be applied. The relevance and credibility will be considered in
respect of the author’s credentials in terms of expertise in the field of corporate governance, the
quality of the material and date of publication. The date of publication is importance because
corporate governance has been shaped and influenced by circumstances at certain specific
periods in history and can thus, be likened to a moving target which changes and adapts to the
changing circumstances. Hence, the time frame within which these changes occur, and the
scholarly work produced can be better appreciated when situated within that specific period.

As already noted, the approach is systematic, and the design will draw its material mainly from
primary sources. Therefore, the analysis and evaluation of the existing literature will be
structured along the following lines.
a) Identification and location of the relevant literature.

b) Systematic gathering and collection of the literature.

c) Review and evaluation of the literature.

d) Draw conclusions and make recommendations based on the analysis and evaluation.

The review of the literature will be partly descriptive, analytical and partly prescriptive. The first part which is mainly descriptive explains and provides an overview of the concept of corporate governance, its evolution and theoretical underpinnings. The rationale and justification for adopting such an approach is that it facilitates a deeper understanding and better appreciation of the context in which corporate governance models have evolved and taken roots in certain jurisdictions. Similarly, the last section will be mainly prescriptive as it intends to make recommendations aimed at reforming corporate governance thinking, policy and practice.

1.4 Jurisdiction

The research will focus on two jurisdictions namely, the United States of America (US), the United Kingdom (UK) for good reasons. The first reason is that the epicentre of the current crisis lies deep in the developed economies of the US and to a lesser extent the UK. Also, although the crisis originated in the US, it quickly spread to the UK and other countries and economies due to increasing technology, information flows and interdependence in terms of trade and finance.\(^4\)

Moreover, for historical reasons, the shareholder primacy theory was developed and used much more extensively in the US and in the UK than in other countries. In fact, the theoretical and methodological perspectives dealing with the historical roots of corporate governance and shareholder primacy have their origins in the US. The explanation is that corporate systems are closely linked to the legal and regulatory traditions, as such the corporate governance system

\(^4\) Guillen (n 56).
(i.e. shareholder primacy model) which evolved in the US and UK reflects a specific economic thinking, political history and legal tradition.\textsuperscript{85} Indeed, much of the theoretical basis of the shareholder primacy concept were developed here, and this concept has held sway in corporate governance thought for several decades. Hence, a fuller understanding of the present crisis requires an examination of what happened in these jurisdictions and their respective responses.

1.5 Limitations

This research is however, not without its limitations. It focuses exclusively on western economies namely US and UK while excluding emerging economies such as Brazil, Russia, India, China and South Africa (BRICS) all of which have become important players and powerful actors in the global economy. This exclusion can however, be justified because corporate governance practices in these countries to a very large extent follow the shareholder-oriented Anglo-America model. This has been made possible through the influence of international institutions such as the World Bank, the IMF and the OECD. That notwithstanding, globalisation and the integration of countries into the global economy, coupled with the increased role of international investors make it imperative that corporate governance reforms in the developed west consider the likely impact and effects in other parts of the world. Against this backdrop, the thesis intends to make recommendations and proposals which go beyond these two jurisdictions and possibly, have universal application. While admitting that corporate governance is path-dependent, this thesis maintains that the institutional notions of transparency, accountability, effective supervision and the need for government intervention through regulation are equally applicable in both developed and developing economies.

Another limitation is the difficulty in accessing research material and relevant information. Although vast amount of literature exists in respect of corporate governance in general, this cannot be said of this research topic. The thesis addresses this limitation by focusing on major works undertaken by established writers, scholars and academics of corporate governance.

1.6 Conclusion

Admittedly, some studies have been done by writers mainly from economic and finance background, who have attempted to analyse the causes of the GFC from that perspective. It is, however, doubtful whether this approach addresses the fundamental problem of the shareholder primacy theory. The goal of this study therefore, is to contribute to the discourse and help bridge the existing knowledge gap in respect of the critical role of the shareholder primacy theory in the GFC. Accordingly, the research adopts a three-way methodological approach namely doctrinal, socio-legal and comparative. Apart from being both descriptive and prescriptive, the thesis is also comparative and analytical. At face value, the adoption of a multiple methodological approach seems to contradict conventional/orthodox research methodologies. But this approach reflects the multi-disciplinary character of corporate governance.

Moreover, and perhaps, more crucially, this approach helps provide answers to some of the important questions that this research seeks to interrogate. In that respect, the research makes a significant contribution by exploring new directions and locating the GFC within the shareholder primacy context. Thus, it provides an entirely new perspective to the corporate governance discourse regarding the causes of the GFC. In effect, a significant contribution of this research is the extent to which it renders obsolete the traditional belief in the shareholder primacy maxim and the need for a redefinition and reconceptualization of the corporate purpose.
Chapter 1

1.7 Structure of the thesis

This thesis comprises of seven chapters. Chapter one gives a broad overview of the GFC, examines its consequences and implications for the global economy. It argues that corporate governance failures merely acted as triggers and cannot be said to be the cause of the GFC. Chapter two evaluates the presumed causes of the GFC and contends that these alleged causes are, in fact, events that merely triggered the crisis. The chapter provides a chronology of the crisis, examines the causes and discusses the debate surrounding it. It recognises that other factors such as the subprime mortgage crisis, deregulation, lax risk management regimes and excessive incentives were important triggers of the crisis. That notwithstanding, the central argument of the thesis posits that the underlying cause of the GFC can be traced to the shareholder primacy theory and not corporate governance failures per se.

Chapter three focuses on the theories of corporate governance with emphasis on the shareholder primacy theory. The chapter begins with a definition of the theory, its evolution and the historical circumstances that have influenced and shaped it. It situates the discussion within the context of the Berlet-Dodd debate regarding the role and purpose of the corporation in society. The discussion challenges some of the underlying assertions and assumptions of the theory and argues that the GFC has undermined the basic assumptions underpinning the theory. It refutes the arguments that shareholders ‘own’ the corporation as such the corporation should be run and managed for their benefits. It concludes that although the justification for the theory have been found to be flawed and therefore undermines the very foundation of its reasoning, the shareholder primacy theory continuous to hold sway as the dominant governance model.

Chapter four traces the genesis of crisis in the US and interrogates the immediate and long-term responses initiated by the US authorities. Consequently, the thesis evaluates the major corporate governance reforms introduced following the crisis. These measures were mainly legislative and regulatory in nature, aimed at minimising and preventing future reoccurrence. As it is
practically impossible to assess and critique all the post-crisis corporate governance response in the US, the chapter limits itself to the most important and relevant legislative initiatives and regulatory changes. Therefore, the focus is on the Dodd-Frank Wall Street Reform and Consumer Protection Act 2010, the American Recovery and Reinvestment Act 2009, the Emergency and Economic Stabilisation Act 2008 and the Economic Stimulus Act 2008. All these laws were passed with the purpose of reducing similar corporate failures to the barest minimum while strengthening corporate governance in that jurisdiction.

Similarly, chapter five reviews and analyses how the crisis occurred in the UK and the government response. To put it in context, the thesis explores the evolution of the UK corporate governance and how the current model has been shaped and determined by that evolutionary process.

In addition to massive government bailouts and the outright nationalisation of some financial institutions, the UK government initiated several legislative, regulatory and governance reforms. The Banking Act 2009, the Turner Review and the Walker Review are some of the major policy and regulatory reforms to be examined in the discussion. Admittedly, these measures have brought some improvements into corporate governance, but the main argument of the thesis is that the fundamental problem that led to the crisis has not been addressed. Apparently, the undue emphasis and indeed, the over-reliance on the shareholder-oriented conception of the corporation remains largely unchanged. It concludes that most of the reforms have been geared towards shareholder empowerment.

Chapter six draws a comparison between the responses in the US and UK by examining the initial responses that were meant to slow down the GFC. The study also evaluates the regulatory and legislative measures that sought to provide long-term solutions to the crisis. Consequently, it argues that despite major differences, especially the fact that while the US adopts the rule-based approach and the UK the principle-based approach, one thing common to both
jurisdictions relates to the unquestioned belief in and continuous adherence to the shareholder primacy theory.

Chapter seven concludes that despite the numerous legislative and regulatory interventions, the reforms have remained largely cosmetic. This arises from the narrow understanding and appreciation of corporate governance as conceived and defined by the shareholder primacy theory. Effectively, the governance model which subsequently evolved made management more responsive to shareholder interest and demands with serious ramifications. The outcomes of the increasing shareholder pressure on management were twofold. First, it led to substantial decline of CEO tenure and created a situation where managers were no longer considered as skilled professionals but simply as agents for shareholder value maximisation. Second, the governance model it produced confronted corporate managers with far more complex governance issues and challenges. These challenges include: performance-based rewards, pressure to meet targets, the expectation by owners to boost the market value of firms and de-diversification of industrial conglomerates. Consequently, the drive to meet the varying demands, expectations and pressures inevitably led to a pervasive risk culture as well as flawed risk perception. Indeed, this flawed risk perception and the attendant corporate governance model which subsequently emerged is what fomented the recent global financial global financial crisis. This final chapter makes recommendations by advocating an alternative corporate governance that takes a long-term view of the corporation, emphasises a more stringent regulatory approach and suggests further direction for future research.

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CHAPTER 2

CAUSES OF THE FINANCIAL CRISIS

2.1 Introduction

The GFC which began to unfold in the US financial markets and quickly spread throughout the global economy remains the worst crisis since the Great Depression of the 1930s. Following the crisis, the entire global economy experienced the worst financial turmoil since the past eighty years. The UK Turner Review Committee set up to review the causes of the crisis and make recommendations, characterised it as ‘the greatest crisis in finance capitalism’. The crisis exposes the inherent dangers of unregulated markets, undermines the reasoning behind the shareholder primacy theory and more importantly, reveals the abysmal failure of corporate governance model it created.

Obviously, when financial crises occur in concentrated outbursts and within short time frames, they raise serious questions and concerns. Thus, the GFC has generated concerns about the corporate governance systems, their theoretical underpinnings, the policy measures, legislative and regulatory responses that have been initiated to minimise such crises. The aftermath of the crises witnessed the introduction of several legislative, regulatory and policy measures across the globe all in an attempt to redesign corporate governance and make it more responsive to future crisis. Rightly or wrongly, sections of the general public and some experts recognise and indeed, identify corporate governance failures as the principal cause of the recent GFC.

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89 FSA (n 5) 5.
90 Clarke (n 33).
92 ibid
This thesis, however, argues that corporate governance failures alone cannot be the cause of the GFC. Rather the crisis is the result of a corporate governance model based on shareholder primacy in which corporate managers focused exclusively on maximising shareholder value and thus became accountable to the markets. Corporate governance failures are not new and this is not the first time these failures have been recognised as important contributory causes to the institutional malaise that have come to be associated with the recent GFC. Available records indicate that the world had witnessed 139 financial crises between 1973 and 1997, 95 of which occurred in emerging economies. Corporate governance failures have therefore, been blamed for previous financial crisis at both the regional and at the level of individual institutions. In the US there was the S & L failure in 1989 and the WorldCom and Enron collapse at the beginning of the decade during which billions of dollars were lost.

It is now widely acknowledged that ineffective corporate governance was responsible for the Japanese Banking crisis of the late 1990s. Kanaya and Woo confirm this proposition and blame weak corporate governance as the main factor that had impeded Japan’s speedy economic recovery for nearly a decade. They argue that apart from consistently misallocating capital and mismanaging risk, weak corporate governance also distorts information and actually leads to inefficiency. Similarly, the Asian crisis of 1997-1999 which originated from Singapore and later spread to Indonesia, the Philippines and Thailand, was also blamed on corporate governance failures. Important among these failures are lack of transparency and poor

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95 Ibid
97 Ibid
99 Mishkin (n 7).
100 Ibid
102 Ibid
quality information resulting in markets having an inaccurate and distorted view of the true state of affairs.\textsuperscript{103} The challenges that the current crisis poses are almost similar to what transpired during the Japanese and the Asian crisis.\textsuperscript{104} Despite some similarities, it should be stressed, however, that the current GFC is far greater and definitely more complex than previous ones in terms of its severity and the global character of the consequences.\textsuperscript{105}

Incidentally, the GFC originated in the US, the epicentre of capitalism and home to some of the most advanced corporate law and governance regimes. Clearly, the frequency of financial crisis in both emerging economies and a well-developed economy such as the US leads critics to contend that the underlying conditions giving rise to the past and current crises have not being addressed but have at best been deferred and at worst gone unchecked.\textsuperscript{106}

While acknowledging that certain questionable board practices, defective risk management systems, and excessive remuneration policies encourage short-termism, this research contends that the causes of the crisis go much deeper than the above-mentioned factors. It argues that the problem arises from the wholesale acceptance and unquestioning belief in the shareholder primacy principle which views profit maximisation as the primary driving force of corporations.\textsuperscript{107} As already indicated, the underlying reasoning considers shareholders as having an entitlement that the corporation be run and managed for their sole and exclusive benefit.\textsuperscript{108} It is now widely recognised, however, that corporations are independent and distinct legal entities that own property by themselves. Their relations vis-à-vis the company is contractual which confers rights and obligations on both parties. As such the shareholders hold

\begin{thebibliography}{9}
\bibitem{103} Tomasic and Akinbami (n 11) 4.
\bibitem{104} ibid
\bibitem{105} Stephen M. Bainbridge, \textit{Corporate Governance After the Financial Crisis} (OUP 2012)
\bibitem{106} Tomasic and Akinbami (n 11) 7.
\end{thebibliography}
no rights over the tangible or intangible assets of the company.\textsuperscript{109} Moreover, in line with the ‘nexus of contract’\textsuperscript{110} theory, participants in a corporate venture own their respective inputs and ‘no single party owns the totality’.\textsuperscript{111} Indeed, once invested, the money becomes the property of the company.\textsuperscript{112} At best shareholders can only claim ownership over their shares in the sense that the exercise of this ownership right is limited to the use, benefit and disposal of such shares.\textsuperscript{113} Consequently, the concept of shareholders as legal owners of the company has come under serious challenge and possible displacement.

According to Blair, the right of ownership consists of the right to possess, use, dispose of, exclude others, manage and control.\textsuperscript{114} The corporate concept divides these rights into bundles giving the shareholder limited rights under very limited circumstances. In practice, however, the right to possess, use, manage and control is exercised by the managers of the corporation.\textsuperscript{115} That notwithstanding, the concept of shareholder ownership continues to remain the ‘central doctrinal explanation’\textsuperscript{116} for shareholder supremacy.

This research, however, argues that this underlying theory and its mistaken assumption which views shareholders as owners having an entitlement and in whose interests the company should be operated, accounts for the GFC. Against this background, the research posits that the 2007/2008 GFC is the ‘natural’ and logical outcome of a corporate governance system that has compelled corporate managers to be accountable to the markets and shareholders.\textsuperscript{117} As Stout

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\item \textsuperscript{109} Christophe Clerc, ‘Questioning the Legitimacy of Shareholder Power’ in Jean-Phillippe Touffut (ed), Does Company Ownership Matter? (Edward Elgar Publishing 2009) 94.
\item \textsuperscript{110} This is idea that the firm is a series of implicit and explicit contractual relationship among various individual managers, shareholders, employers and creditors. This was first propounded by Jansen and Meckling.
\item \textsuperscript{112} ibid
\item \textsuperscript{113} ibid
\item \textsuperscript{114} Margaret M. Blair ‘Ownership and Control: Rethinking Corporate Governance for the Twenty- First Century’ in Thomas Clarke (ed), Theories of Corporate Governance (Routledge 2004) 175.
\item \textsuperscript{115} Stout (n 29) 37.
\item \textsuperscript{116} ibid
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explains, the ‘mantra’ that compels directors to maximise shareholder value often leads to reckless and excessive risk-taking which not only harms the corporation but the public as well as investors.\textsuperscript{118} Similarly, Key suggests that managerial short-termism with its emphasis on stock prices and quarterly earnings are the inevitable outcome of the desire to meet shareholder expectations and demands.\textsuperscript{119} Other academics including Dogman argue that a corporate governance system that mistakenly characterise shareholders as owners and thus encouraging excessive risk-taking is unsustainable in the long-term and constitutes a danger to itself and society at large.\textsuperscript{120}

The aim of this chapter is twofold. First, it describes the events that occurred before and during the crisis. The purpose is to recount the chronology of the events as they unfolded with the view to demonstrating how these events are interlinked. Secondly, it explores not just how corporate governance failed in averting the crisis, but why it failed in the first place.\textsuperscript{121} In so doing, the chapter focuses on both the remote and immediate causes of the crisis because present events can be better appreciated by examining what had already transpired. Therefore, it is important to revisit the debate that has been generated among academics, corporate governance scholars, practitioners, policy makers and the public regarding the underlying causes of the GFC.\textsuperscript{122}

2.2 The Debate

For over three decades corporate governance issues have attracted a lot of media attention. A topic once considered arcane and very technical had suddenly attained critical importance and

\textsuperscript{118} Lynn Stout ‘New Thinking on Shareholder Primacy’ in P.M. Vasudev and Susan Watson (eds), \textit{Corporate Governance after the Financial Crisis} (Edward Elgar Publishing 2012) 5.
\textsuperscript{121} William Sun, Jim Stewart and David Pollard (eds), \textit{Corporate Governance after the Global Financial Crisis: International Perspectives} (CUP 2011) 18.
\textsuperscript{122} Rob Moulton and Nicola Higgs, ‘Corporate Governance in Financial Institutions’ (2013) 109 Compliance Officer Bulletin 1, 12.
attention across the world. Corporate fraud, corporate failures, abuse of managerial power and excessive remunerations became topical in media reports, public forums, academic debates, governmental policy and regulatory agendas. Financial scandals involving major firms such as Enron, WorldCom, Arthur Anderson, Royal Arnold and Pamela led to loss of confidence and millions of Dollars. Arguably, many of the corporate governance issues would not have gained much prominence and exposure but for the GFC of 2007/2008. As a result, many scholars, policy analysts and practitioners have linked the nature and severity of the current GFC to corporate governance failures, be they systemic, functional or technical.

Thus, the question whether and to what extent corporate governance failure played a part remains a subject of continuous debate. The causes of the GFC are rather complex involving several actors and different factors including institutional, regulatory and policy failures that shape and inform the corporate governance system. Basically, there are three different views regarding the role and contribution of corporate governance failures to the GFC. These are; the unlikely relations hypothesis, ineffective implementation hypothesis and the systemic failures hypothesis.

2.2.1 Unlikely relations hypothesis

The first view as advocated by Adams, a finance and corporate governance expert at the School of Business, University of South Wales, is that the GFC was unrelated to or at best had very little connection with corporate governance. She argues that since the early 1970s, corporate governance in the US and other developed economies have witnessed remarkable

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123 Salacuse (n 93).
125 ibid
126 Sun et al. (n 121) 3.
127 Stout (n 29)
128 Sun et al (n 121) 3.
improvements in all aspects. These improvements, according to Adams, are evidenced in the introduction of independent directors, separation of the positions of board chairmen and CEOs, the establishment of independent audit and risk committees, incentive-driven executive pay to deliver value for shareholders and the protection of shareholder rights. All these measures, she argues, were introduced to ensure effective monitoring and instil discipline into corporate management.

This school of thought further contends that many countries across the globe have since the 1990s adopted corporate governance codes, principles and guidelines provided by international Organisations such as the OECD, the World Bank and the IMF. As a result, these multilateral organisations have in various ways shaped and channelled corporate behaviour towards greater accountability and responsibility. Furthermore, research carried out by Adams reveals that 171 governance codes and principles have either been introduced or updated in the years between 1993 and 2010 by 195 countries world-wide. According to Adams, the significance of the findings is that more countries instituted or adopted corporate governance reforms in 2002 than the preceding ten (10) years.

Admittedly, these developments were not isolated events but prompted by the corporate scandals involving Enron, WorldCom and One-Tel among others. Therefore, the reforms constitute a recognition of the defects in the current corporate governance model and the need for reform. Moreover, the fact that many countries have embarked on these reforms indicates

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130 ibid
131 ibid
132 ibid
133 ibid
134 ibid
135 ibid
136 ibid
137 In responding to the Enron scandal, the US Congress enacted the Sarbanes-Oxley Act 2002 while the SEC issued new listing rules as its response to the said scandal
138 One-Tel scandal in Australia occurred following serious deficiencies in corporate governance including weaknesses in internal controls, financial reporting, board’s scrutiny of management
and indeed, confirms that the corporate governance regime at the time was fraught with difficulties. But Adams insists that corporate governance standards were very high in the US just prior to the 2007/2008 GFC. According to her, the fact that the US was viewed as having a robust corporate governance regime explains why many people could not predict the crisis.\(^{139}\)

The Sarbanes-Oxley Act of 2002\(^ {140}\) is cited as having strengthened corporate governance by making best practices such as board independence, transparent and independent audit procedures mandatory. For example, the new listing rules require a company listed on the New York Stock Exchange (NYSE)\(^ {141}\) to have majority independent directors, a three-member independent audit committee which must include one financial expert,\(^ {142}\) independent nominating committee (corporate governance) and compensation committee.\(^ {143}\) From this perspective, Adams concludes that corporate governance both in the US and across the globe has significantly improved since the 2002 crisis. In view of that, the causes of the financial crisis, she argues, could not be attributed to corporate governance failures.\(^ {144}\)

Similarly, Shinn posits, that the financial crisis is not a story of ‘wholesale corporate governance failure’,\(^ {145}\) but a challenge limited to a small number of listed firms in the financial sector.\(^ {146}\) He suggests that corporate governance in listed firms in most developed countries has been improving over the last decade and this improvement continued right through the crisis of 2007/2008 albeit with some divergence between developed and emerging economies.\(^ {147}\)

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\(^{139}\) ibid  
\(^{140}\) Sarbanes-Oxley Act was passed in 2002 by the US congress in response to accounting scandals that hit companies such as Enron, Tyco WorldCom and shook investor –confidence in the financial statements of Corporations. It was enacted to protect investors from the possibility of fraudulent accounting activities by corporate entities.  
\(^{141}\) New York Stock Exchange Listing Rules  
\(^{142}\) Sarbanes Oxley Act 2002  
\(^{143}\) Hoecke (n 41).  
\(^{144}\) Conway (n 16) 9.  
\(^{146}\) ibid  
\(^{147}\) ibid
notable proponent of this view is Christopher Cox, the then Chairman of the Securities and Exchange Commission (SEC) who while speaking to the US Congress notes that ‘We have come a long way since 2002. Investor confidence has recovered. There is greater corporate accountability. Financial reporting is more reliable and transparent. Auditor oversight has significantly improved’.\textsuperscript{148}

Mukwiri and Siems share this view and explain that corporate governance failures cannot be blamed for the GFC arguing that the causes seem to lie in risk management which according to them is a ‘question of judgement for the directors’.\textsuperscript{149} They insist that the divergent views illustrate the challenges involved in blaming corporate governance for the GFC.\textsuperscript{150} According to them, a possible explanation is that the relevant causes of the crisis are closely linked and dependent of each other. It is therefore, difficult, they argue, to single out deficiencies in corporate governance as the cause of the GFC adding ‘the 2008 financial crisis was not a verdict on corporate governance’.\textsuperscript{151}

It can be counter argued, that risk management is a governance issue and that the failure to identify, evaluate and monitor and properly manage the risk is in fact a serious corporate governance failure. Moreover, risk management is a vital function that cannot be separated from corporate governance and any attempt to suggest otherwise undermines the very foundation and essence of corporate governance.\textsuperscript{152} Cheffins agrees with the proposition that public corporations were in general satisfactorily governed both before and during the crisis.\textsuperscript{153} According to him, no significant correlation

\textsuperscript{148} Zabihollah Rezaee, \textit{Corporate Governance Post Sarbanes-Oxley} (John Willey & Sons 2007) 38.
\textsuperscript{150} ibid
\textsuperscript{151} ibid
\textsuperscript{152} Clerc (n 108) 92.
\textsuperscript{153} Brian Cheffins, ‘Did Corporate Governance “Fail” During the 2008 Stock Market Meltdown?’ The Case of the S & P 500’ (2009) 65 (1) 1 The Business Lawyer 1, 11.
exists between corporate governance and the GFC that erupted in 2000/2008.\textsuperscript{154} Based on an empirical study of thirty seven firms taken from the S\&P 500 Index in 2008, Cheffins concludes that the sharp decline of the stock markets in 2008 was not necessarily related to corporate performance.\textsuperscript{155} In his view, governance in those firms functioned ‘tolerably’ well and did not cause the crisis as being suggested. He insists that in contrast with the corporate scandals that occurred in the early part of 2000s, even companies that were over stressed in 2008 remained largely solvent indicating the resilience of the governance regime.\textsuperscript{156} While admitting that mistakes were made by some key corporate governance players in 2008, Cheffins contends that the overall corporate governance arrangements in place were able to respond well to the challenges posed\textsuperscript{157} and wonders whether a different corporate governance regime would have reacted differently to the GFC. He therefore, criticised any attempt to link the GFC with corporate governance as lacking in sufficient precision to establish any possible linkages between corporate governance, risk- taking and the GFC.\textsuperscript{158}

Convincing as these arguments may appear, they are based on a faulty proposition that cannot stand the test of scrutiny for two reasons. First, if indeed, corporate governance functioned ‘tolerably well’ as Cheffins claims, the question that remains unanswered is why the system failed to contain or prevent the crisis from happening? Indeed, in the face of the numerous corporate failures that occurred during the period under consideration, it will be misleading to suggest that corporate governance worked well. A closer look at the corporate scandals involving Enron, WorldCom, Pamalat, Maxwell Communications, Polly Peck and One-Tel reveals that the corporate governance system was defective. Arguably, these reforms are a

\textsuperscript{154} ibid
\textsuperscript{155} ibid
\textsuperscript{156} ibid
\textsuperscript{157} ibid
\textsuperscript{158} ibid
recognition and a tacit admission of the weaknesses and failures of the prevailing corporate governance model.

Second, the issue is not whether countries and companies have adopted these codes and principles; rather it is the effective implementation and enforcement that is important and indeed, makes the difference. The OECD draws a similar conclusion as the next section demonstrates. This thesis recognises the severe lapses in corporate governance preceding the GFC and acknowledges that such lapses played a role. It argues, however, that at the centre of the GFC is the wholesale acceptance of the shareholder primacy theory and its focus on short-termism which led to a corporate governance system that made the crisis impossible to avoid and the consequences difficult to mitigate.\textsuperscript{159}

Also, the methodology and the sample size used in the research have been questioned. While not discounting these findings, it is important to note that a study sample of thirty-seven firms from S & P 500 Index to conduct research cannot be a fair and accurate representation of firm behaviour across the US. Apart from the sample being too narrow and unrepresentative, the research focuses on a particular type of corporate governance model that emphasises shareholder primacy, deregulation, market efficiency and a rigid adherence to an outdated conception of ownership rights that bears little resemblance to the reality.\textsuperscript{160} The corporate governance model that formed the focus of the study emerged from a specific legal and political traditions constructed by certain beliefs, values, ideological and social conventions.\textsuperscript{161} It reaffirms a neoliberal economic thinking and represents ‘an ideological legitimation

\textsuperscript{159} Nasser Saidi, ‘Corporate Governance in the Islamic Finance Industry and Mitigation of Risk Post the Global Financial Crises’ William Sun, Jim Stewart and David Pollard (eds), Corporate Governance and the Global Financial Crisis: International Perspectives (CUP 2011) 291.


\textsuperscript{161} Laura Horn, Regulating Corporate Governance in the EU: Towards a Marketization of Corporate Control (Palgrave Macmillan 2012) 14.
underlying the American world view that has dominated corporate governance discourse and practice for the past three decades’.\textsuperscript{162}

\textit{2.2.2 Ineffective implementation hypothesis}

The second proposition in the debate is that the GFC is not caused by corporate governance failures per se. Instead, the crisis is closely associated with insufficient implementation of corporate governance codes and principles both at the national and international level.\textsuperscript{163} A leading proponent of this school of thought is the OECD, which argues that there is nothing wrong with the current corporate governance framework. In its report of 29 June 2009 the OECD Steering Group on Corporate Governance identifies four major weaknesses in corporate governance which, the organisation insists, contributed to the GFC.\textsuperscript{164} These weaknesses include: excessive executive compensation schemes, ineffective risk management, board practices and the exercise of shareholder rights.\textsuperscript{165} It asserts that the various principles of corporate governance as agreed among most OECD countries prior to the crisis had adequately addressed these governance issues and concerns.\textsuperscript{166} It concludes that ‘the major failures among policy makers in corporations appear to be the lack of implementation of the principles’.\textsuperscript{167} According to the OECD, the key issue is the lack of effective implementation of the existing corporate governance arrangements, codes and principles.\textsuperscript{168}

Several reasons explain this lack of effective implementation. First, the existing codes and principles are much too broad in scope and lack precision.\textsuperscript{169} Consequently, corporations have

\textsuperscript{162} ibid
\textsuperscript{164} ibid
\textsuperscript{165} ibid
\textsuperscript{166} ibid
\textsuperscript{167} ibid
\textsuperscript{168} ibid
been allowed too much scope for interpretation and sometimes misinterpretation as well. Moreover, some of the principles and codes have proved very complex and difficult to implement; as such they have become mere formalities/box-ticking exercise leaving no room for qualitative assessment.\textsuperscript{170} Another issue is the apparent lack of clarity in terms of the allocation of roles and responsibilities which often makes it difficult to determine who is responsible for implementing these codes and principles. It raises the question whether the corporations themselves should ensure implementation or an independent regulatory body should be assigned that responsibility.

The problem of implementation is further complicated by the non-binding nature of the principles and codes. Indeed, because these principles are not legally binding, corporations often ignore them without any consequences. This explains why the implementation of such corporate governance codes and principles has remained largely ineffective and in some respects defective.\textsuperscript{171}

The OECD is, however, sceptical of the use and effectiveness of legislation and regulation to implement corporate governance principles, preferring instead voluntary codes which it argues, would be more effective in terms of implementation and have better outcomes. The OECD therefore recommends more efficient implementation and enforcement mechanism but opposes any substantial revision of the current governance regime.\textsuperscript{172}

Examples of these voluntary corporate governance codes include the OECD Principles\textsuperscript{173} of corporate governance 1999 and 2004 which were subsequently reviewed in 2010 and 2013,

\textsuperscript{170} ibid
\textsuperscript{171} ibid
\textsuperscript{172} ibid
\textsuperscript{173} The OECD Principles of Corporate Governance were first endorsed by the OECD council of Ministers in 1999 and have since become an International standard bearer for policy makers, investors, corporations and stakeholders. The purpose is to advance corporate governance as well as provide guidelines for legislative and regulatory initiatives. The principles have undergone several revisions since 1999.
the Basel Committee Guidelines\textsuperscript{174} relating to enhanced governance of banks issued in 1999 and later revised in 2006. Obviously, the advantages of voluntary codes and principles cannot be denied but the reality is that the self-regulatory governance regime (codes and principles) that characterised the corporate governance system before and during the crisis was found wanting when the crisis struck. The system proved to be inadequate and ill-prepared to meet the challenges and complexities of the modern corporation.\textsuperscript{175}

Moreover, an effective corporate governance system depends on the corporation’s commitment to maintaining the needed governance standards and values as part of the corporate culture.\textsuperscript{176} On that basis, it is unrealistic to rely on state intervention alone to monitor complex corporations and the market.\textsuperscript{177} It should be pointed out that although the US had some of the most comprehensive rules and regulations governing the conduct of corporations, a highly developed legal system, an advanced corporate governance framework and a sophisticated corporate culture, these alone were not enough to prevent or avert the GFC. Thus, it is submitted that effective and enforceable regulatory regime, a strengthened legal system combined with a focus on disclosure and transparency become inevitable.\textsuperscript{178} But these measures alone are not enough to resolve future crisis without adopting a long-term approach and redefining the role of the corporation in society regarding whose ‘interest is to be recognised as the object of corporate activity’.\textsuperscript{179}

\textsuperscript{174} The Basel Committee Guidelines are issued with the aim of enhancing understanding of key supervisory issues and improve the quality of banking worldwide. The guidelines were first issued in 1999 and have been revised several times to accommodate the changing economic and financial challenges.

\textsuperscript{175} Thomas Clarke, ‘Corporate Governance Causes of the Financial Crisis’ in William Sun, Jim Stewart and David Pollard (eds), Corporate Governance and the Global Financial Crisis: International Perspectives (CUP 2011) 33.

\textsuperscript{176} Roman Tomasic, ‘The Failure of Corporate Governance and the Limits of Law: British Banks and the Global Financial Crisis’ in William Sun, Jim Stewart and David Pollard (eds), Corporate Governance and the Global Financial Crisis: International Perspectives (CUP 2011) 111.

\textsuperscript{177} ibid

\textsuperscript{178} Suzanne Young and Vijaya Thyil, ‘Holistic Approach to Corporate Governance: Lessons from the Financial Crisis’ in William Sun, Jim Stewart and David Pollard (eds), Corporate Governance and the Global Financial Crisis: International Perspectives (CUP 2011) 302.

\textsuperscript{179} Adolf A. Berle and Gardiner C. Means, The Modern Corporation and Private Property (Harcourt, Brace & World 1967) 312.
In the UK, similar claims were made to the effect that there were no major problems with corporate governance codes prior to the crisis. Like the OECD, the FRC concedes that the main challenge is with the implementation of the already-existing codes and principles. The UK Corporate Governance Code of 2010, formerly called the Combined Code on Corporate Governance which has undergone several revisions is cited as example of the constant evolution of corporate governance codes and principles. These codes are characterised by a self-regulatory regime with minimal government involvement and strict adherence to the principle of comply or complain. Under this model, codes of corporate governance principles or good practice are what determine board responsibilities and not the rule of law. Companies are therefore, required to either comply with the codes and principles or provide reasons for non-compliance. The outcome is that self-regulation becomes the guiding principle and compliance remains voluntary. The voluntary nature of compliance coupled with the absence of effective controls, arising from the lax regulatory regime was a significant factor in the build up to the GFC. According to Chambers, the self-regulatory regime in the UK was not sufficient to stop the collapse of Northern Rock when the crisis occurred. Despite these obvious shortcomings, proponents of self-regulation and their unwavering attachment to the efficient market hypothesis continue to hold onto the deeply entrenched belief in the inherent superiority of self-regulation. As noted in chapter 1, this system was idolised and

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181 ibid
182 ibid
183 Young and Thyil (n 178).
185 ibid
promoted as the ideal model to which other countries could aspire.\textsuperscript{188} Proponents argue that, the UK system provides more flexibility than what pertains in rule-based jurisdictions such as the US.\textsuperscript{189} Dallas affirms this position by pointing out that reliance on rules and regulations is fraught with danger and could be counter-productive in terms of good corporate governance.\textsuperscript{190} From this perspective supporters of the UK model continue to insist that the cause of the GFC is not about the corporate governance model itself but linked to the defective implementation and lack of enforcement of the existing governance codes and principles.

Admittedly, corporate governance reforms in both developed and developing countries have witnessed significant improvements and generated some fruitful outcomes in the form of independent boards, shareholder rights, independent audit committees and appointment committees among others. The fact, however, still remains that the GFC still occurred notwithstanding these developments. This can be explained by the over-reliance on a corporate governance model that is largely driven by profit maximisation for shareholders and short-termism. The model not only failed to prevent the crisis, it encouraged and permitted the creation and taking of excessive risk for short-term profit maximisation.\textsuperscript{191} Invariably, the GFC is a product of a corporate governance system that compelled corporate managers to focus on maximising shareholder value to the detriment of other stakeholders.

\textbf{2.2.3 Systemic failure hypothesis}

The third position in the debate and probably the most popular is that the GFC was caused by systemic failure of corporate governance. Perhaps, few people would disagree with the

\textsuperscript{188} Douglas M. Branson, ‘The Very Unfortunate Prospect of “Global” Convergence in Corporate Governance’ in Thomas Clarke (ed), \textit{Theories of Corporate Governance: Philosophical Foundations of Corporate Governance} (Routledge 2004) 266.

\textsuperscript{189} ibid.


OECD’s identification of some aspects of corporate governance failures. The consensus among many critics is that the failure of corporate governance during the GFC may not be purely an issue of implementation but it is more of a fundamental systemic failure of institutional arrangements. These arrangements are underpinned by increasingly popular but mistaken assumptions that shareholders ‘own’ the corporation hence it should be run for their benefit. This approach, according to Keay, leads to short-termism arising from shareholder-pressure and the emphasis on quarterly earnings. These represent an abysmal failure of the broad governance movement underpinned by market fundamentalism that gained momentum at the beginning of the decade. Indeed, it is a collective failure by the invisible hand of the market and the visible hand of management made possible by shareholder value thinking that account for the crisis. Clearly, the reliance on the shareholder primacy theory and its propositions- profit maximisation, efficiency of the markets and short-termism have all proved to be faulty and misplaced.

The crisis, is undoubtedly, a creature of human failure, hence it is only rational that the role of corporate managers and their perception of the corporate purpose takes centre stage in the discourse. It would, however, be unfair to blame management alone for the crisis because management itself was ‘hijacked’ by ideology. As caulking rightly points out ‘the corporate governance framework since the 1980s has largely been shaped by “Reaganomics”; a version of market fundamentalism that has been influenced by neoclassical economics’.

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192 Gourevitch and Shinn (n 30) 7.
194 Benard W. Heineman Jnr, ‘Boards Fail Again’ Business Week (New York,26 September 2008)
196 ibid
197 ibid
198 ibid
Corporate governance models and practices are path-dependent and reflect the social, legal, political, economic and ideological milieu in which they exist. Indeed, the present Anglo-American corporate governance model is a product of specific political, economic and ideological forces that swept through the UK and the US in the late 1980s. For example, the continuous dominance of the shareholder primacy theory can be explained in the context of specific economy thinking and ideological position fuelled by the struggle to define the corporate purpose. Within that context Gourevitch and Shinn argue that:

> [T]he choice of corporate governance practices in any country expresses the interaction of economic preferences and political institutions. Corporate governance arises from incentives created by rules and regulations that emerge from a public policy process, reflecting the power of alternative political coalitions.

Contrary to the common narrative, the GFC reflects an unsustainable global economic imbalance and an indictment of a corporate governance model that produced and maintained policies which encourage corporate managers and financial markets to engage in excessive risks-taking for short-term purposes. Driving the often unnecessary but excessive risk-taking is the desire to maximise shareholder profits as espoused by the shareholder primacy theory. This model is in turn, premised on an ideological legitimation arising from the prudential, functional and moral claim hypothesis as earlier mentioned.

The International Corporate Governance Network (ICGN) agrees with this proposition and attributes the recent crisis to the weaknesses in the edifice of corporate governance model that has been constructed and propagated by the private sector in recent times. This market-driven agenda allowed the control of corporate governance to be done through private ordering instead

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199 Gourevitch and Shinn (n 30) 5.
of public ordering.201 The model altered the incentive system and thus, enabled shareholders to influence and change regulations of corporate governance through the political process.202 Similarly, the International Corporate Governance Network reports that poor corporate governance has been a significant cause of the GFC.203 According to ICGN, poor supervision, lack of accountability and transparency, ineffective risk management system and a general systemic weakness, account for an otherwise avoidable crisis. Clearly, the current crisis raises questions about the accountability and responsiveness of the current corporate governance regime. This, coupled with the large public demand for reforms following the GFC provides an opportunity for a redefinition and reconceptualization of the role and purpose of the corporation and the current governance arrangements.204

Following the GFC, many financial institutions have either collapsed or have been bailed out by governments worldwide.205 Observers including Erkens et al. are convinced that the root cause of the GFC lies in the breakdown of prudent corporate governance practice as evidenced by excessive managerial incentives, ineffective board oversight and insufficient risk-management practices among others.206

An already explained, failings in corporate governance have been faulted for exacerbating the GFC. But these failings are the symptoms and indeed, the inevitable outcomes of the wrong perceptions and definition of the role and purpose of the corporation. For nearly three decades corporate purpose has been defined exclusively by the shareholder interests (shareholder

201 James Shinn, ‘The Great Recession’s Impact on Global Corporate Governance’ in William Sun, Jim Stewart and David Pollard (eds), Corporate Governance and the Global Financial Crisis (CUP 2011) 314.
202 Saidi (n 159) 384.
203 ICGN (n 199).
204 ibid
primacy) while ignoring the equally important interests of other corporate constituents. The crisis not only challenges these assumptions but more fundamentally, demonstrates that the unitary vision of corporate purpose founded on shareholder primacy is faulty in law and in fact. It is, thus, submitted that at the heart of the GFC lies the narrow definition of the role and purpose of the corporation with its emphases on the shareholder-oriented governance model which puts profit maximisation beyond any other interests.

After examining the various strands of the debate regarding the role and contribution of corporate governance failures to the GFC, it becomes obvious that, corporate governance failures may have triggered the crisis, but the primary cause is the overreliance on the shareholder primacy theory and short-termism. Apparently, the underlying assumptions and assertions have proved misplaced and must be replaced by an emerging model that takes a long-term view of the corporation.

The next section examines the triggers and their cumulative effect on the financial crisis. But before proceeding, it is important to provide a brief chronology of the crisis with the view to answering some of the questions relating to what and how it happened and thus, help organise the discussion. More importantly, this will help contextualise the crisis and enhance a deeper understanding. After all, the purpose of this study is not just about how corporate governance failed in preventing the financial crisis, but crucially why it failed.

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208 ibid
211 ibid
212 Clarke (n 33)18.
2.3 Chronology of the Crisis

The crisis originated from the US mortgage problems starting in 2007. It was triggered by the bursting of the housing bubble and became both a real estate and financial crisis marked by a sharp rise in mortgage delinquencies, foreclosures and a decline in the market values of subprime mortgage-backed securities.\footnote{Gurvourtz (n 28) 11.} This was followed by a drop in the capital and liquidity of banks and other financial institutions which led to a tightening of credit in the US.\footnote{Christine A. Malin, \textit{Corporate Governance} (4th edn. OUP 2010) 5.} The domino effect was a dramatic fall in the US and European housing market, the collapse of several large banks, financial institutions, financial markets and the global stock market.\footnote{Gurvourtz (n 28) 13.}

2.3.1 United States of America

The crisis in the US was hastened by government refusal to bailout Lehman Brothers. As a result, credit markets in the US and across the world seized up, and eventually accelerating the growing slump in the world economy.\footnote{Donald Nordberg, \textit{Corporate Governance: Principles and Issues} (Sage Publishing 2010) 5.} The failure/refusal by the US government to bailout Lehman Brothers has become a contentious issue and will remain so for a long time to come. Understandably, no issue has aroused more passion than the bailouts for financial institutions during the recent GFC. The standard argument for bailouts has been one of necessity and fear.\footnote{Vern McKinley, \textit{Financing Failure: A century of Bailouts} (The Independent Institute 2012) 21.} The justification is that some of these financial institutions and intermediaries are so critical to the economy that it would not be politically and economically prudent to let them fail.\footnote{ibid} These are the so called ‘too big to fail’ institutions which governments and regulators alike deem too critical due their size, interconnectedness and relevance to the economy.\footnote{Clarke (n 33) 31.} Consequently, providing bailouts for such institutions becomes an economic necessity and socio-political imperative.
Opponents of government bailouts argue to the contrary that, the reasoning driving the policy is flawed because it sends the wrong signal that government would always come to the rescue in times of failure. Critics maintain that bailouts are not the right mechanism for promoting and sustaining the safety and soundness of the financial system because bailouts tend to contradict and undermine the very foundation of the efficient market hypothesis and its self-correcting mechanism.\textsuperscript{220}

Notwithstanding the merits or demerits of bailouts, the US government refused to rescue Lehman Brothers whose collapse was not entirely its making but had been one of the many intermediaries in a rather complex web of transactions which the system failed to correct or regulate.\textsuperscript{221} Under the circumstances, Lehman Brothers was compelled to file for chapter 11 bankruptcy protection, making it the largest bankruptcy filling in US history.\textsuperscript{222}

Realising that failure to rescue Lehman Brothers was major policy mistake with severe consequences, the US authorities decided to rescue the American Insurance Group (AIG) to prevent it from imminent collapse.\textsuperscript{223} Indeed, the government could hardly afford to allow AIG to join the league of failed American companies because of its strategic importance in the global insurance market for credit default swaps (CDS).\textsuperscript{224}

As credit dried up around the world, the credit default swaps still had to be paid out but without sufficient money to meet these immediate debt obligations would have made a bad situation even worse.\textsuperscript{225} This is what necessitated the Treasury Department’s intervention to save AIG. But critics argue that the intervention had proved to be too little too late to prevent the string of

\textsuperscript{220} McKinley (n 217) 32.
\textsuperscript{221} ibid
\textsuperscript{222} This refers to the US Bankruptcy Code that permits reorganisation under the Bankruptcy Laws in the US. It gives the debtor a fresh start, subject to the debtor’s fulfilment of its obligations under its plan of reorganisation.
\textsuperscript{223} ibid
\textsuperscript{224} These are Tradable Securities that initially served as an insurance against corporate borrowers, individuals, mortgage holders and banks unable to meet their commitments.
\textsuperscript{225} McKinley (n 217).
corporate failures witnessed in UK, Germany and other parts of the world. This contagion effect can be explained by the process of globalisation, cross-border lending and the integration of capital markets that began in the 1980s.

The crisis also hit America’s biggest stockbroker Merrill Lynch compelling it into a takeover arrangement with Bank of America, the country’s second largest commercial bank. Similarly, Wachovia, the fourth largest bank had to be rescued by Wells Fargo. Moreover, City Group, the world’s largest bank had to be propped up with tax payer’s money, effectively turning the American tax payer into ‘the proud owner of the largest bankrupt financial institution’.

After the failure of Lehman Brothers, its immediate rivals Goldman Sachs and Morgan Stanley turned themselves into commercial banks and thus, became subject to a myriad of new regulations in exchange for the right to borrow directly from the Federal Reserve just to stay solvent. These new regulatory requirements are akin to what obtained under the Glass-Steagall Act of 1933 which separated commercial banking from investment banking. Paradoxically, the repeal of this Act in 1999 and its subsequent replacement with the Gramm-Leach Bliley Act of 1999 paved the way for investment banking, commercial banking and insurance business to be undertaken by a single institution. These changes reveal a new reality that the model of investment banking that had dominated capital markets on Wall Street, including mergers and acquisitions as well as stock and bond trading had come to an end.

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226 Jensen and Meckling (n 111).
228 McKinley (n 217) 32.
230 The Glass-Steagall Act 1993, (Banking Act) s 16, 20,21 & 33
231 The Glass-Steagall Act 1933, s 16
232 The Gram-Leach Bliley Act 1999
233 Jensen and Meckling (n 111) 11.
As tension continued to mount in the US financial sector, the Fed had to broker a deal allowing the investment bank JP Morgan to acquire its troubled-rival Bear Stearns with a $138 Billion Federal Reserve-backed facility. Following the crisis, several commercial banks in the US and other parts of the world had to be nationalised by governments of all persuasions in direct contravention of the efficient market hypothesis.

2.3.2 United Kingdom

Financial institutions in the UK have suffered from the GFC although the extent to which they have been affected differs widely. The first indication of an impending financial crisis began to emerge in 2007 with an increase in the US subprime mortgage defaults and the rising cost of insuring these securities against default.

The initial stage of the GFC in the UK claimed its first high profile victim when government was forced to nationalise the mortgage lender Northern Rock after the banks had lost confidence in its ability to repay its loans. Northern Rock, which had relied heavily on wholesale money markets as its source of finance was confronted with serious liquidity problems following the crisis. Subsequently, it was compelled to apply to the BoE for emergency support on September 13 2007. Government responded with a £10 billion package to stabilise Northern Rock and to restore shareholder confidence in the financial institutions. The measure was, however, not enough to reduce the massive withdrawals amounting to £1 Billion within a three-day period by panic-stricken depositors who seem to have lost confidence in Northern Rock.

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234 Stiglitz (n 229) 347.
237 Jensen and Meckling (n 111).
240 Clerc (n 109) 93.
UK government then announced a full guarantee of depositors’ savings by revoking an earlier provision under which only 90 percent of deposits between £2,000 and £35,000 was guaranteed. Under the new regime, the UK had effectively lifted the ceiling on the deposit guarantee scheme from £35,000 to £50,000.\footnote{ibid} This move came under serious criticism especially from the banking community who saw the measure as too little because it felt short of the guarantees on deposits recently announced in Germany and Ireland.\footnote{ibid} By February 2008 the UK had exhausted all attempts at finding private sector investors to buy the embattled Northern Rock. Thus, the government was left with no option than to embark on a full-scale nationalisation as the last resort.

The underlying causes of the failure of Northern Rock, Goddard \textit{et al.} argue, include the rather over-aggressive growth in mortgage lending, over-dependence on short-term wholesale funding and an ineffective risk management regime.\footnote{Goddard \textit{et al.} (n 236).} From this perspective, it is submitted that regulatory failure was a significant factor in the downfall of Northern Rock.\footnote{Maximilian J.B. Hall, ‘The Subprime Crisis, the Credit Crunch and Bank “Failure” An Assessment of the UK Authorities’ Response’ (2009) 17 (4) Journal of Financial Regulation & Compliance 427, 430.} This was confirmed in the House of Commons Treasury Committee Report which notes that the FAS systematically failed in its regulatory duties to ensure that Northern Rock does not pose a systemic risk.\footnote{ibid} The failure of Northern Rock was historic as it represents the first run on a UK bank since 1886 and raises questions about the principles-based, self-regulatory and shareholder-oriented model of corporate governance in the UK.\footnote{David T. Llewellyn, ‘The Northern Rock Crisis: A Multi-Dimensional Problem Waiting to Happen’ (2007) 16 Journal of Financial Regulation & Compliance 35.}

Northern Rock was not the only casualty of the GFC; the UK government was also forced to nationalise the mortgage division of Bradford and Bingley in September 2008. Under the
Banking Supervision Act\textsuperscript{247} of 1987, the retail branch was transferred to Abbey National while the remaining business came under public ownership.\textsuperscript{248} The fall of Bradford & Bingley, according the House of Commons Treasury Committee, stems from its business model which focused on self-certified mortgages and rapid expansion.\textsuperscript{249} Speaking before the Treasury Committee, Mr Pym, CEO of Bradford and Bingley admits ‘there is no denying that a mortgage bank with a large element of self-certified mortgages and a buy to-let book is not going to be an attractive asset in these markets.’\textsuperscript{250}

Similarly, the Royal Bank of Scotland, once a proud financial institution with a track record in prudential banking had to be bailed out with taxpayers’ money.\textsuperscript{251} A £20 billion capital raising programme in October 2008 failed to materialise as the terms of the share offer proved unattractive to shareholders and potential investors.\textsuperscript{252} This compelled government to inject £20 billion into RBS and acquired majority stake in the bank albeit reluctantly.\textsuperscript{253} Sir Fred Godwin, former CEO of RBS admits that the bank’s failure was because it was over-optimistic about the economic situation while ignoring warnings from the BoE and the FSA. Another important issue that accounts for RBS’s failure is risk management policy particularly, in terms of risk control, the size, concentration, types and quantum of risk.\textsuperscript{254}

Testifying before the House of Common Treasury Committee, the CEO of RBS revealed that risk controls were inadequate and incorrectly designed.\textsuperscript{255} According to him, ‘there was an issue not about risk recognition but about how the risk was calibrated. The risk was recognised but

\begin{footnotes}
\item[247] Banking Supervision Act 1991
\item[250] ibid
\item[251] Cheffins (n 153) 91.
\item[252] ibid
\item[253] Mukwiri and Siems (n 148)57.
\item[254] ibid
\item[255] Goddard \textit{et al}. (n 236) 277.
\end{footnotes}
in the risk systems, it was quantified as being very small’. The demise of RBS was expedited by the acquisition of ABN AMRO and failure to recognise the scale of its indebtedness. According to the House of Commons Treasury Committee, RBS management failed to carry out due diligence on the transaction but chose to rely on very reassuring statements from ABN AMRO. Sir Godwin described the acquisition of ABN AMRO as a glaring miss-step and admits that the £ 10 Billion spent on ABN AMRO was ‘the wrong price, the wrong way to pay, at the wrong time and the wrong deal’. Incidentally, this complex and expensive acquisition had the unanimous approval and support of both the directors and shareholders of RBS. Against this backdrop the question that remains unanswered is whether the shareholders and directors were given full and accurate information regarding the financial position of ABN AMRO to enable them make informed decisions in respect of the acquisition. Alternatively, did the board of directors and shareholder allow short-term profit maximisation to over shadow their sense of judgement and best corporate governance practices? This is not surprising because shareholders of public companies are often more interested in short-term gains rather than long-term sustainability of such firms. From this perspective the desire to maximise short-term profits as advocated by shareholder thinking was arguably what led to the GFC as the ABN AMRO case demonstrates.

Just as the UK government was announcing plans to provide protection to deal with toxic assets and to assist banks facing liquidity challenges, panic broke out in the financial markets. As a result, the share price of Halifax Bank of Scotland (HBOS), the biggest mortgage lender

257 ibid
258 ibid
260 ibid
261 Kickert (n 239) 169.
dropped despite reassurances by the Treasury Department that the financial crisis was under control.\textsuperscript{262} This led TSB Lloyds to acquire HBOS at the cost of £12 billion thereby creating a merged entity that controls a third of the UK savings and mortgage markets in direct contravention of competition rules.\textsuperscript{263} Although it was a clear breach of competition rules, especially Articles 101 and 102 of TFEU\textsuperscript{264}, UK competition authorities argued that preventing HBOS from collapse was far more important than any strict adherence to competition rules.\textsuperscript{265} This measure was however, not enough to put the merged TSB Lloyds and HBOS on a sound financial footing; hence government had to announce a combined capital injection of £17 Billion for the two entities\textsuperscript{266} leading to increased government stakes in the newly-created entity to 40 per cent making it the largest shareholder.\textsuperscript{267} According to Peter Cummings, CEO of HBOS, like many of the financial institutions affected by the GFC, the problems of HBOS were self-inflicted.\textsuperscript{268} He told the House of Commons Treasury Committee that the downfall was due mainly to the business model and the quality of risk management within the bank.\textsuperscript{269} The business model HBOS pursued was property based and relied heavily on wholesale funding.\textsuperscript{270} The rapid growth of the bank especially in the area of commercial property and the over-reliance on wholesale funding left it in a vulnerable position when property prices began to decline.\textsuperscript{271} In effect, the bank was over-exposed because they lent too much at the wrong parts of the cycle.\textsuperscript{272}

\begin{itemize}
\item \textsuperscript{262} ibid
\item \textsuperscript{263} ibid
\item \textsuperscript{264} Articles 101 & 102 TFEU
\item \textsuperscript{265} ibid
\item \textsuperscript{266} ibid
\item \textsuperscript{267} ibid
\item \textsuperscript{268} Evidence by Peter Cummings before the House of Common Treasury Committee (10 February 2009) <www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/uc144_vii/uc14402.htm> accessed 20 July 2016
\item \textsuperscript{269} ibid
\item \textsuperscript{270} Goddard et al. (n 236).
\item \textsuperscript{271} ibid
\item \textsuperscript{272} Corporate Governance Code (n 182).
\end{itemize}
In return for bailouts, recapitalisation and credit guarantees, the UK government established the UK Financial Investments Limited Company (UKFI) to manage banks such as Northern Rock and Bradford & Bingley that have come under public ownership.\(^{273}\) This raised concerns about the business model and undermined the underlying philosophy of the efficient market hypothesis that have influenced and shaped corporate governance thinking and practice in recent times.\(^{274}\) Effectively, such governmental interventions lead to the socialisation of losses and privatisation of profits. This clearly exposes the defects in the corporate governance arrangements and more importantly, questions the philosophical foundation and justification for the shareholder primacy theory and its proposition of market efficiency and less government intervention.\(^{275}\)

Critics have also questioned and even rebuked government bailouts as inappropriate use of tax payer’s money to support entities that see their role as profit maximising organisations for their shareholders. The public outrage against bailouts was fuelled by reports of bailed-out financial institutions paying lavish bonuses to their executives at a time when the UK and the US public was faced with joblessness and repossessions.\(^{276}\)

It may be argued that, despite the legal justifications regarding economic stability and ethical obligations in the face of the crisis, government bailouts are not the antidote to the GFC.\(^{277}\) Accordingly, government bailouts around the world raise questions as to whether capitalism in general and the efficient market hypothesis in particular have failed, not to mention the ethical dimension of bailouts and their long-term ramifications.\(^{278}\) Therefore, there are doubts as to

\(^{273}\) Young and Thyil (n 178) 281.
\(^{274}\) ibid
\(^{275}\) ibid.
\(^{278}\) ibid
whether the bailouts address the underlying and reoccurring problem in the financial system and whether the classical economic theory still has any relevance.\(^{279}\)

Government bailouts of financial institutions are not without some support, which has largely come from policy makers, regulatory bodies, governments and the business community. Proponents insist the bailouts are necessary and indeed, unavoidable to prevent the entire world economy from going into a recession. Arguably, the decision by the US government to let Lehman Brothers fail aggravated an already stressed global financial system.\(^{280}\) This school of thought contends that the collapse of Lehmann Brothers made matters worse as markets were becoming more dysfunctional.\(^{281}\) Thus, the spectacular failure of Lehman created a new sense of urgency, leading to a rethink and change in government policy vis-a-vis bailouts. Meanwhile, governments across the world have had to grapple with the notions of ‘moral hazard’ on the one hand and ‘too big to fail’ on the other.\(^{282}\) In the end, it was recognised that some bankruptcies were too big for the economy, so it became economically necessary and politically imperative for governments to intervene with bailouts.\(^{283}\)

Significantly, the massive bailouts by governments across the world seem to be addressing the symptoms rather the causes of the crisis. This is not surprising because governments have misdiagnosed the cause of the GFC and have thus come out with the wrong prescription in the form of bailouts. Bailouts by themselves neither explain nor address the fundamental cause of the crisis. In this context, it is submitted that a clearer understanding and appreciation of the GFC requires an interrogation of the shareholder primacy theory and how it has shaped managerial thinking and practice in recent corporate history.

\(^{279}\) ibid

\(^{280}\) Watson (n 276).

\(^{281}\) Conway (n 16).

\(^{282}\) Watson (n 276) 1527.

\(^{283}\) ibid
2.4 Causes of the Crisis

Following the GFC, the process of attributing blame and finding out the cause of the greatest financial crisis since the great depression of the 1930s began in earnest. What continues to puzzle the minds of most people is why the marked improvements witnessed in corporate governance codes, principles and structures in the last two decades failed to restraint or prevent the crisis.\(^{284}\) The scale and depth of the GFC led governments, policy makers and business people around the world to question the effectiveness and suitability of the current corporate governance system to deal with financial innovation in a globalised world.\(^{285}\) Indeed, countries around the world have undertaken significant reforms of their corporate governance regimes. But it is now acknowledged that the governance framework in terms of risk management, supervision and regulation are inadequate and in some cases have been found wanting.\(^{286}\) The current GFC, as the Turner Review notes, goes beyond a mere failure on the part of corporate boards or the work of a few rogue traders.\(^{287}\) Rather, it highlights the weaknesses in the corporate governance system that has been constructed mainly by the private sector which over-emphasised shareholder primacy and profit maximisation.\(^{288}\)

The causes of the GFC are very complex in nature and interconnected.\(^{289}\) While some causes are remote and have been brewing for several years, others are immediate and indeed, triggered the crisis. Whichever way one looks at it, it becomes obvious that the cumulative effect of both the remote and immediate causes are what account for the severity of the GFC.

\(^{284}\) Stout (n 29) 17.
\(^{285}\) EC (n 168)
\(^{286}\) Rob Moulton and Nicola Higgs, ‘Corporate Governance in Financial Institutions’ (2013) 109 Compliance Officer Bulleting 1.
\(^{288}\) Stout (n 29) 41.
Lastra and Wood identify and explain the causes of the crisis under ten ‘non-mutually-exclusive’ groups. According to them, the causes include: macroeconomic imbalances, lax monetary policy, regulatory and supervisory failures, the doctrine of too big to fail, excessive securitisation, unregulated and lightly regulated firms, corporate governance failures, risk management failures, corporate greed and faulty economic theories. They divide the causes into three sub-groups and blame governments, regulators and central bankers for the first three while blaming the markets especially financial products, managers, risk, greed and leverage for the other five. The blame for the last group is put on economists for propounding faulty economic theories. Much as Lastra and Wood’s explanation throws some light on the causes, the categorisation itself is very artificial. Except the too big to fail doctrine and the faulty economic theories, the remaining causes that Lastra and Wood mention are all corporate governance issues. And as already mentioned, the issue of short termism also contributed significantly to the GFC.

Obviously, this is not meant be an exhaustive list of all the likely triggers; instead it is intended to draw attention to some of the salient ones and set the tone for discussion. Therefore, these factors are merely triggers rather than being the underlying cause. The underlying cause as mentioned earlier is the Shareholder-oriented governance model constructed by laissez-faire capitalism with the sole purpose of maximising shareholder profits at the expense of other corporate constituents. Indeed, the current corporate governance arrangement (shareholder

291 ibid
292 ibid
295 ibid
primacy) is based on social power relations that are inherently capitalist.\textsuperscript{296} This relationship underpins the shareholder primacy theory which advocates minimal external interference so as not to distort market efficiency by reducing the role of the state in economic decision-making.\textsuperscript{297} The different triggers are discussed in the subsequent section.

\textbf{2.4.1 Securitisation}

The rapid growth in the securitisation market, encouraged by questionable accounting rules and financial innovation and a deliberate government policy aimed at encouraging home ownership among people who could otherwise not afford it (sub-prime) were the initial triggers (\textit{causa proxima}) of the crisis.\textsuperscript{298} Questionable mortgage policies driven largely by profit motive coupled with lax credit ratings methods by rating agencies became substitutes for the due diligence required of financial intermediaries and institutions.\textsuperscript{299} Driven by short-term profit motives, mortgage originators particularly, mortgage brokers, home finance companies and commercial banks provided loans to people who did not qualify for conventional mortgages.\textsuperscript{300} Consequently, mortgage generation became riskier due to the massive deterioration in lending standards as most sub-prime mortgagees were unable to meet their debt obligations.

As a result, securitisation became the viable option for such people to refinance their mortgages. Even homeowners who qualified for conventional mortgages were encouraged to accept non-prime mortgages at an additional cost of $5222 per mortgage.\textsuperscript{301} Clearly, such practices had nothing to do with encouraging homeownership among the disadvantaged in society as has been alleged but about short-term profit maximisation.


\textsuperscript{297} ibid

\textsuperscript{298} Saidi (n 159)348.

\textsuperscript{299} ibid

\textsuperscript{300} Dallas (294) 282.

\textsuperscript{301} ibid
To maximise profits, mortgage originators sold these mortgages to investment banks and other financial institutions at substantial fees. The institutions in turn sold these products to securities investors in the form of residential mortgage-backed securities (RMBSs).\(^{302}\) In most cases, the mortgage brokers simply originated these subprime mortgages and lent it to households who neither had the income nor assets to continue to service such loans.\(^{303}\) Moreover, documentation of income and assets was not only weak but in some instances non-existent.\(^{304}\) This was by no means accidental but deliberate because most borrowers were also investors anticipating quick resale and huge profits on these properties.\(^{305}\) A key assumption underlying the rapid growth in the subprime market was that house prices would continue to appreciate. Such unrealistic expectation for future price increases, however, failed to materialise and defaults began to rise as most home owners were unable to fulfil their mortgage payment obligations.\(^{306}\)

Driven by the desire to maximise profits, banks hurriedly resorted to repackaging subprime mortgages to CDOs which they resold to unsuspecting investors.\(^{307}\) Unfortunately, too many investors accepted the triple AAA ratings provided by the rating agencies at its face value and packed their portfolios with these questionable financial products.\(^{308}\) This complex process of securitisation depended on demand for RMBSs and of course, the availability of money to fund them. But, when the financial institutions were unable to provide further funding due to liquidity problems, the entire edifice of securitisation started to crumble thereby triggering the GFC.\(^{309}\)

As Gladwell argues, ‘the tipping point in the GFC emerged as liquidity dried up and financial

\(^{302}\) ibid


\(^{304}\) Pool (n 259) 424.

\(^{305}\) ibid

\(^{306}\) ibid


\(^{308}\) ibid

institutions lost trust in the capacity of counterparties to meet their obligations to repay borrowing’. 310

Admittedly, the collapse of the housing market and the dramatic crush of the credit markets contributed to the depth and severity of the GFC. 311 It would, however, be too simplistic to accept the securitisation hypothesis as the cause of the GFC although its role cannot be discounted. Arguably, what motivated financial institutions to finance these products, mortgage brokers to sell mortgage to people who could not afford and CRAs to provide first grade ratings can be explained by the desire to maximise short-term profits to satisfy shareholder demands.

2.4.2 Lax monetary Policy

The causes of the global financial crisis went beyond the US housing problems and can be explained from the point of view of both long-term and short-term factors. 312 After the 2000/2001 dot com bubble, governments around the world became fearful of another 1934 type of recession. 313 To avoid this, the US government injected money into the money market in order to stimulate demand and jump-start the economy. 314 Consequently, the FED reduced interest rates to 1 per cent, the lowest in forty five years thereby flooding the market with cheap credit which in turn created the incentive to borrow. 315 As a result, credit became available for all manner of purposes such as student loans, car loans, mortgages, luxury goods and consumables. 316

311 Saidi (n 159) 290.
312 Tomasic and Akinbami (n 11).
313 ibid
314 ibid
316 ibid
Second, the shadow banking system in the US became another major source of easy credit for the purchase of capital assets especially mortgaged-backed securities. Major players in the shadow banking industry included well-known financial firms and investment banks like Bear Stearns and Lehman Brothers, hedge funds, structured investments and nonbank mortgage lenders.

Either by design or omission, the necessary regulatory safeguards were not in place to control or even limit the excessive leverage in which these institutions were engaged. The failure to regulate these financial institutions created a regulatory gap and represents a key corporate governance failure that exacerbated the GFC.

Indeed, excessive leverage distorts the entire financial system especially in situations where institutions are less regulated as happened prior to the GFC. Moreover, excessive leverage creates the illusion that the financial sector is adding more value to the entire global economy which in fact is not the case. In effect, this illusion of value creation in fact, triggers excessive compensation packages to reward market players whose activities generate and encourage the use of more debt.

Equally important to the discourse is the demand for US investments and the subsequent influx of foreign capital especially sovereign wealth funds into the American economy. This led to

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317 The shadow banking system refers to non-depository banks and other financial entities like investment banks and money markets funds involved in the facilitation and creation of credits across the global financial system, but whose members are not subject to regulatory oversight. They engage in short-term borrowing for long-term investment in assets. Shadow banking system also refers to unregulated activities by regulated institutions.


319 Excessive Leverage refers to financing with too much debt relative to the amount of equity a firm has.

320 Blair (n 308) 225.

321 Roland Perez, ‘Finance, Governance and Management: Lessons to be Learned from the Current Crisis’ in William Sun, Jim Stewart and David Pollard (eds), Corporate Governance and the Global Financial Crisis: International Perspectives (CUP 2011) 113.

322 ibid

323 ibid

324 A sovereign wealth fund is a state-owned investment fund comprising financial assets such as stocks, bonds, real estates, or other financial, instruments funded by foreign assets. These assets can include: balance of
an increase in the easy accessibility to credit and loans.\textsuperscript{325} It is estimated that nearly thirty percent (30\%) of all sub-prime mortgage-related products were purchased by foreign investors.\textsuperscript{326} Finally, this period saw a significant decrease in yields from more conventional assets due largely to the demand and appetite for more risky but profitable (short-term) investments in the form of sub-prime mortgage backed-securities.\textsuperscript{327}

A combination of the above factors created the ideal conditions for the GFC which finally erupted in the summer of 2007. Undoubtedly, the ready availability of credit helped US businesses to recover earlier than expected following the dotcom bubble and the Enron failure in 2000/2001.\textsuperscript{328} The downside, however, is that the cheap credit was not channelled into production but went into the financial services and housing sectors, thus triggering the most dramatic speculative bubble in recent times.\textsuperscript{329}

\textbf{2.4.3 Deregulation}

Regulating corporate entities particularly financial institutions is critical to the operation and functioning of every economy. Seabrooke and Tsingou, define regulation as ‘the set of rules and standards that govern financial institutions; their main objective is to foster financial stability and to protect customers of financial service’.\textsuperscript{330} Unfortunately, regulatory standards and requirements before the GFC proved insufficient in some areas and ineffective in most sectors of the financial services industry.\textsuperscript{331} The period preceding the GFC was characterised

\begin{footnotesize}
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\item[326] ibid
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\item[328] ibid
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\item[329] Frederick Sheehan and William A. Fleckenstein, \textit{Greenspan’s Bubble: The Age of Ignorance at the Federal Reserve} (McGraw Hill 2008)
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\item[331] ibid
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by a ‘light touch’ regulatory regime made possible by the deregulatory movement of the 1980s. As a result, regulations that safeguarded economic stability after the 1932 Great Depression witnessed gradual erosion and were finally dismantled.\textsuperscript{332}

In the US, President Reagan championed the deregulatory crusade by enacting the Garn St German Depository Institutions Act which deregulated the savings and loans Industry.\textsuperscript{333} Also the repeal of Glass-Steagall Act of 1932 by the Clinton Administration in 1999 paved the way for regulatory loosening in the US financial system.\textsuperscript{334} Under the 1932 Glass-Steagall Act, retail banking and investment banking were separate and could only be undertaken by separate financial intermediaries. The repeal of the Act in 1999 and its replacement with the Gramm-Leach Bliley Act in 1999 introduced changes allowing retail banking, investment banking, insurance and real estate business to be carried out by a single institution under one roof.\textsuperscript{335}

Consequently, these regulatory changes enabled commercial banks to engage in speculative business practices in the financial markets with its attendant excessive risk-taking.\textsuperscript{336} The enactment of this act marks the ‘death of gentlemanly capitalism and a new era of casino capitalism’.\textsuperscript{337} The situation was further exacerbated by the passage in 2000 of the Commodity Futures Modernisation Act 2000 (CFMA).\textsuperscript{338} This Act allowed for self-regulation of the futures and derivatives market and also made any attempt at regulating these markets illegal.\textsuperscript{339} The CFMA 2000 deregulates Over the Counter (OTC) financial products as was the case under the

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{332} Thomas Clarke and Jean-Francois Chanlat (eds), \textit{European Corporate Governance, Readings and Perspectives} (Routledge 2009) 13.
\item \textsuperscript{333} Roberto De Vogli,'The Financial Crisis, Health and Health Inequities in Europe: The Need for Regulations, Redistribution and Social Protection' (2014) 3 (1) International Journal for Equity in Health 1,7.
\item \textsuperscript{334} ibid
\item \textsuperscript{335} ibid
\item \textsuperscript{336} Philip Augur, \textit{The Death of Gentlemanly Capitalism. The Rise and Fall of London’s Investment Banks} (Penguin Books 2001)
\item \textsuperscript{337} ibid
\item \textsuperscript{338} Commodity Futures Modernisation Act 2000 (CFMA)
\item \textsuperscript{339} ibid
\end{itemize}
\end{footnotesize}
Commodity Exchange Act of 1936.\textsuperscript{340} Instead Congress opted for what it calls ‘modernized regulation’, a term that has remained as ambiguous as is misleading.

Further, the introduction of the new Securities Exchange Commission rules lowered the capital requirements, eased the calculation of counter-party risk and enabled brokers to assign their own credit ratings to unrated business entities thereby preparing the grounds for the GFC.\textsuperscript{341} The justification for removing the controls, be they regulatory or legislative, arises from the over-reliance on and unquestioned faith in the efficient market hypothesis. This hypothesis views the markets as the most efficient and rationale mechanism to allocate resources, monitor corporate activities and discipline corporate inefficiency and misbehaviour.\textsuperscript{342} These assumptions simply re-echo the ideological premise of laissez-faire economic theory, the foundation of which has proved shaky over the years.\textsuperscript{343} As the GFC demonstratres, defending this key assumption has been found to be too simplistic and unsustainable at best. Effectively, the apparent lack of effective regulatory mechanism saw financial excesses permeate through nearly all aspects of the financial services industry.\textsuperscript{344} In the end, nobody could imagine or envisage the scale of the tragedy that befell many investments banks on Wall Street.\textsuperscript{345}

In fact, regulatory failure in the financial market is not new to governments and regulators across the world. After the earlier corporate failures including Enron, WorldCom, Pamalat and Arnold, there was widespread recognition that this regulatory failure could not be allowed to continue any longer. The OECD for example raised its concern in 2001 and 2007 and called for greater prudence and effective regulatory enforcement regime.\textsuperscript{346} Similarly, Stiglitz derides

\begin{thebibliography}{9}
\bibitem{340} Commodity Exchange Act 1936
\bibitem{341} Branson (n 188) 260.
\bibitem{342} Clarke (n 33) 14.
\bibitem{343} Joel Bakan, \textit{The Corporation} (Constable 2005) 116.
\bibitem{344} Clarke (n 33) 17.
\bibitem{346} Klaus Regling and Maxwell Watson, \textit{A Preliminary Report on the Sources of Ireland’s Banking Crisis} (Government Publications Office 2010) 35.
\end{thebibliography}
the lack of regulation, which he argues, allowed the financial crisis to erupt in the US and later spread to Europe and across the world.\textsuperscript{347} According to Stiglitz, both the US and UK rejected proposals to regulate hedge funds and CRAs adding ‘it was said for a long time that let the markets take care of themselves, now even America and Britain realise the need for transparency and better standards’.\textsuperscript{348}

From this perspective, the GFC crisis can be explained and understood in terms of regulatory failure at both the market and firm level.\textsuperscript{349} It may be argued, however, that lax regulation cannot be faulted for the crisis.\textsuperscript{350} The fundamental problem stems from the failure and lack of adequate economic analysis by private sector actors and regulatory agencies coupled with the over-reliance on the profit maximising concept of the corporation.\textsuperscript{351} The failure to understand the risks of subprime mortgages and to foresee the declining house prices might be a mistake; but is it an inexcusable mistake with catastrophic consequences as the GFC reveals.

\textbf{2.4.4 Masters of the Universe}

A major contributory factor of corporate failure that eventually led to the financial crisis is what Clarke describes as the ‘master of the universe’ mind-set that became prevalent in the financial services industry.\textsuperscript{352} This mind-set created an indulgent culture that encouraged and supported excessive risk-taking and inflated rewards leading to the emergence and explosion of new financial products and innovations in the financial sector.\textsuperscript{353}

The complexity of these new products allowed derivative dealers and hedge fund managers to manipulate trillions of dollars while charging excessive fees on unsuspecting clients and

\begin{footnotesize}
\textsuperscript{348} ibid
\textsuperscript{349} Tomasic and Akinbami (n 11).
\textsuperscript{350} Poole (n 259) 38.
\textsuperscript{351} ibid
\textsuperscript{352} Clarke (n 33) 35.
\textsuperscript{353} ibid
\end{footnotesize}
customers. Complexity by itself, constitutes risk but was not factored into the business model in the build up to the crisis. In the face of the growing complexity of these new financial products, industry operators rather choose not to recognise the threats but convinced themselves they had everything under control. As these new financial instruments were developed, not only did individual financial institutions become more vulnerable to shocks from the underlying risk factors, but more importantly, the entire financial system became less resilient. As Buchheit rightly concludes ‘when history looks back on the crisis, a big culprit will be the astonishing complexity of modern financial instruments and the drafting of contracts’.

In fact, these questionable business practices and models did not go unchallenged. Some critical voices including Warren Buffet raised serious reservations regarding the complexities of these financial products as far back as 2003 describing them as ‘financial weapons of mass destruction, carrying dangers that, while now latent are potentially lethal’. The excessive risk culture combined with the apparent lack of effective regulatory mechanism saw financial excesses permeate through nearly all aspects of the financial system. It thus, became obvious that financial innovation had out-paced regulatory responsiveness.

Against this backdrop, the question that remains unanswered is why was it allowed to happen just a few years after the Enron and WorldCom failures? The answer lies, first, in the failures and weaknesses in the corporate governance arrangements which did not safeguard against the indulgent and excessive culture of risk-taking in the financial services industry. Second, and more importantly, these failures can be traced to the shareholder-oriented model of corporate

354 Ibid
355 Ibid
356 Ibid
357 Ibid
359 Ibid
360 House of Commons Treasury Committee (n 249).
361 Ibid
governance which encourages short termism and excessive risk taking.\textsuperscript{362} From this perspective it is submitted that the financial crisis was not a spontaneous event but a time bomb that has been building over the years and waiting to explode.

\textbf{2.4.5 Risk Management Failure}

Risk remains part and parcel of every business enterprise and can only be avoided by choosing to do nothing.\textsuperscript{363} The challenge is to strike a balance between the risk and the acceptable outcome, to understand the level of exposure to risk and determine the appropriate risk management strategy.\textsuperscript{364} Against this backdrop, it can be argued that the failure to get the balance right has remained a major contributing factor to the current GFC because most financial institutions failed to recognise or even neglected the basic rules of risk management and control.\textsuperscript{365} Risk management according to Tricker is:

\begin{quote}
[A] Process effected by the entity’s board of directors and management and other personnel, applied in strategy session and across the enterprise, designed to identify potential events that may affect the entity, and manage the risk so that it is within the appetite to provide reasonable assurance regarding the achievements of objectives.\textsuperscript{366}
\end{quote}

Corporate risk arises at every level in organisations and could be operational, managerial and strategic.\textsuperscript{367} The risk management failures witnessed before the GFC were not firm specific but systemic and cut across different industries in different countries.\textsuperscript{368} Corporate governance failures arising from unacceptable and risky business practices have been recognised at all

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\textbf{Ref} & \textbf{Details} \\
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\textsuperscript{362} ibid & \\
\textsuperscript{363} Tricker (n 184). & \\
\textsuperscript{364} ibid & \\
\textsuperscript{365} EC (n 169) & \\
\textsuperscript{366} Tricker (n 184) 204. & \\
\textsuperscript{367} Erkens et al. (n 206) & \\
\textsuperscript{368} ibid & \\
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\end{tabular}
\end{table}
levels preceding the crisis as evidenced by the inadequate risk management practices that have characterised the corporate governance regime prior to the GFC.\textsuperscript{369}

Reviewing, guiding and ensuring effective risk management policies and practices are the key functions of the board in every corporate entity. But a complete lack of board oversight and robust risk management contributed to the weaknesses and failures of the pre-crisis corporate governance arrangements.\textsuperscript{370}

First, information flow between management and board of directors on risk management issues was neither effective nor adequate. Often, vital information concerning risk exposures did not reach boards or management to ensure evaluation and the appropriate risk management response. Thus, inadequate information about the quality of loans, especially, sub-prime mortgages and their affordability were major risk factors that were overlooked by most lending institutions.\textsuperscript{371}

Second, lending institutions applied faulty estimates of default rates while rating agencies backed their ratings with wrong estimates of the underlying default risk based on short credit history.\textsuperscript{372} Until recently, sub-prime borrowers were expected to make a down payment of at least 20 per cent of the purchase price of a house but the new finance model did away with this important risk management tool. As a result, default rates increased and default on mortgages was no longer an isolated event but as systemic phenomenon.\textsuperscript{373} The failure to observe some of the basic risk management practices and the general decline in credit standards provided a fertile ground that triggered the recent GFC.\textsuperscript{374}

\textsuperscript{370} McKinley (n 217) 521.
\textsuperscript{372} ibid
\textsuperscript{373} ibid
\textsuperscript{374} ibid
Furthermore, because risk management issues seldom reached board level, the management of such risk became piecemeal and undertaken at business unit level. This led to a risk-management approach where each unit within an organisation was left to stand on its own without coordination throughout the entire organisation.\textsuperscript{375} Consequently, risk management became an activity rather than an enterprise-based system.\textsuperscript{376} Furthermore, most of the risk management policies were reluctantly complied with or simply ignored.

A recent OECD report on the GFC indicates that boards had established and approved risk management strategies, but most did not establish metrics to monitor implementation; thus, neglecting an essential aspect of the governance function.\textsuperscript{377} A critical function of the board of financial institutions is to undertake a constant review of its risk management policies;\textsuperscript{378} but boards in most institutions failed to perform this crucial function.

In the case of Enron, the board failed to realise that the company had moved from being an energy supplying company to a business engaged in financial derivatives. Clearly, as financial institution with an entirely different risk management needs, it failed to develop the necessary risk management policies commensurate with its new status.\textsuperscript{379} Similarly, Northern Rock focused on revenue generation rather than risk management, traded in sub-prime mortgage products with different risk management needs and requirements.\textsuperscript{380} Apparently because the board of Northern Rock did not appreciate the scale of the risk involved, it failed to monitor what was happening in the company. This has been confirmed by the House of Commons Treasury Committee which identifies lack of effective risk management regime as one of the serious flaws that led to the collapse of Northern Rock.\textsuperscript{381} The committee notes that

\textsuperscript{375} Erkens \textit{et al.} (n 206).
\textsuperscript{376} Clarke (n 33) 5.
\textsuperscript{377} McKinley (n 217).
\textsuperscript{378} ibid
\textsuperscript{379} Erkens \textit{et al.} (n 206) 201.
\textsuperscript{380} ibid
\textsuperscript{381} ibid
management of Northern Rock failed to ensure the solvency of the bank and its ability to provide against the risk involved.\textsuperscript{382} The Observer Newspaper was rather blunt on its assessment of Northern Rock and describes it as ‘a bit like putting a Ferrari engine into a Micra’.\textsuperscript{383} Clearly, the GFC has revealed the catastrophic failures in risk management practices on the part of financial institutions in most parts of the developed world.\textsuperscript{384} For the past two decades the financial services industry in particular has witnessed growth both in size and complexity.\textsuperscript{385} Risk management techniques have, however, failed to keep pace with the sophistication of financial products and services on the market.\textsuperscript{386} As a result innovation in the financial services industry far exceeded the capacity of risk management measurement and monitoring tools to gauge risk.\textsuperscript{387} The failure to measure, monitor and manage risk was not industry or firm specific but widespread and endemic prior to the GFC.\textsuperscript{388}

2.4.6 Wrong Incentives

Excessive executive compensation schemes explain why most corporate entities, especially financial institutions engage in extreme risk-taking, while neglecting risk management practices, governance principles and ethical conduct. Failures of risk management systems in major financial institutions were made worst by an incentive culture that encouraged and rewarded high and often reckless risk-taking in the short-term.\textsuperscript{389}

\begin{thebibliography}{99}
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\bibitem{384} ibid
\bibitem{385} Clarke (n 33)\textsuperscript{39}.
\bibitem{386} ibid
\bibitem{387} ibid
\bibitem{388} ibid
\bibitem{389} Keay (n 193) 791.
\end{thebibliography}
Such wrongly-designed remuneration policies and compensation schemes emerged from the desire to align the interest of management and shareholders as part of the attempt to resolve the agency problem.\textsuperscript{390} In the process, executive compensation shifted from a cash-based system to an equity-based system\textsuperscript{391} Thus, it engendered an excessive risk culture and ‘short-termist approach’ that has characterised managerial behaviour in recent times.\textsuperscript{392}

The abrupt changes in compensation were however, not accompanied by the needed regulatory changes in corporate governance to control the predictably perverse incentives that reliance on stock options creates.\textsuperscript{393} A study by Hall reveals the changes that have occurred over the decade for a chief executive officer (CEO) of an S&P company.\textsuperscript{394} According to the study as of 1990, a CEO earning $1.25 m received 92 per cent of that amount in cash and only 8 per cent in equity.\textsuperscript{395} The scale and composition of executive compensation changed dramatically, and by 2001 the CEO of an S&P industrial company was earning in excess of $6 m of which 66 per cent was in equity and 34 per cent in cash.\textsuperscript{396} The impact of this change is that it creates pre-mature recognition of revenues using stock price as the basis for such decisions. Obviously, the new payment regime for CEOs using stock options creates incentives for short-termism and financial ‘manipulation and gamesmanship’.\textsuperscript{397}

A similar study by Cheng and Warfield confirms that corporate managers with high equity incentives sell more shares in subsequent periods, and are more likely to report earnings to meet or exceed forecast and projections.\textsuperscript{398} Increase in manager’s equity ownership corresponds to

\textsuperscript{390}ibid
\textsuperscript{392}ibid
\textsuperscript{393}ibid
\textsuperscript{395}ibid
\textsuperscript{396}ibid
\textsuperscript{397}ibid
\textsuperscript{398}Qiang Cheng and Terry Warfield, ‘Equity Incentives and Earnings Management’ (2005) 80 (2) The Accounting Review 441.
his stock options which in turn, increases the need to diversify the high risk associated with it. The down-side to stock options-based executive compensation especially in an environment of weak regulatory regime, is that it leads to excessive risk-taking, poor risk-management and short-termism, all of which are driven by the desire to maximise shareholder returns in the shortest possible time.

Changes in US tax laws also account for the shift towards using stock options to compensate executives. The amendment of US tax laws in the early parts of the 1990s restricting the corporate deductibility of high cash compensation induced corporations to resort to the use of equity instead of cash.399

Another explanation is the immense pressure by institutional investors who see executive compensation as probably their most potent tool to exert control and to align managerial incentives with shareholder interests.400 Indeed, changes in US tax law coupled with institutional pressures produced a shift to equity compensation which in turn compelled managers to seek to maximise not just share price but shareholder value as well.401 What these institutions failed to recognise and anticipate, however, is that such aggressive use of incentives tends to encourage manipulative techniques and practices to maximise stock price in the short-term.402 This distorted incentive system accentuates risk-taking and encourages financial institutions to ignore the long-term risk inherent in their governance models as well as in their products.403

399 McKinley (n 217) 521.
400 Jensen and Meckling (n 111).
401 ibid
402 ibid
2.4.7 Gatekeeper Failure

Failure by Gatekeepers and the subsequent breakdown in the systems of internal control and external monitoring is a critical trigger of the financial crisis. The role of the Gatekeeper is a key means of ensuring effective corporate governance both within and outside of the corporation. Within the broader corporate context, a Gatekeeper is an independent professional with two distinct roles. First, the Gatekeeper’s role is to prevent wrong doing by withholding cooperation or consent and second, acts as a repeat player providing verification and certification to investors and vouch for other people with greater incentive than the Gatekeepers themselves. The most widely accepted definition of a Gatekeeper is provided by Coffee in which he states that ‘a gatekeeper is an agent who acts as a reputational intermediary to assure investors as to the quality of the signal sent by corporate issuer’.

Gatekeepers can either be internal or external. Internal Gatekeepers include: the board of directors, CEO, and the general meeting of shareholders; while external gatekeepers refer to auditors, credit rating agencies, attorneys, investment analysts and other regulatory agencies. As a reputational intermediary, the Gatekeeper performs by pledging his/her reputational capital to the corporation which enables the markets or investors to rely on the corporation’s own disclosure or assurance. Auditors for instance, certify that the corporation’s financial statements comply with generally acceptable accounting principles while the investment analyst delivers a fair opinion in a merger or takeover bid. Also investment analysts, corporate attorneys and CRAs upon whom investors have come to rely, failed to raise the red

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406 ibid
407 ibid
408 ibid
409 ibid
410 ibid
411 ibid
flags and in fact seemed ‘to have wilfully shut their eyes’.\textsuperscript{412} In that regard, it can be argued that the corporate failures such as the collapse of Lehman Brothers and Northern Rock can be understood as a variety of gatekeeper failure.\textsuperscript{413} Obviously, the desire by management of Northern Rock to show immediate earnings and growth while concealing liabilities seems a direct consequence of how its management was compensated.\textsuperscript{414} Like many of the corporations that collapsed following the crisis, the management of Northern Rock was incentivised to manage for the short term and not surprisingly they did, with devastating consequences.\textsuperscript{415} In that regard it is submitted that failure by the Gatekeepers to perform their functions played a vital role in triggering the GFC.\textsuperscript{416}

While admitting that Gatekeeper failure played a role, it should be noted that acquiescence of Gatekeepers to management pressure was driven by the fervent desire to maximize corporation’s stock price and satisfy shareholder interests.\textsuperscript{417} Moreover, the failure by Gatekeepers to perform their roles effectively is not surprising and can be viewed from three perspectives namely: conflicts of interests, over-concentration and complexity of financial products.\textsuperscript{418}

\textbf{2.4.8 Conflicts of interest}

The failure by Gatekeepers to perform their roles as watch dogs can be explained by the issuer-pay- model of governance which inevitably creates conflict of interest situations. The issuer-pay-model is where the party paying the Gatekeeper is the party the Gatekeeper is expected to monitor.\textsuperscript{419} The situation prior to the crisis was that the auditors, rating agencies, investment

\textsuperscript{412} Ibid
\textsuperscript{413} Tomasic and Akinbami (n 11).
\textsuperscript{414} Ibid
\textsuperscript{415} Ibid
\textsuperscript{416} Coffee (n 405) 15.
\textsuperscript{417} Ibid
\textsuperscript{418} Ibid
\textsuperscript{419} Coffee (n 405) 13.
analyst were all paid by the corporation that had hired them, as a consequent their independence and neutrality was compromised.

Furthermore, the Gatekeepers often took on the additional duties of providing lucrative consultancy services for the very corporate entities they were required to monitor and watch. The impact of such a relationship is that it creates a fertile ground for capture by clients’ interest. In the end, these bodies that were expected to act as Gatekeepers compromised their independence and neutrality and effectively became junior partners in the very entities they were expected to supervise and regulate. This cosy relationship led to acquiescence on the part of the Gatekeepers who failed to raise the alarm but wilfully shut their eyes when it mattered most.

2.4.9 Over-concentration

With the rapid expansion of the international financial markets, the role of these bodies has become critical in maintaining the stability of the international financial system. According to Coffee, the corporate governance failures were to a large degree a product of over-concentration and the lack of competition in the credit rating market. Currently, Moody’s, Standard & Poor’s and Fitch seem to have a monopoly over the market for credit ratings. As to be expected, the lack of competition made possible by governmental actions and entry restrictions have enabled these three organisations to make huge profits without a corresponding investment in upgrading their services to meet the new challenges.

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420 ibid
421 Saidi (n 159) 18
422 ibid
423 ibid
2.4.10 Complexity of financial Products

Equally important to the discourse relates to the constant introduction of new products into the financial markets and the failure of Gatekeepers to keep pace with such innovations.424 The scandals at Northern Rock, Lehman, Freddie Mac and Fannie Mae for example reveal several instances of complex frauds including fabricated earnings, differed earnings and off-balance sheet transactions.425 Arguably, the scandals indicate a breakdown of both internal and external controls and monitoring mechanism.426 Apart from these problems, the challenges posed by the new business models and practices were not properly understood by a large section of the gate keeping community. As the International Organisation of Securities Commission (IOSCO) explains, the role of CRAs among others, is to assess the credit risk of corporate or government borrowers and issuers of fixed income securities.427 Unfortunately, such assessments to ascertain the credit worthiness of real or potential creditors failed to materialise. Consequently, the question being asked after the crisis has erupted is how could asset-backed securities that contained subprime mortgages with high risk debts possibly be given AAA ratings by the CRAs? The answer according to Coffee, are three-fold namely: (a) the complexities of the new financial products, (b) the fact that financial innovation has outpaced regulatory prowess, (c) conflict of interest that has overcome good governance practices.428

Admittedly, self-dealing was evident, but it cannot be said to be the underlying motive. As Tomasic explains ‘driving the principal actors in these scandals was the fervent desire to maximise the corporation’s stock by any means necessary’.429 Indeed, corporate governance cannot function effectively, and management held accountable when Gatekeepers fail to live

426 ibid
428 ibid
429 Tomasic (n 425).
up to their responsibilities as corporate watch dogs.\textsuperscript{430} In an editorial, the \textit{Business Weekly} sums up the failure of the Gatekeeper and concludes: ‘The financial crisis has disclosed that every component of the corporate governance infrastructure was dysfunctional: Company accounts were misleading, their auditors conniving, lawyers conspiring, rating agencies asleep and regulators inadequate’.\textsuperscript{431}

2.5 Conclusion

The failure of so many major international corporations following the GFC highlights the centrality and importance of corporate governance issues. And when put to the test corporate governance routines failed to serve the purpose of safeguarding excessive risk-taking and this became apparent during the GFC. Indeed, the risk management regime failed in many cases due to flawed corporate governance theory and the inadequacy of what Kirkpatrick calls ‘computer models’ of risk management.\textsuperscript{432}

In analysing the financial crisis five key areas that stand out include: (a) critical weaknesses in risk management of most financial institutions (b) excessive remuneration policies (c) excessive securitisation and (d) specific breaches of basic corporate governance principles (f) failure on the part of Gatekeepers.\textsuperscript{433}

While admitting that all the above factors may have played some role in triggering the GFC, this thesis maintains that these were just manifestations and mere symptoms of the shareholder-oriented model of governance. Hence the central argument is that the underlying cause of the crisis stems from the wrong assumptions and misunderstanding of the nature and purpose of the corporation in society. Such misconceptions and the exaggerated emphasis that have been

\textsuperscript{430} ibid
\textsuperscript{432} ibid
\textsuperscript{433} ibid
placed on short-term profit maximisation at the expense of long-term sustainability of the firm is what accounts for the GFC.  

As already indicated, the shareholder-oriented corporate governance system has increased investor pressure for greater returns on short-term investments. Such short-term investors rarely engage with corporations on long-term basis in view of the drive to raise stock price and maximise profits in the shortest time possible. Against this backdrop, it can be concluded that the financial crisis and the subsequent corporate failures can be traced not to flawed individuals or faulty corporate governance arrangements; but to a flawed idea. This is the idea that corporations are managed well when they are managed to maximise share price for shareholders in the shortest time possible. Arguably, this overly-simplistic mantra is, in effect, the underlying cause of the GFC, with corporate failures as mere manifestations of this deep-seated but flawed conception of the corporation. Indeed, the entrenchment of the shareholder primacy theory led to a corporate governance system and a management culture that made company managers more accountable to the market. But sensitivity to the market poses problems especially when the market becomes overly euphoric and unethical as happened in the pre-crisis period. The next chapter explores the shareholder primacy theory, its evolution and how it has influenced and shaped management thinking and practices and argues that the underlying cause of the crisis cannot be divorced from the shareholder-oriented governance system.

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434 Erkens et al. (n 206).
435 Mukwiri and Siems (n 148).
436 Ibid
437 Stout (n 29) 15.
438 Ibid
CHAPTER 3

THEORIES OF CORPORATE GOVERNANCE

3.1 Introduction

Corporate governance as a concept is laden with paradoxes. Prima facie, whilst it appears to be characterised by a set of practical concerns, it is also bedevilled by contested theories. Secondly, while the concept has gained prominence in the last three decades, finding an acceptable definition has remained elusive and sometimes controversial. The third, and perhaps, the most difficult challenge is that the concept has been evolving and undergoing dramatic changes which can be likened to a moving target. Such constant changes often present major difficulties in developing and retaining a theoretical framework.

The present theoretical debate on corporate governance and the accompanying controversy is very much about the role of the corporation in society, and how these assumptions and theoretical underpinnings have influenced and affected corporate governance models, practice and thinking. Admittedly, the theory that has had the greatest influence over the past three decades on corporate governance is the shareholder primacy theory, which emphasises maximising profits for shareholders. Therefore, the central argument in this chapter is that the GFC is the direct consequence of a mistaken idea about corporations. This is the idea that corporations ought to be managed with the sole purpose of maximising shareholder value as measured by the share price and quarterly earnings.

The greatest appeal of the shareholder primacy theory stems from how its proponents have been able to simplify a rather complex reality, which has, in turn, influenced the way corporate
governance is conceptualised and defined. Consequently, this chapter contends that the shareholder primacy theory of corporate governance is inherently flawed and that the GFC of 2007/8 is a clear demonstration of such an inherent weakness. Arguably, the Anglo-American corporate governance model which is underpinned by shareholder primacy and its underlying assumptions has over the years proved to be the cause of and not a cure for corporate failures. Arguably, the recommended cures advocated by the shareholder primacy theory ‘are often worse than the disease’.

Before delving into the theoretical debate, it is crucial to understand the concept of corporate governance to guide the subsequent discussion. It is equally important to point out from the onset that corporate governance in this context is mainly concerned with public companies and not private entities or family owned companies. Thus, the definitions and discussions that follow will focus mainly on large public corporations with some form of stock market listing or those with several shareholders who are not involved in the day-to-day management of the company.

The chapter is divided into three sections. Section one looks at some definitions of corporate governance while section two examines the theoretical framework of the concept. Section three explores the Berle-Dodd debate, its relevance and implications for subsequent corporate thinking and practice. The final section evaluates the shareholder primacy theory and situates it within the Berle-Dodd discourse. It concludes that the underlying assumptions of the shareholder primacy theory are questionable because the premise upon which the theory rests has become increasingly difficult to justify and sustain.

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444 ibid
3.2 Definition

Corporate governance as a concept has several competing definitions and hence defies a single accepted definition. There is neither a statutory definition nor one set out through case law. Corporate governance has been influenced by various disciplines including: law, economics, accounting and business management. Consequently, the different definitions reflect the background of each author and more importantly, the theoretical underpinnings that have shaped and informed their perception and understanding of the corporate purpose.

The challenge of finding a common definition arises from the difficulty in navigating through the complex issues surrounding corporate governance and determining where the boundary lies, as no one knows where it begins and ends. This is further complicated by the global and globalising nature of corporate governance, which involves a plethora of complex legal issues, cultural differences and historical experiences.

Whereas some definitions are narrow and focus on just some aspects of the corporation, others are very broad, encompassing the entire corporate entity. Generally, the narrow definitions reflect the shareholder view of corporate governance which Bloomfield refers to as the ‘inward-facing aspects of corporate governance,’ on one hand, while the much broader approach relates to the stakeholder view, that is, ‘the outward-facing aspects of corporate governance.’ Notwithstanding the multiplicity of the theories, this thesis will focus mainly on the shareholder primacy theory.

Financial economists define corporate governance in terms of how markets function and influence the ability of business entities to achieve the maximum utilization of resources.

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446 Clarke (n 33) 24.
447 Tricker (n 184) 31.
448 Nordberg (216) 5.
449 Malin (n 214) 17.
451 Tricker (n 184) 35.
From this perspective, the efficient functioning of the market remains the central theme of corporate governance because without capital markets the corporation as an organisational form would be unable to achieve its objectives and prominence. A prevailing view among financial economists is that the corporation exists mainly to meet the needs of shareholders, hence the idea of the corporation as a vehicle for investment and the production of goods and services for the public good is secondary.

To achieve this profit maximising objective, corporate governance attempts to align as much as possible the interests of managers with that of shareholders. In line with this narrow approach, Nordberg defines corporate governance as ‘a mechanism of economic utility, a construct whose main aim, is the maximisation of profit for a given amount of resources’. In a narrow sense, corporate governance looks at the mechanisms employed to guide and monitor the financial performance of companies. Consequently, the focus is on the internal arrangements of the company while the role of the board is to oversee the processes to achieve the greatest share value creation and profit maximisation.

Similarly, Schleifer and Vishny adopt the narrow shareholder approach when they state ‘corporate governance deals with the ways in which suppliers of finance assure themselves of getting a return on their investments’. To them, the bottom line is the returns in terms of profit that the shareholders can derive from their investments. This is not surprising because as financial economists, their primary concern and indeed, preoccupation is the protection of shareholder interest and the needed legal protection to be accorded investors in terms of returns. Hence, their view of corporate governance is primarily about return on investments.

452 Hoecke (n 41).
453 ibid
454 Nordberg (n 216) 42.
457 ibid
as evidenced in high share prices which remains the main motivation behind their investment decisions.

Another narrow definition that has influenced corporate governance thinking around the world is the one by the Cadbury Committee set up by the UK Financial Services Authority in 1992 to investigate the financial aspects of corporate governance. It was a response to the corporate scandals involving Bank of Credit and Commerce International (BCCI), Robert Maxwell Communications and Polly Peck. Arguably, the setting up of the committee was an admission that corporate governance in the UK was defective and needed to be improved. Interestingly, the shortcomings which the Cadbury Committee sought to resolve failed to materialise as the governance failures post Cadbury seem to have become even more frequent with devastating consequences.

The Committee defines corporate governance as ‘the system by which companies are directed and controlled’. This definition is rather limited in scope as it focuses only on the internal workings of companies while ignoring other corporate constituencies who affect or are affected by the activities of the company. Apparently, the narrow shareholder approach adopted by the committee underscores the fact that it was ‘reporting not on corporate governance in general but on good financial corporate governance, with a focus on the control and reporting functions of boards and the role of auditors’.

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458 The Cadbury Committee was set up in May 1991 by the Financial Reporting Council, the London Stock Exchange and the Accounting Profession to address the financial aspects of corporate governance in view of the financial scandals that hit the UK in the early 1990s.


460 ibid

461 Bloomfield (n 450) 46.


concentrate on the internal management of the company while ignoring the wider implications for society at large.

Interestingly, Sir Adrian Cadbury who chaired the Cadbury Committee reviewed his stance in 2000 when he broadened the definition of corporate governance. In a foreword, he provided a much broader stakeholder-oriented definition of corporate governance which states that:

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

This widened definition, which recognises the interests and concerns of other stakeholders, is gradually gaining currency in recent corporate governance discourse. Stakeholders by definition, refer to all the groups that affect and are affected by the activities of the corporation. They include shareholders, employees, suppliers, creditors and customers collectively referred to as primary stakeholders. The media, courts, the local community and government make up the secondary stakeholders.

The increasing interest in the stakeholder theory reflects the gradual changes occurring in corporate governance theory and practice particularly the emergence of compelling new literature challenging the traditional shareholder primacy theory. Writers including Romano, Bhagat and Martins not only expose the pitfalls but also denounce the shareholder primacy of

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464 Bloomfield (n 450).
467 ibid
468 Nordberg (n 216) 5.
469 Robert A.G Monks and Neil Minow, Corporate Governance (5th edn, Wiley and Sons 2013) 25.
corporate governance as ‘quack governance’ because the theory, they argue, lacks empirical support for its supposed superiority.\textsuperscript{471}

The shareholder-oriented theory was further weakened by the dot-com bubble of 2000/2001 and the 2008 crisis both of which have their origins in this flawed theory and its underlying assertions.\textsuperscript{472} These developments indicate that corporate governance is not static continues to evolve in response to the changing perceptions and understanding of the role of the corporation in society.\textsuperscript{473} As Nordberg rightly notes ‘it is a moving target and a subject that has been at the centre of serious public debate across the globe.’\textsuperscript{474}

Following these developments, commentators such as, Blair, Monks, Tricker and Demb advocate the broader (stakeholder) approach in their definitions and discussions of corporate governance. From the stakeholder perspective Demb et al. state that ‘corporate governance is the process by which corporations are made responsive to the rights and wishes of stakeholders’.\textsuperscript{475} Obviously, this stakeholder view of corporate governance seems more progressive and inclusive of the various corporate constituents that collectively make up the corporation. The challenge, however, is in finding the right balance between the often-conflicting interests of the different stakeholders.\textsuperscript{476}

On his part, Tricker maintains that corporate governance is about the exercise of power over corporate entities but admits that taking an overarching position does not help in understanding the boundaries and process of the concept.\textsuperscript{477} Tricker is more in favour of the stakeholder

\begin{thebibliography}{99}
\bibitem{2} ibid
\bibitem{3} Roger L. Martin, \textit{Fixing the Game: Bubbles, Crashes, and What Capitalism Can Learn from the NFL} (Harvard Business Review 2011) 12.
\bibitem{5} Nordberg (n 216) 5.
\bibitem{6} Ada Demb and Frederich Neubauer, \textit{The Corporate Board: Confronting the Paradoxes} (OUP 1992) 42.
\bibitem{7} Tricker (n 184) 30.
\bibitem{8} ibid
\end{thebibliography}
perspective which takes a much broader approach by including other stakeholders apart from shareholders, board of directors and management. The central proposition of the stakeholder theory is that the corporation exists to cater for the interest of shareholders and also serve a larger social purpose. The definitions by Djembe and Neuberger reflect this approach.

This perspective of corporate governance had a significant influence on the definitions provided by Blair and Sir Cadbury in 2000. As already indicated, Blair takes the stakeholder approach when she defines corporate governance as:

[T]he whole set of legal, cultural and institutional arrangements that determine what publicly traded corporations can do, who controls them, how the control is exercised and how the risks and returns from their activities they undertake are allocated.

The institutional arrangements occur at three levels and consists of regulatory governance, market governance and internal governance. Regulatory governance refers to the public control over corporations by statutes, through regulations, government policies, governmental bodies and professional associations. Market governance, on the other hand, refers to the use of market mechanisms, particularly demand and supply, competition, entry and exit conditions to control and discipline corporate behaviour and actions. Internal governance on the other hand defines the interaction between the participants and how they relate to and interact with each other. It should be stressed that the ability of a corporation to exercise control is limited to internal governance while regulatory and market governance fall outside its remit.

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478 ibid
480 Tricker (n 184) 31.
481 Blair (n 479).
482 ibid
483 William Sun, Jim Stewart and David Pollard, Corporate Governance and the Global Financial Crisis: International Perspectives (CUP 2011)7.
The definition of corporate governance has undergone dramatic changes. For example, the OECD initially took the narrow approach but later broadened its definition by adding the relationship and operational aspects which are gradually gaining grounds in much of the corporate governance discourse.\textsuperscript{485} The revised corporate governance definition by the OECD states that:

[T]he corporate governance structure specifies the distribution of rights and responsibilities among the different participants in the organisation-such as the board, managers, shareholders and other stakeholders; and lays down the rules and procedures for decision making.\textsuperscript{486}

Despite the attempt to broaden its definition, the OECD’s pro-shareholder position has remained unchanged.\textsuperscript{487} Indeed, the OECD has been at the forefront of promoting and advocating the shareholder-oriented model of corporate governance across the world for the past two decades. It has done so by enacting and propagating various corporate governance codes and principles which have been embraced by both developed and developing countries alike.\textsuperscript{488}

From the above discussion, one theme that runs through all the definitions is that corporate governance is concerned mainly with the processes, systems and procedures governing institutions, and how those rules are enforced or followed.\textsuperscript{489} Thus, corporate governance focuses on how the rules and regulations determine, create, facilitate or hinder those relationships. But corporate governance is not just about rules and regulations; it has an ethical dimension as some governance decisions by boards or management may not necessarily be covered by law or regulation.\textsuperscript{490} For instance, accounting principles and capital markets

\textsuperscript{485} Tricker (n 184) 52.
\textsuperscript{487} William Sun, Jim Stewart and David Pollard (eds), Corporate Governance and the Global Financial Crisis (CUP 2011) 24.
\textsuperscript{488} ibid
\textsuperscript{489} Blair (n 309).
\textsuperscript{490} Tricker (n 184) 53.
dynamics fall outside the legal or regulatory framework and thus, allows management a margin of discretion to decide whether a course of action is ethically acceptable or not.\textsuperscript{491}

Apparently, a new and much broader agenda of corporate governance is emerging in respect of how corporations relate to the wider society in which they exist and operate and from which they derive their legitimacy.\textsuperscript{492} This emerging approach, whether one calls it corporate social responsibility (CSR), sustainability, ethics or corporate responsibility has significantly changed the way corporate governance is conceptualised and defined.\textsuperscript{493} These developments constitute an integral part of a broader movement that seeks to redefine the role and purpose of the corporation against the backdrop of the recent GFC.

The definitions examined in this chapter whether they adopt the narrow shareholder approach or the broad-based stakeholder perspective of corporate governance, revisits an issue that has for decades dominated the corporate governance debate- the role of the corporation in society. Having examined some definitions, the next section assesses the theories that underpin the definitions.

3.3 Theoretical framework

Without theories, it would be difficult for researchers and scientists to carry out any meaningful research, be it empirical or doctrinal.\textsuperscript{494} Consequently, researchers use theories to help define what needs to be studied and to guide researchers in shaping research questions and in deciding the necessary evidence in support of their arguments and propositions.\textsuperscript{495} Porter defines theory as ‘a set of logical propositions about how the real world is structured, or the way in which it operates.’\textsuperscript{496} Thus, corporate governance theories refer to a set of ostensibly logical

\textsuperscript{491} ibid
\textsuperscript{492} ibid
\textsuperscript{493} Tricker (n 184) 48.
\textsuperscript{495} Talcott Parson, The System of Modern Societies (Prentice Hall 1971)34.
\textsuperscript{496} Porter (n 493).
propositions which aim at, and tend to explain how corporate governance as a concept has occurred, the thinking that has shaped its evolution and how it should occur in the future.\textsuperscript{497} There are several theories of corporate governance ranging from the shareholder, stakeholder, stewardship, agency to resource dependency theory. But they fall under two broad categories namely the shareholder and the stakeholder theories.

The discussion will centre mainly on the shareholder theory for two reasons. First, the shareholder theory has dominated corporate governance thinking and practice for the last three decades. Secondly, its underlying assumptions, albeit flawed and lacking in empirical evidence are what account for the GFC.\textsuperscript{498}

3.3.1 The Theories

The classical shareholder theory considers the corporation as a vehicle to maximise profits for the shareholders who, it is wrongly claimed are the ‘owners’ of the corporation and the residual claimants. According to proponents of this theory, the ‘ownership rights’ provide grounds and justification for the corporation to maximise profits for the shareholders.\textsuperscript{499}

The stakeholder theory, on the other hand, views the public corporation as a creation of the state as such its role goes beyond the satisfaction of shareholder interests through profit maximisation.\textsuperscript{500} Consequently, stakeholder theorists insist that the corporation recognises the interests of the wider group who are affected by the actions and operations of the corporation rather than focusing on shareholders alone.\textsuperscript{501}

Apart from the shareholder and stakeholder theories which form the main strands of corporate governance theories, there exists also the stewardship theory, the agency theory and the

\begin{flushleft}
\textsuperscript{497} ibid
\textsuperscript{498} Stout (n 29) 84.
\textsupersoftsup{499} ibid
\textsupersoftsup{500} ibid
\textsupersoftsup{501} Malin (n 214) 20.
\end{flushleft}
resource dependency theory all of which are minor variations and form part of either of the two major theories.502

The stewardship theorist takes the view that managers are stewards of the corporation and would act in its best interest and thus rejects any suggestion of managers being opportunistic agents acting in their own interests.503 It posits that no conflict of interest exists between managers and shareholders and cautions against accepting agency theory ‘as a given’.504 It may be argued that stewardship theory, is in effect, an alternative approach to corporate governance vis-à-vis the agency theory.505

The agency theory emerged from the writings of Jensen and Meckling who view the firm as a nexus of contracts between management and shareholders.506 This contractual relationship they argue, is that of an agent and a principal with the managers acting as the agents of the shareholders who are considered principals.507 The central proposition of the agency theory is that it views the firm as a ‘nexus of contracts’ between the various factors of production each of whom aims at maximising its own utility.508 In that regard, managers end up with substantial power and control over the use of corporate resources. Arguably, because managers are considered self-interested individuals acting on bounded rationality, their actions may not necessarily be in the best interest of the corporation.509 But the separation of ownership from management often creates agency costs510 and puts the shareholder in a pre-eminent position as the principal in whose interest the corporation should be managed.511

502 ibid
503 ibid
504 ibid
505 ibid
506 Jensen and Meckling (n 111) 305.
507 ibid
508 ibid
509 ibid
The resource dependency theory considers the role of the directors as essentially providing the necessary resources and securing linkages with the external environment.\textsuperscript{512} As Hillman \textit{et al} admit, the role of the board under the resource dependency theory, goes beyond reducing uncertainty; but also brings resources such as legal, banking, accounting and financial skills all of which are essential for the effective and efficient management of the corporation.\textsuperscript{513} By providing access to certain key constituents, these boards are helping to reduce the corporation’s dependency on its environs.\textsuperscript{514}

In view of the multiplicity of corporate governance theories, this section will examine just one of the theories namely: the shareholder primacy theory, its emergence, development, transformation, relevance and its central role in the GFC.

\textbf{3.4 Corporate Purpose}

As already mentioned, the present debate on corporate governance theories is very much about the role of the corporation in society.\textsuperscript{515} While some argue that the main and probably the sole purpose of the corporation is to satisfy shareholder interests through increased share price, others contend that the role and indeed, the purpose of the corporation is to serve the larger society.\textsuperscript{516} This ‘shareholders versus stakeholders’ and ‘shareholders versus society’ debate is what has been driving the corporate governance discourse in the last decades and influenced the current corporate governance theory and practice.\textsuperscript{517}

\begin{footnotesize}
\begin{enumerate}
\item Tricker (n 184) 68.
\item ibid
\item Mathew H. Nemeroff, ‘Dodd-Frank: Frankly an Inefficient Form of Corporate Governance’ (2012) 23 (3) University of Florida Journal of Law & Public Policy 431.
\item ibid
\item Stout (n 29)7.
\end{enumerate}
\end{footnotesize}
Undoubtedly, shareholder primacy continues to dominate corporate governance thinking among academics and the business community. But other critical voices argue that the corporation should serve a larger public interest not just that of the shareholders. Understandably, much of the discourse articulated in the shareholder primacy theory arises from the commitment to orthodox ideas of the corporation (profit maximisation) that is arguably too deterministic and dogmatic. Evidence from the recent GFC undermines and rejects the assumptions and presumptions underpinning the shareholder theory which eventually shaped corporate governance practice.

Corporate failures of major corporations such as Lehman Brothers, in the US and the Royal Bank of Scotland, Northern Rock, Halifax Bank of Scotland in the UK and the ongoing financial crisis in Greece have rekindled an age-old debate. Unfortunately, this debate has failed to answer the fundamental question regarding the role of the corporation in society which is: for what purpose does the corporation exist and whose interests must it serve?

Indeed, the current debate between the shareholder and stakeholder theories is not new but a continuation of a century-old discourse that reflects the two opposing views of the corporation since its inception in the nineteenth century. The debate underscores the power relations within the company in terms of the corporate purpose and in whose interest it should be managed, and also reflects economic and ideological preferences. These economic preferences reinforce the proposition that the shareholder-oriented governance model is a construct of power relations that is ‘inherently capitalist’.

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518 ibid
519 ibid
520 Blanaid Clarke, ‘Where was the “Market for Corporate Control” When We Needed It?’ in William Sun, Jim Stewart and David Pollard (eds), Corporate Governance and the Global Financial Crisis (CUP 2011)75.
521 Letza et al. (n 210).
522 ibid
523 Horn (n 161)13.
524 ibid
Before evaluating the shareholder primacy theory, it is important to examine the debate and discussions that have shaped the present conceptions and to some extent misconceptions of the shareholder-stakeholder dichotomy.\textsuperscript{525} Arguably, there can be no meaningful discussion in respect of the purpose of the corporation without revisiting the Berle-Dodd debate which occurred in the US in the 1930s.

3. 5 The Berle-Dodd Dialogue

To fully appreciate the import of the Berle-Dodd debate requires a clearer understanding of the corporate management practices and the general economic environment at the time, both of which were significant in triggering the debate. First, the domination of the American economy in the 1920s by a few large corporations created a situation where management of these corporations exercised enormous power vis-a-vis their stockholders.\textsuperscript{526} It is estimated that the 200 largest business corporations owned and controlled nearly 49 per cent of all corporate wealth in the US at the time.\textsuperscript{527} With this enormous wealth came power and influence. Cases of the arbitrary use of power became very frequent and pervasive, making it necessary for aggrieved shareholders to seek redress in courts. For instance, in Dodge v. Ford Motor Co. (1919)\textsuperscript{528} the complainants (shareholders) resorted to legal action to address an alleged abuse by management against shareholders. In its ruling, the court held that the defendant company must pay dividends to its shareholders, rather than keeping the money to offer lower prices to consumers and pay employees higher wages.\textsuperscript{529} The court stated amongst other things: ‘There should be no confusion that a business corporation is organised and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end’.\textsuperscript{530}

\textsuperscript{525} ibid
\textsuperscript{527} Adolf A. Berle Jr, and Gardiner C. Means, The Modern Corporation and Private Property (MacMillan 1932)
\textsuperscript{528} Dodge v. Ford Motor Co., 170 N.W.688 (Mich.1919)
\textsuperscript{529} ibid
\textsuperscript{530} Berle and Means (n 527).
Nearly a century later, the ruling in *Dodge* is routinely cited to support the idea that shareholder primacy is a requirement under American company law. It should be noted, however, that the statement was in fact mere dicta with no binding effect in law, hence future courts are at liberty to uphold or disregard it.

Moreover, the growth of these corporations was financed through the issuing of securities, corporate pyramid-building and investment trust most of which turned out to be worthless. A typical example is the sale of nearly a billion securities by Goldman, Sachs & Co in 1929 which turned out to be valueless. The dispersed nature of the stockholders made it virtually impossible for them to exercise control or have an oversight role over management and directors.

Added to this, was the lack of a uniform regulatory system within and across states and an ineffective enforcement regime. The lack of uniformity was further exacerbated by the relatively little inter-state traffic in securities and other financial products. In addition, the provision of information to shareholders, which is today taken for granted was voluntary and not mandatory at the time of the debate. For example, corporations in Delaware were required to provide annual reports but were not compelled to disclose information regarding their financial transactions. Companies incorporated in Arizona for instance, were not obliged to present any reports or statements either to stakeholders or the public.

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531 Stout (n 29) 26.
532 ibid
533 Macintosh (n 526) 139.
534 ibid
535 ibid
536 ibid
538 ibid
539 ibid
540 ibid
Obviously, this lack of corporate accountability, coupled with the widespread dispersion of stockholders, gave management complete control over corporations.\textsuperscript{541} Unsurprisingly, the extent of corporate power and the total absence of accountability generated apprehension among the stockholder community and further caused disquiet among academics like Berle who denounced the way shareholders had been marginalised and relegated to the background by management.\textsuperscript{542}

Indeed, Berle’s pro-shareholder position becomes understandable when one looks at the prevailing conditions which seemed to have put stockholders in a very disadvantaged position. These conditions included the shortcomings of the corporate law regime, the financial practices of Wall Street and the lack of control over corporate management.\textsuperscript{543} The debate, therefore, arises from Berle’s conviction of the need to harmonise the different corporate law rules and to improve management practices that were thought to undermine the interest of stockholders. Thus, it was during this time and under those circumstances that the Berle-Dodd debate took place.

### 3.6 The Debate

Of all the controversies surrounding the new economic creature called the corporation, none has been more fundamental as the Berle-Dodd debate regarding its purpose and place in society.\textsuperscript{544} The formal origins of the debate can be traced to two articles published in the \textit{Harvard Law Review} in 1931. In an article entitled ‘\textit{Corporate Powers as Powers of Trust}’ Professor Adolf Berle of the Columbia Law School examined the powers granted in law to corporations and argued that the exercise of such powers should be for the sole benefit of

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{541} ibid
\item \textsuperscript{542} ibid
\item \textsuperscript{543} ibid
\item \textsuperscript{544} Stout (n 29).
\end{itemize}
\end{footnotesize}
shareholders. He likened the situation to that of individuals acting towards other people in a trusteeship relationship adding:

[A]ll power granted to a corporation or to management of a corporation, or to any other group with the corporation, whether derived from statute or charter or both, are necessarily and at all times, exercisable only for the rateable benefit of all shareholders as their interest appears.  

The publication of this article and the subsequent controversy it generated sought to answer the same question but from different perspectives. First, should management of public corporations focus just on maximising profits for the benefits of the shareholders? Alternatively, should the public corporations have a broader purpose that goes beyond and above making profits for the shareholders? These two opposing views of the public corporation have inevitably created tensions within the corporate governance community. The controversy surrounding the shareholder and stakeholder view of the public corporation is not new. It has, in fact, been in existence since the establishment of the modern corporation in the nineteenth century and reflects the two opposing views of the corporate purpose. These opposing views regarding the purpose of the corporation led to the emergence of two theories: the shareholder value also known as the shareholder primacy theory and the stakeholder theory. But, it was the exchanges between Adolf Berle and Merick Dodd that gave the debate the prominence and currency that it has gained.

Berle holds the view that because the responsibility of managing the corporation has been delegated by shareholders to management, corporate managers have the responsibility to exercise those powers to advance the interest of the shareholders. According to Berle ‘all powers granted to a corporation or management are at all times exercisable only for the rateable

545 Berle and Means (n 527).
546 Letza et al. (n 210).
547 Keay (n 455) 57.
548 Macintosh (n 526) 144.
benefit of the shareholders’. 549 In effect, corporate performance should be measured through what Stout calls the ‘single metric of share price’ 550 and profit maximisation for shareholders. Accordingly, Berle posits that corporations are simply vehicles for the advancement and protection of the shareholder interest, hence, corporate law should reflect this both in application and interpretation. Berle further argues that any other account of corporation’s function and purpose would defeat the very object and nature of the corporation itself. 551 He declared:

[I] n every case, corporate action must be tested twice: first, by the technical rules having to do with the existence and proper exercise of the power; second, by equitable rules somewhat analogous to those which apply in favour of a trust created for a beneficiary. 552

To strengthen this position, Berle made a comprehensive analysis of corporate governance and concludes that the exercise of corporate power should revolve around the principles of equity. This, he insists, is to ensure that management acts in utmost good faith towards all shareholders arguing ‘corporate law is in substance a branch of the law of trusts’. 553 He admits, however, that corporate power should be less rigorously applied than in a trust situation as more flexibility is required in running a business corporation. 554

Berle’s position represents the shareholder school of thought which views the corporation as the property of the shareholder whose interest the corporation exists to serve. From this perspective, corporate managers are viewed as agents acting upon the instruction and direction of the shareholders. Berle opines that because managers derive their authority and legitimacy

550 Stout (n 29) 19.
552 Berle (n 549) 136.
553 ibid
554 ibid
from the shareholders, it becomes imperative that their actions should aim at advancing shareholder interest. This contrasts sharply with the position adopted by Dodd, who argues that corporate managers as representatives of the corporation are required to seek and promote the interest of all the corporate constituents and not just the shareholders.

Exactly a year after the publication of Berle’s article, Professor Merrick Dodd of the Harvard Law School challenged Berle’s assertion in an article entitled ‘For Whom are Corporate Managers Trustees?’ Dodd rejects the traditional view as advocated by Berle that a corporation is an association of stockholders formed for private gains and to be managed by the board of directors for the sole purpose of making profits.\textsuperscript{555} He further argues that the corporation becomes a distinct legal entity upon incorporation and cannot be regarded as the mere aggregation of the shareholders adding ‘our legal tradition is rather in favour of treating it as an institution directed by persons who are primarily fiduciaries for the institutions rather than for its members’\textsuperscript{556}

According to Dodd, the contractual relationship between the managers of the corporation and the shareholders is that of agency rather than trusteeship.\textsuperscript{557} He opines that because the corporation is considered a distinct legal entity separate from its shareholders, it is in fact, the corporation and not the shareholders who contract with outsiders.\textsuperscript{558} Therefore, the management as agents and indeed, representatives owe fiduciary duties to the corporation and not its shareholders.\textsuperscript{559} To this end, he argues that the law should ensure that corporations are accountable to the society in which they exist and operate saying:

\textsuperscript{555} Merrick E. Dodd, ‘For Whom Are Corporate Managers Trustees?’ (1932) 45 Harvard Law Review 1148, 1149.
\textsuperscript{556} ibid
\textsuperscript{557} ibid
\textsuperscript{558} ibid
\textsuperscript{559} Macintosh (n 526)148.
[T]here is in fact a growing feeling not only that business has responsibilities to the community but that corporate managers who control business should voluntarily and without waiting for legal compulsion manage it in such a way as to fulfil those responsibilities.\textsuperscript{560}

To buttress this point, Dodd referred to the Supreme Court decision in \textit{Mum v. Illinois} where the court held that the State of Illinois had the power to set maximum prices for grain storage because such businesses were ‘affected with a public interest’.\textsuperscript{561} This ruling had two major implications. First, it made it possible to extend the proposition that public interest considerations need to be factored into corporate managerial decisions and actions. Second, as Dodd points out, the law is gradually moving towards the view that all businesses affect and are also affected by the environment and the society in which they operate. Indeed, the enactment of the Adamson Act of 1916 to specifically cover the rail road industry was intended to increase the wages of workers; and exemplifies how workers’ economic security have been prioritised over and above shareholder profits.\textsuperscript{562}

Dodd points out the significant shift both in terms of the law and public opinion in the direction where the corporation is seen as ‘an economic institution which had a social as well as a profit-making function’.\textsuperscript{563} Dodd cites Owen Young, the then CEO of General Electric as an example of the growing public opinion that is gradually shifting towards the stakeholder paradigm.\textsuperscript{564} According to Young, corporate managers were no longer just attorneys for stockholders but have become trustees for the corporations they manage, adding ‘I am a trustee of the institution and not merely an attorney for the investor’.\textsuperscript{565} This admission is quite significant because it underscores a shift in public opinion towards the stakeholder theory of corporate governance.

\textsuperscript{560} Dodd (n 555) 1163.
\textsuperscript{561} \textit{Mun v. Illinois} 94 U.S. 113 (1877)
\textsuperscript{563} Dodd (n 555).
\textsuperscript{564} Bratton (n 562) 12.
\textsuperscript{565} Merrick E. Dodd ‘For whom are Corporate Managers Trustees’? (1932) 14 Harvard Law Review 1145.
and that business leaders and management of corporations were beginning to accept albeit reluctantly, that their obligations extend to constituents other than shareholders.

This voluntary assumption of social responsibility was gradually manifesting itself in matters such as contributions to charity and other socially responsible acts. Berle’s response to this proposition was prompt but not unexpected. In his view, giving management that much freedom to use corporate resources for charitable purposes could lead to possible abuses and managerial absolutism.\textsuperscript{566} Social responsibility, he argues, cannot be justified for two reasons.

First, most managers, with a few exceptions do not subscribe to the idea that corporations have social responsibilities.\textsuperscript{567} Secondly, the mechanism to ensure enforcement and compliance did not exist and thus, dismissed that proposition as an avenue for managerial abuse. Against this backdrop, Berle rejects the suggestion that corporations had any responsibility to consider outside those of shareholder-interests noting ‘responsibility to stockholders should not be weakened except for a clear and reasonably enforceable scheme of responsibilities to someone else’.\textsuperscript{568}

The final aspect of the Berle-Dodd debate centres on how effective the law can be in ensuring that the directors act in the best interest of shareholders. Considering the reality of the situation in the 1930s, Dodd takes the position that the law should enable corporate managers to assume larger social responsibilities in view of the pervasive influence of corporations on society in general. Berle, on the other hand, feared that such a proposition would further confer legitimacy on uncontrolled and excessive corporate power.\textsuperscript{569}

\textsuperscript{566} Bratton (n 562)13.  
\textsuperscript{567} ibid  
\textsuperscript{568} Adolf A. Berle Jr, ‘Foreword’ in Edward Mason (ed), \textit{The Corporation in Modern Society} (Harvard University Press 1960)  
\textsuperscript{569} Bratton (n 562) 14.
3.7 Discussion and Analysis

The Berle-Dodd debate has generated a lot of interests, provided insights and to some extent, questioned some of the ideological assumptions underpinning the purpose of the firm. In this context, it provides a detailed exposition about some of the long-held propositions, conceptions and perhaps misconceptions regarding the two main contested theories of corporate governance namely shareholder theory and stakeholder theory. The eighty-year old debate concerning the corporation and its purpose goes beyond mere historical interest but has current relevance and significance as well.

The issues raised in the debate were very clear and unambiguous. Arguing in favour of shareholder primacy, Berle explains that corporate management should be required by law to act in the utmost good faith towards shareholders. This relationship, he argues, should be defined and mandated by law along the lines of trusteeship where the power is exercised for the benefits of shareholders.

It is important to stress that this is not the first time Berle had expressed this proposition. While examining the position of management in 1926, Berle contends that the best way to hold management accountable is through disclosure of information adding ‘courts cannot act, and public opinion cannot act unless the facts are disclosed’. According to Berle, because individual shareholders are incapable of exercising any meaningful and effective control over corporate management, control should be imposed by law.

Moreover, the dispersed nature of shareholders coupled with the cost involved in enforcing their rights and the difficulty in obtaining information, explain why shareholders are unable to

571 ibid
572 ibid
exercise any effective control over management. Berle’s propositions have however, been
criticised as flawed and defective.

First, Berle fails to demonstrate in concrete terms how these laws are to be fashioned, what
forms they should take, how they can be enforced, and more importantly, who takes charge of
the enforcement. Secondly, it is important to point out that merely having legislation in place
is not enough. Indeed, as the recent GFC demonstrates, legislations per se do not guarantee
prudent conduct on the part of corporate management just as voluntary codes alone cannot
ensure good corporate behaviour.

Dodd adopts a more extreme position by relying on the managerial principle which states that
in a situation where shareholders are dispersed, management should not be accountable to any
specific group. Rather, the responsibility, he argues, should be the protection of the interest of
all stakeholders including shareholders. Against this backdrop, Dodd maintains that such
responsibilities should be made mandatory, saying ‘any substantial assumption of social
responsibility by incorporated business through voluntary action on the part of managers cannot
be reasonably expected’. 574

In this context, Dodd proposes the concept of ‘managerialism’ as a principle of corporate law
since doing so would enable both the law and public opinion to influence the conduct of those
who direct and control corporate affairs. 575 It is equally important to note that the conduct of
 corporations is affected not just by the laws that regulate them but by the force of public opinion
 and the attitude of business towards their social obligations. It is submitted that corporate law
 and indeed, corporate governance must reflect this shifting public opinion regarding the purpose
 of the corporation in society.

573 Dodd (n 555)1161.
574 ibid
575 ibid
Like in many debates, the views of Berle and Dodd were surprisingly compatible particularly concerning the lack of corporate accountability and the extensive powers and influence management have acquired at the expense of shareholders. These powers were often so arbitrary that the two protagonists recognised the need to have a mechanism to curb these managerial excesses. Moreover, they both agree on the need to hold management accountable for the proper discharge of their duties according to law. It is however, doubtful whether the imposition of legal requirements is enough to make corporate managers accountable. In the same breath, giving corporations a free hand to operate without certain minimum legal requirements is also not viable option.

As already indicated, the debate exposes some serious disagreements regarding the role of corporate management and what should be their position vis-à-vis the shareholders. The major difference between Berle and Dodd is whether managers should be required to act merely as fiduciaries towards stockholders or accept a greater role by acknowledging that their duties and relationship extend to other stakeholders.

There is now a growing recognition, particularly in the US and other jurisdictions that the responsibilities of corporate management towards other stakeholders should be mandatory as these powers are held in trust for the entire community. The justification being that corporations are legal entities created by the state for public benefit, hence they should necessarily have a much broader purpose beyond making profits for their shareholders.

Dodd provides several interpretations of his view on the need for the law and explains that social responsibility requires that corporate managers pay attention to the needs and concerns of other stakeholders.

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577 Macintosh (n 526) 150.
578 ibid
579 ibid
580 Frank Dobbin and Dirk Zorn, ‘Corporate Malfeasance and The Myth of Shareholder Value’ in Davis Diane (ed), Political Power and Social Theory (Elsevier 2005) 182.
of their employees and customers as this would ultimately benefit stockholders. For instance, Dodd opines that although corporate charity does not immediately increase stockholder wealth, it could generate goodwill in the community. Such goodwill could be beneficial both to stockholders and the entire company in view of the favourable image and perception customers have about such an entity. In the end, it accomplishes two goals by increasing both profits and growth while at the same time contributing to the well-being of society.

Berle however, rejects this proposition and argues that any extension and broadening of the responsibilities would rather lead to greater powers being vested in the corporate management who may be tempted to abuse such powers. He maintains that the only way to avoid this is to require the ‘publicizing’ of their activities by putting in place a full disclosure regime. While agreeing with Berle for a full information disclosure regime, it is unclear whether such disclosures should be legally required or simply embodied in voluntary codes. Each of the two approaches to information disclosure has its own merits and demerits. For instance, although the US had some of the strongest and legally-binding disclosure regimes in the world, that alone could not stop the managerial abuses and excesses that led to the failure of Enron, WorldCom, Arthur Anderson and Lehman Brothers. Similarly, the UK prides itself of the superiority of its voluntary codes under the principle of comply-or-explain. Yet it could not prevent the fall of Northern Rock, Royal Bank of Scotland and Halifax Bank of Scotland to name but a few. Against this background, it is submitted that the success or otherwise of information disclosure requirements will to a large extent depend on the readiness of corporate management to comply with both the letter and spirit of the legal requirements and disclosure regime.

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581 ibid
582 ibid
583 Bakan (n 343) 47.
584 ibid
585 Bainbridge (n 105) 48.
586 ibid
587 Clarke (n 33) 77.
588 ibid
Interestingly, with the passage of time, the parties to the debate have tended to shift and even changed their positions.\textsuperscript{589} Nearly ten years after the debate had begun; Dodd openly acknowledged and admitted in 1942 that some of his earlier views and concerns about the lack of corporate accountability had been addressed by certain specific legislations granting statutory labour rights such as the right to organise and the right to bargain with management on equal terms.\textsuperscript{590}

Moreover, many of the policy changes including unemployment, insurance and social security had been incorporated into federal laws and unemployment policies in the US as well as in Germany.\textsuperscript{591} Further, Dodd changed his earlier position and admits that the new federal securities laws have dramatically and successfully affected the balance of power between shareholders and managers.\textsuperscript{592} This sudden retreat by Dodd from his earlier stance is in recognition of the reassurances provided under the various governmental interventions under the New Deal.\textsuperscript{593} Also, contrary to his earlier proposition, Dodd became increasingly sceptical of managers and their willingness to act in the interests of shareholders. He therefore, questions whether and to what extent managers can be trusted to protect shareholder interests, arguing ‘A situation in which the shareholders have to depend rather on the conscience of the management than on their own legal rights is a dangerous one’.\textsuperscript{594} This statement contradicts and indeed, represents a fundamental shift in Dodd’s earlier assertion that most managers could be trusted to act in the best interest of shareholders. These developments can be explained by the changes in the legal, political and economic landscape. Indeed, the passing of the new federal securities

\textsuperscript{589} Bratton (n 562)\textsuperscript{590} ibid\textsuperscript{591} ibid\textsuperscript{592} ibid\textsuperscript{593} ibid\textsuperscript{594} Merrick E. Dodd, ‘The Modern Corporation, Private Property and Recent Federal Legislation’ (1941) 54 (6) Harvard Law Review 927.
laws and the fact that the economic crisis that engulfed America had almost come to an end attest to the new reality.

Similarly, in 1954, Berle altered his position in response to changes in American society following the introduction of the minimum wage, antitrust laws and other legislative initiatives. This is quite understandable considering the fact that it was the absence of these socially-oriented policies that provided the epilogue to the debate in the first place. Clearly, Berle’s more recent optimism and to a large extent the willingness to accept some level of controls appears diametrically opposed to his previous assertions. Berle, had by this time overcome, albeit reluctantly, the hitherto misgivings he had in respect of the lack of a clearly defined legal framework for wider corporate responsibilities. He admits that:

[T]wenty years ago, the writer had a controversy with the late Professor Merrick Dodd, of Harvard Law School, the writer holding that corporate powers were trust for shareholder while Professor Dodd argued that corporate powers were held in trust for the entire community. The argument has been settled (at least for the time being) squarely in favour of Professor Dodd’s contention.

Berle’s admission although very significant does not represent a complete shift or reversal of his earlier position. There is no doubt that he acknowledges and accepts Dodd’s point of view but Berle still remains unconvinced when he insists that ‘It is one thing to agree that this is how social fact and judicial decisions turned out. It is another to admit that this was the ‘right’ disposition: I am not convinced that it was’. Clearly, this statement does not give any indication or provide evidence of surrender by Berle in this debate. That notwithstanding, Berle in the latter part of his writings accepts that the corporate purpose goes beyond shareholder value maximisation. He declares:

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595 Bratton (n 562)18.
596 ibid
597 Macintosh (n 526) 152.
598 ibid
600 Berle (n 568) 7.
601 Macintosh (n 526) 154.
[I]t seems almost essential that if the corporate system is to survive, the control of the great corporations should develop into a purely neutral technology, balancing a variety of claims by various groups in the community and assigning to each a portion of the income stream based on public policy rather than private cupidity.602

Despite the change in his positions, the earlier proposition advocated by Berle remains the prevailing theory that has dominated corporate governance theory and practice up to date. This thinking has given rise to a governance model that compels executives to prioritise the interest of shareholders above all others.603 Indeed, the assertion that corporations exist solely to maximise returns to their shareholders has in the words of Kelly ‘become the law of the land’604 universally accepted as a kind of divine, unchallengeable truth.

3.8 Relevance and Implications

Often, general propositions do not decide specific cases, but future predictions and developments are hardly possible without them. It may therefore, be argued, that the Berle-Dodd debate goes beyond just mere intellectual disagreements between two renowned academics.605 The debate and its relevance has been demonstrated by the legislative initiatives adopted in response to the widespread demand for accountability, transparency and the need to reform the way companies are directed and controlled.606

Despite the importance of the issues raised by the debate, it was a Senate Committee investigation into security dealings of the New York Stock Exchange that finally prompted President Franklin D. Roosevelt to establish a committee to draft new bills to address the concerns raised in the Berle-Dodd debate.607 The Committee uncovered massive tax avoidance

603 Bakan (n 343) 39.
604 Majorie Kelly, The Divine Right of Capital: Dethroning the Corporate Aristocracy (Berrett-Koehler 2001) 89.
605 Berle (n 568).
606 ibid
607 ibid
by stock market dealers, the sale of bad investments to an unsuspecting public, the manipulation of stock prices and insider trading.\textsuperscript{608}

Following these revelations, it became necessary to enact legislations to rein in these unacceptable practices and bring them under control. Pressure was thus, brought to bear on the government which in turn responded by setting up a committee to review such business practices. Critics however argue, that this action though progressive at its face value was, simply a confidence-building measure aimed at restoring public confidence and more importantly, avoid another stock market failure as happened in 1929/30.\textsuperscript{609}

Whatever the motivation, the work of the committee led to the enactment of the Securities Act of 1933, the Glass-Steagall Banking Act of 1933 and the Securities Exchange Act 1934.\textsuperscript{610} The Securities Exchange Act (1933) required full and complete disclosure of information by dealers in new securities and imposed heavy penalties for failure to state or deliberately misstating any material fact in their prospectus.\textsuperscript{611} Accordingly, the Federal Trade Commission was set up to administer the Act and given the additional responsibility of prescribing the form and contents of the financial statements by firms listed on the NYSE.\textsuperscript{612}

Furthermore, the Glass-Steagall Banking Act 1933 was also passed to resolve the challenges confronting the banking and the financial industry.\textsuperscript{613} This Act specifically requires the strict separation of commercial banking from investment banking activities so as to avoid the abuses that have engulfed the banking industry prior to the market crash of 1929.\textsuperscript{614} In effect, the Act was designed to provide for safer and prudential use of bank assets, regulate internal bank

\textsuperscript{608} Collin Mayer, \textit{Firm Commitment} (OUP 2013) 32.

\textsuperscript{609} ibid


\textsuperscript{611} ibid

\textsuperscript{612} ibid

\textsuperscript{613} Bratton (n 562) 738.

\textsuperscript{614} ibid
control and prevent the abuse and diversion of funds into speculative activities. The general belief was that separation would lead to a much healthier financial system.

Another important innovation of the Act was the introduction of the federal guarantee of bank deposits which created the Federal Deposit Insurance Corporation (FDIC). Under this scheme, the FDIC insured deposits up to $2,500 which was thereafter increased to $5,000 a year later. The passing of the Securities Exchange Act 1934 and the subsequent establishment of the Securities and Exchange Commission was yet another important outcome of the Berle-Dodd debate.

Unsurprisingly, government presented these legislation amidst much fun-fare as responding to public interest and satisfying the demands of the American public for more transparency and greater corporate accountability. From this perspective, it is submitted that the “New Deal” represents an important milestone in the evolution of corporate governance because it introduced major regulatory reforms designed to restore economic stability and curb the excessive powers of corporations. Notwithstanding the strong resistance and outright hostilities, the spirit of the “New Deal” along with many of the regulatory regimes prevailed.

These legislations were greeted with scepticism by critics who questioned the motives and intentions of government in passing these laws. Questions were raised as to whether the passing of the legislation regarding full information disclosure was indeed, a genuine attempt to rectify the shortcomings in the existing corporate law regime. Or were these just cleverly-designed ploys to placate investor needs and satisfy the political mood of the time? Arguably, the introduction and the eventual passing of the securities legislations were politically motivated

615 Dodd (n 555) 56.
616 ibid
617 Bratton (n 562).
618 Bakan (n 343) 24.
619 ibid
and self-serving.\footnote{Ross L. Watts and Jerold L. Zimmerman ‘The Demand for and Supply of Accounting Theories: The Market for Excuses’ (1979) 4 The Accounting Review 135.} Apparently, the legislations followed what is often referred to as the ‘justification demand’ or ‘public interest’ approach to regulation.\footnote{ibid} This method of regulation is used merely to facilitate wealth transfers: including the imposition of higher taxes and tariffs by using the public interest argument as the main weapon. Such policies are usually advocated under the pretext that it is in the public interest to do so, or everybody is made better off or that the action is fair.\footnote{ibid} In view of this, it can be argued that the legislations had very little to do with safeguarding or promoting public interests.\footnote{ibid} Later events tend to support this view as it became obvious that despite the widespread expectation generated by the passing of the securities legislations, very little had been achieved in terms of exerting greater control on corporations and ensuring that management maintain the high level of accountability and transparency envisaged under the Act.\footnote{ibid} In fact, the Securities Act for example, only applies to the issuing of new securities but fails to address one of the main issues raised by Berle; which is that corporate management should be required by law to act in a fiduciary capacity towards the shareholders.\footnote{Macintosh (n 526) 152.}

Furthermore, although the legislations received widespread acceptance at the level of government, they failed to address the underlying philosophy of ‘publicizing’ corporate affairs.\footnote{One-Tel scandal (n 137).} As a result, financial reporting by corporations in the US remained largely unregulated till the late 1960s due mainly to the absence of a full and complete disclosure regime.\footnote{ibid} Until then, corporate reporting in the US was based on the notion that the reporting system should reflect the principle of managerial supremacy and control over corporate assets.
and the ability of the corporation to discharge its duty to shareholders.\textsuperscript{629} This made corporate managers to focus on share price and quarterly earnings on the assumption that corporate purpose must be viewed solely from the perspective of the shareholder.\textsuperscript{630}

The Securities Exchange Act that was passed ostensibly to address the issue failed to live up to expectation. Instead of conforming to its stated goals and objectives, it applied different reporting requirements in respect of filing reports to shareholders and the Securities and Exchange Commission (SEC).\textsuperscript{631} The dangers of different reporting requirements and standards became apparent following the failure of the Atlantic Research Corporation to report its 1968 annual losses to shareholders although such losses had earlier been reported in the fillings submitted to the SEC.\textsuperscript{632} Admittedly, the Securities legislations that have been enacted between 1933-34 provide legislative and administrative checks on corporate management in America.\textsuperscript{633} Dodd however, insists that these were considerably different from what was envisaged at the beginning of the debate.\textsuperscript{634}

Berle on the other hand was more concerned about the inadequacies of the legislative measures (Securities Acts). In his view, nothing in the Act could have actually prevented the misuse and abuse of corporate powers which sparked the debate in the first place.\textsuperscript{635} He argued that the act only prohibited speculation by management; hence, the securities legislation had essentially little to do with the conduct of the corporation’s affairs beyond requiring regular publication of

\begin{itemize}
\item \textsuperscript{629} ibid
\item \textsuperscript{630} Stout (n 29).
\item \textsuperscript{631} ibid
\item \textsuperscript{632} George J. Benston’ Public (U.S) Compared to Private (U.K) Regulation of Corporate Financial Disclosure’ (1976) 51 (3) The Accounting Review 483.
\item \textsuperscript{634} Bratton (n 562) 17.
\item \textsuperscript{635} ibid
\end{itemize}
information considered accurate by accounting standards. These criticisms are, however, not justification to consign the Berle-Dodd debate to the ‘scrap heap of irrelevant texts’. The Berle-Dodd debate helped draw attention to the issue regarding the purpose of the corporation, the extent of its responsibilities and to whom corporate managers should be held accountable. Moreover, despite the differences regarding a corporate accountability, there was a consensus that in the absence of effective shareholder control, a full and complete disclosure of information remains the most effective way of ensuring that corporate managers act in the interests of the corporation. This laid the foundation for the full disclosure philosophy that has become an integral part of the corporate governance regime in the US.

Moreover, the concerns expressed by Berle and Dodd on the lack of corporate accountability had significant influence in the drafting of the subsequent securities legislations. Of relevance is Berle’s assertion that the most effective way to control corporate management is to require them to publicise their activities. The need for full disclosure of information as advocated by Berle became an integral part and indeed, the focus of the securities legislation enacted in 1934. Similarly, the views expressed by Dodd were equally important in providing an alternative conception of corporate purpose which stresses greater accountability on the part of corporate management towards the larger community and not just shareholders. Arguably, the Berle-Dodd debate went beyond being a mere intellectual exercise. In fact, it played a critical role in shaping corporate governance thinking and the evolution of corporate governance rules and legislation in America over the years.

It is worth mentioning that the debate, though very important, did not represent a major conceptual shift in the shareholder primacy view of the firm. The shareholder view of the
firm continues to be the dominant theory in both business and academic circles. It has also attracted a rather disproportionate attention of laymen, journalists, economist and legal scholars who passionately propagate the superiority of this corporate governance model. Subsequently, the perceived superiority of the shareholder primacy theory became embedded in corporate governance practice and inspired a legion of academics and practitioners to find ways to perpetuate a governance model that compels managers to focus more on maximising shareholder value.

To fully appreciate how the shareholder primacy has assumed such prominence in the corporate governance discourse, the next section of this chapter evaluates its evolutions, development and the forces that continue to drive and sustain it.

3.9 Shareholder Primacy Theory

The debate between Berle and Dodd on corporate governance scholarship has continued till present date among those who favour shareholder primacy. Shareholder primacy is based on the idea that shareholders ‘own’ the company and hence its primary purpose is to maximise profits for the shareholders. The theory assumes that corporate purpose must be viewed from the perspective of the shareholder whose only interest and concern centres on the share price of the company. On the other hand, there are those who subscribe to the view that because of the immense power it exercises over society, the corporation has an obligation to serve the interest of society as a whole not just those of shareholders.

Among these competing ideas, it is the shareholder primacy theory that has gained traction and prominence in corporate governance practice. Since the early 1990s corporations have come

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639 Stout (n 29)10.
640 ibid
642 Stout (n 29) 11.
643 ibid
644 ibid
under considerable pressure to adopt the shareholder primacy orientation as a central policy as well as the driving force of corporate governance.\textsuperscript{645} The pressure was more intense in the US where the concept had its origins and is alleged to have transformed the economy. Similarly, businesses in Europe began to follow suit so as not to be left out or put into a competitive disadvantage.\textsuperscript{646} This partly explains why the rhetoric of shareholder primacy\textsuperscript{647} and its supposed ability to enhance the earnings of shareholders gained prominence in major European economies like Germany, France and Sweden traditionally associated with the stakeholder-oriented model of corporate governance.\textsuperscript{648}

The spread of the shareholder primacy model into Europe and other parts of the world was further facilitated and promoted by the IMF, World Bank and OECD through the various corporate governance codes and principles.\textsuperscript{649} Accordingly, standards such as fairness, transparency, accountability and responsibility were touted by the OECD as ‘universal standards’ that can be applied across board irrespective of differences in the political, economic or legal environment.\textsuperscript{650} The guidelines derived from the OECD standards with its Anglo-American shareholder-oriented governance became the benchmark against which to measure good corporate governance.\textsuperscript{651} Apart from the IMF, World Bank and OECD, Credit Rating Agencies (CRA) also played a significant role in propelling the shareholder primacy model into becoming such a pervasive and deeply entrenched concept in corporate governance circles.\textsuperscript{652} At this juncture, it is important to have a clear understanding of the terms shareholders and ownership as applied in this thesis because the entire debate regarding the role of the corporation

\begin{footnotesize}
\begin{enumerate}
\item Clarke (n 33) 289.
\item Ivaschenko and Koeva Brooks (n 24) 52.
\item Stout (n 29) 76.
\item ibid.
\item Soederberg (n 296) 145.
\item ibid.
\item ibid.
\end{enumerate}
\end{footnotesize}
and whose interest it is meant to serve hinges on the concept of ownership and the rights arising thereof.

In general terms, shareholders refer to those who own shares in a company and the concept of shareholding is synonymous with membership. Shares of a company can be acquired through subscription to the memorandum and articles of association of the company at its formation; purchase of shares directly from the issuer company; purchase and transfer of shares from an existing shareholder and finally the transmission of shares on the death or bankruptcy of a shareholder. The acquisition of shares by the shareholder confers contractual and statutory rights on the shareholder vis-à-vis the company.

Ownership denotes a legal right or any legally protected interest that one may have in a particular property. According to Waldron, ‘ownership expresses the abstract idea of an object being correlated with the name of an individual’. Blackstone on the other hand, takes a more cynical view of ownership, and defines it as ‘the sole and despotic dominium which one man claims and exercises over the external things of the world in total exclusion of the rights of any other individual in the universe’. All the above definitions consider ownership as the ultimate property interest and the means by which society signifies the person or persons with primary, but not necessarily exclusive control over a thing.

Ownership remains the foundation on which all other rights in property depend. This right of ownership comprises three elements namely: the right to use, the right to regulate the use by

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653 Abugu (n 466).
654 ICGN (n 200).
659 Clarke and Kohler (n 656) 180.
660 Ibid
others and the right to transfer the rights to another on agreed terms.\textsuperscript{661} These three fundamental elements of ownership will form the basis of assessing if shareholders ‘own’ the company.

The central argument and perhaps, justification for shareholder primacy is the ownership rights that have been ascribed to shareholders. But as Ireland rightly argues, whichever way one looks at it, whether form the nexus of contract or the agency theory perspective, shareholders do not own the company but the capital.\textsuperscript{662} According to Ireland, by the close of the 19\textsuperscript{th} century, the concept of shareholder no longer involved ownership of corporate assets due mainly to the principle of limited liability which has made holding more diverse and less risky.\textsuperscript{663} Arguably, with the passage of time, shares came to ‘exhibit debt-like features’\textsuperscript{664} as shareholders get more ‘passive, functionless and without appreciable risk’.\textsuperscript{665} These developments and changes in the ownership structure render the justification for their residual ownership rights untenable.\textsuperscript{666} Similarly, Pennington contends that shares ‘are simply bundles of contractual and statutory rights which the shareholder has against the company’.\textsuperscript{667} Therefore, the relationship between the shareholder and the company is that of creditor and debtor.\textsuperscript{668} This reaffirms the position in \textit{Blight v. Brent} as far back as 1834 when the court held that ‘shareholders had no direct interest, legal or equitable in the property owned by the company, only a right to dividends and a right to assign their share for value’.\textsuperscript{669} This ruling reinforces the proposition that the tangible assets are owned by the company, whilst the intangible share capital of the company remains the property of the shareholders.\textsuperscript{670} As Ireland rightly notes, ‘a vital legal space has emerged

\begin{footnotesize}
\begin{itemize}
  \item \textsuperscript{661} ibid
  \item \textsuperscript{663} ibid
  \item \textsuperscript{664} ibid
  \item \textsuperscript{665} ibid
  \item \textsuperscript{666} ibid
  \item \textsuperscript{667} Robert R. Pennington, ‘Can Shares in Companies be Defined?’ (1989) 10 (7) Company Lawyer 144.
  \item \textsuperscript{668} Pennington (n 655) 54.
  \item \textsuperscript{669} Blight v. Brent (1837) 2 Y & C Ex 268
  \item \textsuperscript{670} Ireland (n 662).
\end{itemize}
\end{footnotesize}
between companies as owners of the property and shareholders as owners of shares’. In this respect, it would be wrong to confuse ‘ownership of capital with ownership of the firm’. Moreover, ownership rights, especially the right to use, appropriate and dispose of are absolute and imprescriptible; hence shareholders cannot claim ownership rights when they do not have direct rights of control over such companies. In fact, it is only the company, as a legal entity that can exercise the right to use, appropriate the returns and dispose of them in accordance with management decisions. The paradox however, is that although the shareholder ownership arguments have been debunked, the idea continues to shape the corporate governance discourse and put shareholders at the centre of the governance stage.

It is worth mentioning that the discussion regarding the relationship between the shareholder and the company predates the Berle-Dodd debate. Prior to the Berle-Dodd debate, it was postulated that shareholders own the company and that companies were established to maximise profits for their benefit. This proposition, however, obscures the fundamental power asymmetries in the political economy of the corporation. The discourse is about power struggle that has been fuelled by the different perceptions of the nature and role of the modern corporation.

The proposition as mentioned earlier, is credited to Robert Lowe, the then Vice President of Board of Trade (UK) who, whilst introducing the Joint Stock Companies Bill of 1856 in the House of Commons, set out the principles to serve as blue prints for future legislations. The underlying principle embedded in the Lowe’s company legislation of 1856(Joint Stock Companies Act 1856) explains that companies are economic entities and owe their

671 ibid
674 Banakar and Travers (n 48).
675 Abugu (n 466) 204.
676 Horn (n 161)13.
677 ibid
Chapter 3

responsibilities to their shareholders even if by so acting, ‘the company may be acting contrary to broader social interests’.

The idea was given legal recognition and became enshrined in the company legislation of 1856 and later reinforced in the subsequent legislation of 1862.

This created not only the social framework within which the modern company now exists and operates but more importantly it laid the theoretical and philosophical foundation for the shareholder primacy as we know it today. Indeed, section 172 of the UK’s Companies Act 2006 affirms this position when it states ‘the primary duty of directors is to run the firm in a way that promotes the success of the company for the benefit of its shareholders’.

This provision effectively endorses and reaffirms the primacy of shareholder under UK Company Law. In the words of Keay, ‘section 172(1) does not introduce a new duty, it is rather a statutory restatement of established Law’.

In their attempt to justify shareholder primacy, advocates make certain influential but questionable claims which unfortunately, have become acceptable on the bases of the perceived superiority of the theory. These claims have led to a situation whereby maximising shareholder profits have become the main and perhaps the only corporate objective.

Basically, proponents make three claims to justify this proposition including: the functional claim, moral claim and prudential claim.

Proponents of the prudential claim argue that shareholder primacy ensures greater control over management and promotes the efficient allocation of capital and other resources.

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678 Robert McQueen, A Social History of Modern Company Law: Great Britain and the Australian Colonies 1854-1920 (Ashgate 2009) 78.
679 Abgu (n 466) 205.
680 ibid
681 Companies Act 2006, s 172
682 Andrew Keay, ‘The Duty to Promote the Success of the Company: It is for Purpose’ in Joan Loughrey (ed), Directors Duties and Shareholder Litigation in the Wake of the Financial Crisis (Edward Elgar Publishing 2013)
683 Stout (n 29) 46.
684 ibid
685 ibid
686 ibid
of thought considers the rate of return as a measure of superior performance and for that reason maximising shareholder value becomes a creed to uphold and defend by prioritising the interest of shareholders above all others. Advocates of the functional claim hypothesis contend that shareholder primacy and control rest on their contribution of risk-carrying capital. It has been argued that because shareholders provide the risk-carrying capital while other claimants are covered by contracts, shareholders deserve to be rewarded by maximising their share value.

The moral claim on the other hand is based on the liberal doctrine of property rights. The main thrust of this argument is that ownership is simply an extension of fundamental rights which gives the owner full and absolute right of disposition over the object. Shareholders should therefore be rewarded in keeping with the ‘principle of reward according to contribution’.

A closer examination of these claims reveals however, that they are as weak as they are unconvincing. First, the efficient market hypothesis depends first and foremost, on an even flow of information among and between the market players. Disclosure and transparency are prerequisites for the operation of an efficient market which has not been the case as far as shareholders and corporate management are concerned.

According to Clarke, ample evidence exists to suggest that in the recent crisis, the relevant information regarding risk management was not made available either to the boards or the

688 Bakan (n 343).
689 ibid
690 ibid
691 ibid
692 ibid
694 ibid
This was acknowledged by the then UK Financial Services Authority (FSA) which admits that information asymmetries between management and uninformed ordinary investors ‘resulted in price inefficiency’ and market distortion.

Information asymmetry apart, there is also the problem of information failure/deficit inherently embedded in the complex systems and structures of most of the corporate entities. This reinforces Stiglitz’s assertion that ‘when information is imperfect, markets do not often work well, and information imperfections are central in markets’.

Also while share pricing, supposedly, remains the objective standard of managerial efficiency, in practice, share prices of most financial institutions preceding the 2008 financial crisis did not reflect or demonstrate any of the presumed efficiencies. Moreover, the idea that the market for corporate control is the optimal governance model was also brought into question as there were no opportunities to easily acquire most of the failing financial institutions. Arguably, shareholder primacy approach characterised by deregulation and short-term profit maximisation has proved to be unsustainable in the long-term. This is because the fundamental prerequisites namely, perfect information, competition and rational markets for the operation of market to act as a disciplining mechanism were absent.

Finally, the moral claim argument becomes untenable in the face of incontrovertible evidence that shareholders are after all not ‘owners’ of corporations. Advocates of shareholder value

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695 Blanaid Clarke, ‘Where was the “Market for Corporate Control” When We Needed It?’ in Sun et al. (eds), Corporate Governance and the Global Financial Crisis? (CUP 2011) 77.
696 The FSA has since April 2013 been abolished and replaced by the Prudential Regulatory Authority.
698 Stiglitz (n 229) 147.
700 ibid
701 ibid
702 Stiglitz (n 229)154.
are asserting a moral claim which upon closer examination is inconsistent with the overall notion of ownership as defined by law.\(^{704}\)

Indeed, the shareholder primacy concept is not monolithic in terms of ownership. Two competing variants namely the principal-agent model and the myopic market model can be identified; the difference being in the nature and type of ownership with respect to the company.\(^{705}\)

The principal-agent model operates on the basic assumption that the purpose of the corporations is to maximise shareholder wealth since they are the residual claimants to the company’s assets and earnings.\(^{706}\) Two problems arise from the principal-agency relations. The first, is how to ensure and also verify what the agent is doing and whether such action serves the interest of the principal.\(^{707}\) Secondly, the preferences of the principal and agent may differ both in terms of actions and attitude toward risk.\(^{708}\) As Letza et al.\(^{709}\) point out, these two problems have led to agency costs as the principal attempts to ensure that the agent acts in the principal’s best interests.\(^{710}\) The paradox however, is that in trying to resolve the agency problem, the current governance approach uses stock options to reward managers under the guise of aligning management and shareholder interest. This unfortunately, leads to excessive risk-taking and short-termism. To overcome these challenges, it is submitted that a more inclusive governance model which takes a long-term view and considers the interest of other equally important corporate constituents should be adopted. This must be backed by an optimal incentive scheme that will balance the various competing interest not just that of shareholders.\(^{711}\)

\(^{704}\) ibid
\(^{705}\) ibid
\(^{706}\) Jensen and Meckling (n 111) 305.
\(^{707}\) ibid
\(^{708}\) ibid
\(^{709}\) Letza et al. (n 210) 18.
\(^{710}\) Jensen and Meckling (n 111) 305.
\(^{711}\) Blackstone (n 658).
The myopic market model takes a common position with the principal-agent model which believes that the corporate purpose is to serve shareholders’ interests.\(^{712}\) It however, remains critical of the preoccupation with short term gains, immediate returns on stock prices and other performance indexes as determined by market pressures.\(^ {713}\)

Advocates of this model contend that the problem with corporate governance arises from its tendency to encourage short-termism at the expense of the long-term view of the corporation.\(^ {714}\)

This has become possible because financial markets often compel corporate managers to behave in a way that may not necessarily ensure the maximisation of long-term wealth for the shareholders.\(^ {715}\) The solution, it is submitted, lies in radical reforms in corporate governance thinking and practices whereby managers are encouraged and where necessary, mandated to adopt long-term horizons rather than short-term profit maximisation.\(^ {716}\)

Whichever way one looks at it, shareholders occupy a privileged position within the firm often with ownership-like rights.\(^ {717}\) In a bid to assert this ‘ownership right’ proponents insist that increasing share value, whether for normative or efficiency reasons remains the ultimate goal of every corporate governance regime.\(^ {718}\) According to them, share value reflects growth and profitability of shareholders’ investments and also indicates overall firm performance and wealth.\(^ {719}\) Hence, management should maximise shareholder value, first, to align the interests of management and shareholders; and second, because financial markets are deemed to be more

\(^{712}\) Letza et al. (n 210) 19.

\(^{713}\) ibid

\(^{714}\) ibid

\(^{715}\) Blair (n 308)74.

\(^{716}\) Jensen and Meckling (n 111) 332.

\(^{717}\) Abugu (n 466) 206.


efficient at deploying corporate resources than managerial discretion.\textsuperscript{720} For these reasons it is imperative that the corporation is run and managed in their interest.\textsuperscript{721}

Another argument that has been used to justify the shareholder primacy is the consequentialist hypothesis. According to proponents of the shareholder primacy theory, it is not just shareholder interest that is enhanced but rather the entire economy benefits.\textsuperscript{722} Supporters of the consequentialist hypothesis argue that as the firm maximises its value, everyone including workers, consumers, suppliers and society become the ultimate beneficiaries.\textsuperscript{723} Advocates opine that job creation and revenue generation by particular firms constitute critical functions of shareholders with huge socio-economic benefits for the larger society.\textsuperscript{724}

Adherents cite the stock market boom of the 1990s and the general prosperity of the American economy in the late 1990s as ample evidence of the economic benefits of shareholder primacy.\textsuperscript{725} To the consequentialists, ‘theory has been borne out by practice’ and that the shareholder value remains the path to the long-term sustainability of the corporation.\textsuperscript{726} These claims and assumptions have provided the theoretical justification for the emergence and eventual dominance of the shareholder-oriented governance model which focuses on protecting and advancing shareholder interests to the neglect of other corporate constituents.\textsuperscript{727}

3.10 Mistaken Assumptions

Shareholder primacy has undoubtedly, attained world-wide prominence and influence over the last four decades.\textsuperscript{728} But this rosy view of shareholder primacy and its ability to deliver superior

\textsuperscript{720}Bratton (n 562) 127.
\textsuperscript{721}Jensen and Meckling (n 111) 332.
\textsuperscript{722}ibid
\textsuperscript{723}ibid
\textsuperscript{724}ibid
\textsuperscript{725}ibid
\textsuperscript{726}Stout (n 29) 54.
\textsuperscript{728}Fligstein and Freeland (n 59).
economic performance is premised on certain faulty assumptions.\textsuperscript{729} Such assumptions, to a large extent, tend to overestimate the efficiency, importance and relevance of the shareholder primacy theory. In fact, these assumptions ignore the inherent weaknesses of the theory as manifested by the devastating events of 2008.\textsuperscript{730} In both theory and practice, the arguments for maximising shareholder value are premised on three basic assumptions, which upon critical examination have proved untenable.\textsuperscript{731}

The first mistaken assumption often made by laymen, economists and in some instances legal scholars is that shareholders are the owners of corporations. Prominent economists such as Milton Friedman often assert that shareholders ‘own’ corporations without providing empirical evidence for their assertions. Writing in the \textit{New York Times} Milton argues that the sole purpose of the corporation is the maximisation of shareholder value to the exclusion of other constituents.\textsuperscript{732} Similarly, Hansmann and Kraakman in their ‘End of History for Corporate Law’ thesis posit that the shareholder model of corporate has triumphed over other models and it would not take long for the other models to converge towards the Anglo-American model.\textsuperscript{733} Interestingly, Hansmann and Kraakman’s claims about the superiority of the shareholder model began to look increasingly suspect as a number of American companies started crumbling under the weight of corporate scandals.\textsuperscript{734}

Aside the lack of empirical evidence to support this proposition, the legal basis cannot be substantiated. From the legal perspective, shareholders cannot be said to own corporations because ‘corporations are independent legal entities that own themselves, just as human beings

\begin{footnotes}
729 ibid
730 ibid
731 Gourevitch and Shinn (n 30).
\end{footnotes}
own themselves’.

As a ‘juridical person’ a corporation can hold property in its own name, enter into binding contracts and can be held liable for committing tortious acts or acting negligently in respect of product and employer liability. For instance, in March 2013, Lamprell Plc, an Engineering company was fined £2,428,300 by the FSA for breaching the listing rules as contained in the Financial Services and Market Act of 2000.

Indeed, the relationship that exists between the shareholders and the company is purely contractual and not that of ownership as shareholders are nowhere near to fulfilling the eleven ownership tests developed by Honore.

Honore’ defines ownership as the ‘greatest possible interest in a thing which a mature system of law recognises’. In analysing jurisprudence in property, Honore’ set out eleven standard tests to determine ownership. This comprises the right to possess, the right to manage, the right to the income, the right to the capital, the right to security, the right to transfer, the prohibition of harmful use, liability to execution and the incident of residuality.

Moreover, the recognition of full ownership rights requires that the entity or individual must meet most of these standards or tests. The ownership claims by shareholders when put to the test reveals that it only satisfies two out of eleven, hence any claim of such ownership becomes untenable. This suggests that ‘while many individuals and groups [customers, shareholders, lenders, employees and directors] have rights and obligations around public companies, none of these claims can plausibly be described as ownership’.

Shareholders own shares of stock which is simply a contract between the shareholder and the corporate entity, which gives the shareholder some limited rights and under certain

735 Stout (n 29) 37.
736 Financial Services and Markets Act 2000 s.118C
738 ibid
739 ibid
circumstances. Hence, the position of shareholders/stockholders with respect to the company is no different from that of bondholders, suppliers and employees; all of whom have contractual relationships with the corporation. Once it is recognised that shareholders and companies contract with each other, the ‘ownership’ arguments become untenable and disintegrates in the face of economic theory according to Black and Scholes. In their work on option pricing which formed the basis of modern options theory, they note that, once a corporation issues debts, the debt holder has purchased the right to the company’s future profits but at the same time provides for option that allows him/her to avoid any losses in the company’s value below a certain point.

Thus, from the option theory perspective, it is untenable for shareholders to lay claim to ownership rights. Corporations according to Stout, ‘own themselves, and enter into contracts with shareholders exactly as they contract with debt holders, employees and suppliers’. Moreover, it should be noted that ‘ownership of capital should not be confused with ownership of the firm’. Arguably, each factor in a firm is owned by somebody; as such the firm is ‘just a set of contracts covering the way inputs are joined to create outputs and the way receipts from outputs are shared among inputs’. Thus, the claim of ownership becomes irrelevant in this context and cannot be the justification for shareholders to demand that the company be run for their benefit.

Another assumption that has persuaded many experts to accept the normative desirability of shareholder primacy is the assertion that shareholders are the ‘residual claimants’. In both

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741 ibid
743 ibid
744 ibid
745 Stiglitz (n 229) 347.
747 ibid
legal and economic terms, a residual claimant refers to the party entitled to keep the residual profits after the business entity has fulfilled its legal and contractual obligations. These obligations include: the payment of interest due creditors, wages due to employees, statutory payments and taxes due to governments. The underlying principle is that there is a ‘voluntary association’ in which the shareholder is regarded the weakest of the parties and whose only right is the right to the residual claim.\textsuperscript{748} Per this reasoning, shareholders are the only residual claimants in public corporations while other constituents such as employees, customers, creditors and suppliers are entitled to what the law and their formal contracts allow. The contention is that because the interest of other constituents/stakeholders are fixed and determinate, whatever is left after all the contractual and other statutory obligations have been met, becomes the residual claim to which shareholders are rightly entitled.\textsuperscript{749} According to Clerc, this represents the ‘crumbs which must be protected so that those crumbs are not taken away by those who have the right to the comfort of fixed payments’.\textsuperscript{750} The way to increase the level of residual claim the argument goes, is by increasing the value of the corporation itself.\textsuperscript{751} Although very appealing at its face value, the justification for the residual claim hypothesis appears to be faulty and unconvincing for several reasons.

First, the proposition that shareholders are the residual claimant has its origins in bankruptcy laws, where the courts in the course of distributing assets of liquated companies are required to pay stockholders last after claims of employees, debt holders, creditors and statutory payments have been settled.\textsuperscript{752} Even under bankruptcy proceedings, courts often require creditors to share in the losses suffered by equity holders to some extent.\textsuperscript{753} Hence, the claim

\textsuperscript{748} Clerc (n 109).
\textsuperscript{749} ibid
\textsuperscript{750} ibid
\textsuperscript{752} Palmer (n 70) 316.
\textsuperscript{753} Gurvourtz (n 28) 1342.
that shareholders are the residual claimants as proponents of shareholder primacy seem to suggest, is factually and legally inaccurate.

Moreover, the concept of residual claimants is in relation to companies that are being liquated in bankruptcy proceedings in court and not companies that are still operating as going concerns.\textsuperscript{754} It is therefore, untenable to equate the function of a living, profit-generating company with that of a business entity under liquidation.\textsuperscript{755} This is because living corporations differ fundamentally from corporations under bankruptcy in terms of their purposes; as such any reference to shareholders as residual claimants becomes a distortion of the reality.\textsuperscript{756} The reality, and indeed, the legal position under company law is that shareholders can only receive money from a functioning public corporation under two conditions.\textsuperscript{757} The first condition is that only directors are legally mandated to declare and pay dividends to shareholders when company is financially sound. Second, the decision to pay dividends only becomes effective when the board decides to exercise that authority and mandate.\textsuperscript{758} Essentially, none of the above conditions can be fulfilled unless the board so decides as the ultimate decision will be contingent upon the financial viability of the firm as well as the willingness and legal ability to pay dividends.\textsuperscript{759}

Even in situations where corporations make enough profits, increase their retained earnings and can pay dividends, directors still retain a wide margin of discretion under the business judgement rule. The business judgement rule is a corporate law doctrine in the US which holds that absent evidence of fraud, illegality or conflict of interests, the courts will not second guess the board’s decision in respect of what is best for the company including the payment of dividends.\textsuperscript{754 ibid} \textsuperscript{755} Palmer (n 70) 342. \textsuperscript{756} Gurvourtz (n 28) 1343. \textsuperscript{757} Gamble and Kelly (n 4) 63. \textsuperscript{758} Palmer (n 70) 320. \textsuperscript{759} Gamble and Kelly (n 4) 72.
The doctrine was applied in *Paramount Communications, Inc. vs. Time Inc.* where the court ruled that the decision by the board of Time Inc. (Respondent) to reject a takeover bid from the Plaintiff Company was an action covered by the business judgment rule. A similar situation pertains in the UK where the courts are very much reluctant to interfere with management decisions. As a result, directors are not obliged to pay dividends even if the corporation has accumulated enough profits or increased its retained earnings. From the above analysis, it is submitted that, it is indeed, a misnomer and mischaracterisation of reality to describe shareholders of a public corporation that continues to operate as a going concern as residual claimants.

Advocates of the shareholder primacy theory further assert that shareholders are principals while directors are agents. The principal-agent relationship evolved following the growth in the size and complexity of modern corporations which made it necessary to engage professional managers to oversee the day to day running of these corporations. Legally, a principal normally refers to someone who hires another person; called the agent to represent and serve his/her interests. In line with the principles governing principal-agent relationships, the principal exists prior to and independent of the agent. But under the present scenario, when a company is formed, it first appoints directors who will later be mandated to issue shares and contract to acquire stockholders. Logically, both the corporation and the board of directors must necessarily exist prior to and independent of the shareholders. Under the principal-agent

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760 ibid
762 ibid
763 Gamble and Kelly (n 4) 83.
764 ibid
767 ibid
768 Gamble and Kelly (n 4) 79.
769 ibid
relationship, the principal retains the right to control the actions of the agent. But a fundamental principle of corporate law is that corporations are controlled by management under the supervision of the board of directors instead of shareholders.\textsuperscript{770} In fact, the ability of shareholders to directly influence managerial decisions is rather limited. The very limited instances in which shareholders can directly influence or exercise any right of control is the right to vote during annual general meetings, the right to sue and the right to sell their shares under certain limited conditions. It can be argued however, that these rights have very little practical effect as the right to vote is severely limited while shareholders’ right to sue has remained but illusory.\textsuperscript{771} Under the shareholder primacy theory, it is expected that shareholders will carefully monitor the activities of management and possibly intervene where genuine and legitimate concerns exist.\textsuperscript{772} The reality, however, is that rather than monitoring management, there appears to have been widespread acquiescence and a culture of apathy especially among institutional investors (shareholders). Mösllein for example, contends that institutional shareholders were particularly impotent, and indeed, apathetic in respect of the sale of ABN AMRO to the Royal Bank of Scotland in October 2007.\textsuperscript{773} There is ample evidence to suggest that both individual and institutional shareholders failed to provide any effective counter-weight to poor managerial decisions of companies and financial institutions prior to the 2008 GFC. This explains why Myners refers to shareholders as absentee landlords before and during the GFC.\textsuperscript{774}

Similarly, Hector Saint accuses shareholders of being ‘too reliant and unchallenging in respect of the companies under their stewardship despite having the right to directly or indirectly

\textsuperscript{770} ibid
\textsuperscript{771} ibid
\textsuperscript{772} ibid
\textsuperscript{773} Florian Mösllein, ‘The Focus of Regulatory Reforms in Europe after the Global Financial Crisis: From Corporate to Contract Governance’ in William Sun, Jim Stewart and David Pollard (eds), Corporate Governance and the Global Financial Crisis: International Perspectives. (CUP 2011)
\textsuperscript{774} Paul Myners, ‘Banking Crisis: Reforming Corporate Governance’ (Paper presented at the Association of Pension Funds Investment Conference, London 21 April 2009)
influence the governance process’. In the face of this, the suggestion that shareholders are principals who have control or leverage over the management (agents) is not supported by empirical evidence. Indeed, the reality tells a different story.

3.11 Conclusion

For nearly eighty years there has been an interesting but often controversial debate about the purpose of the public corporation in society. The long-running discourse which culminated in the Berle-Dodd debate centres on whether the public corporation’s main and indeed, sole purpose is to serve the narrow interests of the shareholders through profit maximisation. The alternative view is whether the corporation should concern itself with serving the interests of other stakeholders such as employees, customers, suppliers and creditors. The outcome of this debate and the subsequent discussion is the emergence of the shareholder and stakeholder theories of corporate governance. A few decades after Berle had surrendered to managerial supremacy, shareholder primacy began to resurface as the new model of corporate governance. By the close of the 20th century, shareholder primacy had become the dominant paradigm of corporate purpose due largely to influential writers including: Michael Jensen, William Meckling, Milton Friedman and other writers from the Chicago school of thought. It was through the influence of their writings that the shareholder primacy assumed the central place in law and economics school of legal jurisprudence.

The shareholder primacy movement was further given impetus at the international level by multilateral organisations such as the OECD, IMF and the World Bank. These organisations devoted considerable attention to the subject and have on several occasions introduced models,

775 Hector Saint, ‘The Financial Crisis: The Role of the Investors’ (Speech delivered at the NAFT Investment Conference, 11 March 2009)
776 Palmer (n 70) 312.
777 ibid
codes of conducts, principles and standards which reinforced the shareholder-oriented model of corporate governance.\textsuperscript{778}

The significance of the shareholder primacy theory in shaping corporate and securities laws in the US and other parts of the world is obvious and cannot be denied.\textsuperscript{779} Interestingly, although the shareholder primacy has lost most of its theoretical credit, it continues to be expounded in practice with astonishing frequency.\textsuperscript{780} It is, thus, fair to say that support for shareholder primacy may have waned but not completely eroded.

Apparently recent events, especially the GFC, has challenged and to some extent, undermined this perspective of corporate governance.\textsuperscript{781} In fact, the theory has come under attack after the Enron debacle in 2001, and has also been severely criticised and blamed for being the underlying cause of the 2008 GFC. Central to this, is the proposition that shareholder primacy gave birth to a corporate governance model that compels executives and management to prioritise the interest of companies and their shareholders above all other interest. In this respect, meeting short-term profit targets became the main pre-occupation of executives and management. Consequently, corporate managers who failed to meet the value maximising demands of shareholders were replaced through the market mechanism, which proponents assert, is the most efficient control mechanism. From the above discussion, it is submitted that the corporate scandals of the past three decades and the recent GFC are emblematic of the shareholder oriented capitalism that evolved and developed in the 1980s and 1990s.\textsuperscript{782}

As already indicated, the shareholder primacy concept has turned out to be a mistaken belief based on the fundamentally-mistaken economic theory of the efficient market hypothesis.

\textsuperscript{779} Alces (620) 778.
\textsuperscript{780} Cioffi (n 778).
\textsuperscript{781} Lynne Dallas, ‘Short-Termism, the Financial Crisis and Corporate Governance’ (2011-2012) 37 (2) Journal of Corporation Law 264.
\textsuperscript{782} Clerc (n 109).
Markets by themselves, as Stiglitz explains, do not produce desirable outcomes or results.\textsuperscript{783} Indeed, the GFC which compelled governments in the US and the UK to use tax payers’ money to bail out failing financial institutions contradicts the efficient market hypothesis and its propositions.\textsuperscript{784} Thus, the GFC has in so many ways exposed the inherent weaknesses, dangers and failures of the markets to self-correct.\textsuperscript{785}

Unlike in the UK where company law makes some provision for shareholder primacy in section 172 of the Companies Act 2006, US corporate law neither requires nor makes it mandatory for managers of public corporation to maximise shareholder value.\textsuperscript{786} Interestingly, although it is yet to adopt a uniform approach to the shareholder primacy theory, there is a general acceptance that shareholder primacy forms the basis of company law in the UK.\textsuperscript{787} Secondly, as this chapter demonstrates, an examination of the economic structures of public corporations reveals that shareholders are neither owners nor residual claimants nor principals as the theory seems to suggest. Indeed, the ownership rights of shareholder become even less convincing when viewed from Honore’s ownership test. Out of the eleven (11) requirements that must be fulfilled before one can claim right of ownership, shareholders at best fulfil not more than two (2).\textsuperscript{788} This leads to the conclusion that the idea of ‘share is a misnomer, for shareholders no longer share any property in common’.\textsuperscript{789} As a result, Ireland dismisses the idea of shareholder ownership and describes it as ‘transcendental nonsense’.\textsuperscript{790}

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{784} ibid
\item \textsuperscript{785} ibid
\item \textsuperscript{786} Gamble and Kelly (n 4) 87.
\item \textsuperscript{788} Kay (n 740).
\item \textsuperscript{789} Paul L. Davies and Laurence C.B. Gower, Davies and Gower’s Principles of Modern Company Law (Sweet & Maxwell 2003)
\item \textsuperscript{790} Ireland (n 662) 32.
\end{itemize}
\end{footnotesize}
Furthermore, there is no empirical evidence to support the proposition that shareholder-oriented approach is superior in terms of economic performance. On the contrary, shareholder primacy with its focus on short term profit maximisation undermines the long-term interests of shareholders, the corporation itself, other constituents and the larger society.\footnote{Mayer (n 608).}

This chapter has provided an overview of the shareholder primacy theory, its evolution, flaws and weaknesses. It has explored the complex interactions between shareholders, management and boards and places the current GFC in its proper context. It thus, explains and concludes that shareholder primacy is not just a mere theoretical abstraction or concept totally unrelated to reality and practice. Against this backdrop it is useful to understand that the emergence and dominance of the shareholder primacy is of conceptual importance and profound practical significance.\footnote{ibid}

Arguably, the theory not only manifests itself in the way corporations have been perceived and governed, but it has also has been influential in shaping the laws, codes and conventions that govern the conduct of corporations. A combination of these developments created a vision of corporate purpose founded on shareholder primacy which focuses on profit maximisation, short-termism and market fundamentalism. Moreover, rules concerning executive compensation, disclosure, protection of shareholder rights and risk management practice all tend to tilt towards satisfying shareholder interest and empowerment.

Clearly, the GFC has tested the fragility of shareholder primacy thinking and rendered most of its assertions obsolete as it failed to fulfil the functions on which its legitimacy is premised. Indeed, the functional claim, the prudential claim and the moral claim hypothesis underlying the shareholder primacy have all been proven to be misleading and faulty.\footnote{Clerc (n 109).} The inherent flaws of this governance model in combination with the management practices that emerged as a
result, account for the 2008 GFC. Having examined the theoretical underpinnings of the crisis, the next chapter explores the how the US government responded to the crisis and questions whether such responses address the underlying cause of the GFC.
CHAPTER 4

Corporate Governance Reforms in the US Post the Financial Crisis.

4.1 Introduction

As already explained in the previous chapter, the GFC is rooted in the shareholder-oriented corporate governance model with its emphasis on profit maximisation and the relentless pursuit of short-term gains regardless of the harmful consequences.\textsuperscript{794} The ineffective risk management practices, excessive compensation schemes and the failure on the part of Gatekeepers are symptomatic of the shareholder primacy governance model which compels executives to prioritise shareholder interest above all others.\textsuperscript{795}

A combination of the above factors triggered the US housing bubble followed by the collapse of large financial institutions around the world.\textsuperscript{796} The conditions that created the potential for the crisis were years in the making and relate to the shift of emphasis in terms of the corporate purpose where the corporation has become a vehicle for the promotion and perpetuation of shareholder interest. The desire to maximise profits coupled with low interest rates, easy availability of credit, lax regulatory regime and toxic mortgages provided a perfect mix that simply ignited an already volatile situation.\textsuperscript{797}

The crisis peaked in September 2008 with the failure of Lehman Brothers and the impending collapse of American International Group (AIG).\textsuperscript{798} Panic followed, first, due to lack of transparency in the balance books of major financial institutions and, second, the interconnectedness among financial institutions deemed too big to fail. Unsurprisingly, the

\textsuperscript{794} Bakan (n 343) 2.
\textsuperscript{795} Michael S. Barr, ‘The Financial Crisis and the Path of Reform’ (2012) 29 (1) Yale Journal on Regulation 92.
\textsuperscript{796} Vourloumis (n 10).
\textsuperscript{798} ibid
failure of these two systemically-important institutions caused the credit market to seize up and compelled trading activities to come to a stand-still. The repercussions of the crisis were widespread, leading to the collapse of financial markets and institutions, sharp decline in industrial output, a drop in foreign direct investments, job losses and a general economic down turn. At the peak of the crisis more than 26 million Americans were out of work, 4 million families have lost their homes and another 4.1 million have slipped into foreclosures. Furthermore, $11 trillion household wealth had vanished while retirement accounts and life savings were swept away.

The financial crisis has highlighted what should have been apparent all along: that without clear rules, transparent and accountable governance systems, crisis become unavoidable. This is because financial institutions when left to self-regulate will inevitably engage in practices that tend to maximise profits for short-term gains and place shareholder interest above any other interest. The events of 2007 were not mere accidents but what analysts have come to expect of a free market economic system. Against this backdrop, it is submitted that most of the problems confronting the corporate sector and the larger American economy are the unintended consequences not of the corporate governance failures per se, but of a mistaken idea that corporations ought to be run ‘to maximise shareholder value as measured by share price’.

Clearly, the underlying assumptions which have dominated corporate governance thinking and practice for the last thirty years have proved to be faulty, misplaced and unsustainable.

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799 ibid
800 ibid
801 ibid
802 ibid
803 ibid
804 Stout (n 29) 5.
intellectual assumptions regarding the supposed superiority, the legal bases and justification for the shareholder primacy model of corporate governance.\footnote{Clerc (n 109).}

Consequently, this thesis argues that the current shareholder-oriented governance model must give way to an emerging governance process that takes a long-term view of the corporation.\footnote{Letza et al. (n 210) 29.} This emerging governance model entails a redefinition of the corporate purpose to satisfy the interest of all corporate constituents as distinct from shareholder interest. In effect, the corporate arrangements must provide a setting where powers are balanced and the diverging interests synthesized.\footnote{ibid} Arguably, a redefinition has become imperative as the GFC has rendered the current governance arrangements obsolete.\footnote{David Millon, ‘Shareholder Primacy in the Classroom after the Financial Crisis’ (2013)8 (1) Journal of Business & Technology Law 191.} In that respect, the GFC provides an opportunity to redesign and rethink an alternative governance model which has relevance both in theory and practice.\footnote{ibid} This shift in the definition and conceptualization of the corporate purpose becomes more urgent because despite the obvious flaws and the dangers it possess to both the corporations and society in general, the shareholder primacy maxim still represents the mainstream theory in today’s corporate governance.\footnote{Raymond Torres, ‘Responding to the Crisis without Addressing Its Causes’ (2010) 149 (2) International Labour Review 227,230.}

What is perhaps, surprising though, is that the policy reforms undertaken by the US authorities and governments around the world after the GFC seem to be addressing the symptoms and not the causes. Arguably, the reforms are considered a return to business as usual as they fall short of sustained intellectual engagement with the underlying causes of the GFC.\footnote{ibid} This section examines the policy responses of the American government in terms of legislation, regulation and governance in the face of the financial crisis. In so doing, the thesis evaluates the post-crisis
policy initiatives in the US and questions whether they constitute the appropriate responses to the GFC.

4.2 US Government Response

The 2008 GFC was obviously a major policy challenge for the government of the US as some of the nation’s largest financial institutions were headed towards collapse while the entire economy was under the threat of recession. To prevent this, the federal government adopted a variety of measures, some conventional, others nonconventional and some even contradictory to traditional government position and orthodox economic thinking. Arguably, the inconsistency in government response was a major policy mistake which added to the uncertainty and panic in the financial system. For instance, the initial decision to rescue Bear Stearns and then place Fannie Mae and Freddie Mac under conservatorship was hailed as a determined attempt by government to stem the effects of the crisis. But a policy reversal saw the collapse of Lehman Brothers only for government to turn around and rescue American Insurance Group (AIG). This demonstrate inconsistency and lack of policy coherence on the part of the US authorities to manage the crisis.

The initial response of the US authorities consisted of slow-paced ad-hoc measures ostensibly designed to mitigate the crisis. This later gave way to a series of legislations, the outcomes of which have not been particularly coherent. The Federal Reserve Bank was the first to respond to the crisis by lowering the discount rate from 100 to 50 basis points to ensure that inter-bank lending transactions are not disrupted. The action had very little effect as financial institutions were still unable to borrow or lend; leading to the downward spiral of the US

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813 ibid
814 ibid
815 Financial Crisis Inquiry Commission (n 796).
816 ibid
817 ibid
818 ibid
financial system. As a result, the administration introduced new policy initiatives including the Economic Stimulus Act 2008 (ESA), the Emergency, Economic Stabilisation Act 2009 (EESA), the American Recovery and Reinvestment Act 2009 (ARRA) and the Dodd-Frank Wall Street and Consumer Protection Act 2010. This section examines these legislations and evaluates whether, and to what extent they address the causes of the GFC.

4.2.1 Economic Stimulus Act 2008 (ESA)

Nearly two years into the crisis, it became evident that the traditional monetary policy approach had its limitations. As a result the US government turned to fiscal policy to help stabilise the economy by enacting the Economic Stimulus Act 2009 (ESA). The legislative intent of ESA is to boost the US economy and avert a possible recession through increased spending and tax rebates. Accordingly, the Act provides tax rebates to low and middle income tax payers such that single individuals received between $300 and $600 while couples were paid between $600 and $1200 in the form of tax rebates. In addition, households also received $300 per child in the form of child tax rebates. The stimulus payments in 2008 were historically larger-amounting to about $100 billion in real terms and twice the size of the 2001 rebate programme. The Treasury Department disbursed $79 billion in the second quarter of 2008—corresponding to 2.2 per cent of GDP, while $15 billion were disbursed in the third quarter of 2008 representing 0.4 per cent of GDP. Furthermore, tax incentives were introduced under the Act to encourage and stimulate business investments. A total of $266 billion million was appropriated under the Act, 50 per cent of which was spent on the payment of tax rebates for

819 ibid
821 Mishkin (n 7).
822 ibid
823 ibid
824 Parker et al. (n 820).
825 ibid
826 ibid

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individuals while the other part offered one-time incentives for investment in new equipment and write-off for tax losses. Supporters of ESA argue that in times of financial crisis, fiscal policy measures in the form of tax rebates and transfer programmes respond quickly and successfully to economic slowdowns. From this perspective, it may be argued that the stimulus programme not only boosts the spending of households receiving tax cuts and transfers or businesses receiving investment incentives, it has other critical indirect effects. For instance, it has a multiplier effect as higher household spending invariably encourages firms to hire more workers which further boosts their incomes and spending. Moreover, the additional incomes in the form of tax cuts and transfers to families/households are likely to be spent on consumption thus, helping to protect families from the effects of the economic down turn while increasing economic activity at the same time. But critics argue that the Act is not the appropriate response and does not go far enough considering the severity of the crisis.

First, it fails to include long-term policy objectives such as permanent tax cuts but focuses narrowly on stimulating the economy through business and consumer spending. Arguably, the Act only serves the present purpose of making modest contribution to the economy by raising consumption but the long term impact has been negligible and to some extent negative. In fact, the stimulus programme under ESA increased the budget deficit by $152 billion in 2008. Against this backdrop, ESA becomes difficult to justify because the cost of the programme far exceeds its purported social and economic benefits as has been argued by its proponents.

Second, it is debatable as to whether the Act did in fact stimulate consumption in the American economy. Apparently, no significant increase in spending has been recorded following the

\[828\] Ibid
\[829\] Ibid
\[830\] Poole (n 259).
introduction of the tax rebates. As Tailor rightly argues, the programme has been wrongly targeted as it focused on providing tax cuts and incentives for businesses most of whom fall within the higher income bracket. Arguably, Households with higher incomes are generally able to handle their consumption during the business cycle and they do this either by reducing their savings or increasing their borrowing. Consequently, making additional resources available to such high-income households is likely to have no or very limited impact on consumption. According to Tailor ‘there was no statistically significant increase in consumption following the rebates because most people saved their funds and did not spend their rebate checks’.

The Congressional Budget Office (CBO) acknowledges that under the current circumstances, the Act may serve a useful purpose but makes no lasting contribution to the economic growth and financial stability of America. According to the CBO, the outcome of the Economic Stimulus Act has not been particularly effective and coherent because by the end of the year, the impact on overall economic activity had disappeared.

Moreover, the ESA is merely an ad hoc measure designed to mitigate the immediate effect of the crisis rather than being a long-term solution. Whichever way one looks at it, the ESA fails to address the fundamental cause of the GFC and in that respect, remains an inadequate policy response. In fact, the Act reinforces the shareholder value approach to corporate governance by incorporating several provisions that rather seek to empower shareholders.

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832 ibid
834 ibid
Perhaps, it is these inadequacies that prompted the US government to seek more comprehensive legislation in place of the present Economic Stimulus Act. This is because the impact and outcome of the Act have not been particularly coherent and effective in resolving the fundamental cause of the GFC.\footnote{ibid} Thus, the Emergency Economic Stabilization Act 2008 which is the focus of the next discussion was enacted in response to the inherent shortcomings and inadequacies of the Economic Stimulus Act of 2008.

\subsection*{4.2.2 Emergency Economic Stabilization Act 2008 (EESA)}

As the economic situation continued to worsen, it became obvious that a much more robust response was required to stabilise the economy. This broader legislative response emerged in the form of the Emergency Economic Stabilization Act 2008 (EESA). Section 101 of the Act establishes the Troubled Assets Relief Programme (TARP) ‘to purchase, and fund commitments to purchase troubled assets from any financial institution, on such terms and conditions as are determined by the Treasury Secretary in accordance with the Act’.\footnote{The Emergency Economic Stabilisation Act of 2008, s 101} The Act defines troubled assets as:

\begin{verbatim}
[REsidential or commercial mortgages and any other securities, obligations, other instruments that are based on, or related to such mortgages that in each case was originated or issued on, or before March 14, 2008, the purpose of which the Secretary determines promotes financial market stability.\footnote{The Emergency Economic Stabilisation Act of 2008, s 3(9)}
\end{verbatim}

The objective of the Emergency Economic Stabilization Act (EESA) is first and foremost, to stabilise the economy through various policy initiatives. To this end, the Act establishes the $700 billion Troubled Assets Relief Programme (TARP) under which the Treasury Secretary is authorised to purchase ‘troubled assets’ such as mortgages, securities and other related instruments. The secretary was further required to develop policies and procedures in relations
to the purchase of such toxic assets.\textsuperscript{839} In essence, the broader objective of EESA is to provide stability to the US financial system, prevent a further disruption in the larger economy and protect the taxpayer.\textsuperscript{840} Before delving into the detailed discussion, it is important to understand the structure of TARP, the powers and authority of the Treasury Secretary, the regulatory mechanism and the oversight framework.

As earlier mentioned, the EESA empowers the Treasury Secretary to purchase, manage and sell assets held by financial institutions as defined in section 3(5) of the Act.\textsuperscript{841} It also allows the Treasury to repurchase or engage in other financial transactions in respect of troubled assets at any time and upon terms and conditions and at a price to be determined by him. Furthermore, the Act grants the Treasury Secretary a wide margin of discretion to determine the specific characteristics of assets that qualify as troubled assets, the manner of arriving at a price and the criteria for participation.\textsuperscript{842}

The rationale behind such broad powers is to enable the Treasury Department to develop wider but prompt responses to crisis rather than allowing different institutions to fashion individual institutional responses.\textsuperscript{843} It is thus, important to stress that these discretionary powers are not without limitations. First, the Treasury Secretary can only sell assets in a manner that is devoid of conflict of interest and with minimum negative long-term impact on the economy.\textsuperscript{844} Second, the exercise of these discretionary powers requires the Treasury Secretary to be guided by the

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{839} ibid
\item \textsuperscript{840} Saptarshi Ghosh and Sajid Mohamed ‘The Troubled Asset Relief Program (TARP) and Its Limitations: An Analysis.’ (2010) 52(2) International Journal of Law & Management 124.
\item \textsuperscript{841} Section 3 (5) of the Economic Stabilisation Act defines Financial Institution as “any institution, including but not limited, any bank, savings association, credit union, security broker or dealer, or insurance company established and regulated under the laws of the United States or any State, territory or possession of the United States....”
\item \textsuperscript{842} Ghosh and Mohamed (n 840).
\item \textsuperscript{843} ibid
\item \textsuperscript{844} The Emergency Economic Stabilisation Act 2008, s 101 (a) (2)
\end{itemize}
\end{footnotesize}
protection of taxpayer interest, the stability of the financial markets, preservation of homeownership and the long-term financial stability of the affected financial institutions.\textsuperscript{845}

Within the context of fulfilling its mandate and providing the appropriate policy framework, the Act establishes a number of offices (bodies) to implement TARP, oversee its operations as well as conduct investigations where necessary. These bodies include: Office of Financial Stability (OFS), Office of Special Inspector General (IG), Financial Stability Oversight Board (FSOB), and the Congressional Oversight Panel (COP). Each of these bodies was given a clearly defined mandate and assigned specific duties, functions and responsibilities. The introduction of these stringent measures forms part of the checks and balances meant to ensure transparency and accountability in the management and operations of TARP.\textsuperscript{846}

In executing its mandate, TARP focuses on four main areas namely: economic stabilisation, preservation of homeownership, taxpayer protection and restrictions on executive pay/compensation.\textsuperscript{847} This section explores how far these measures achieve the goals set under the Act and most critically whether such taxpayer-funded purchase of troubled assets is the appropriate response to the GFC.

\textit{4.2.1.1 Stabilising the Economy}

As already indicated, the need to mitigate the effects of the crisis and stabilise the economy became the immediate concern and priority of the US government. A cornerstone of the stabilisation effort was the government’s purchase of equity in financial institutions and insuring troubled assets against unforeseen future losses. Consequently, $700 billion were

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{845} The Emergency Economic Stabilisation Act 2008, s 101 (b) (1)
\item \textsuperscript{846} Ghosh and Mohamed (n 840).
\item \textsuperscript{847} ESSA s 134
\end{enumerate}
\end{footnotesize}
provided under EESA allowing the Treasury Secretary to buy mortgages and other toxic assets on the balance sheets of most financial institutions in the US.\footnote{848}{Barbara Black, ‘The US as “Reluctant Shareholder”: Government, Business and the Law’ (2010) 5 (2) Entrepreneurial Business Law Journal 561, 574.}

In fact, the capital levels of financial institutions in the US following the GFC were depleted to the extent that it became difficult to raise new capital in the market so government capital injection to stabilise the banks through public funding became the only viable policy option.\footnote{849}{Bill Canis and Baird Webel, ‘The Role of TARP Assistance in the Restructuring of General Motors’ (CRS, 9 May 2013) <www.business.cch.com/BANKD/CRS-Report-R41978.pdf> accessed 19 May 2016}

The $700 billion facility authorised by the Act was implemented in two stages of $350 billion each.\footnote{850}{ibid} First, the Treasury invested $250 billion directly in the equity of US financial institutions half ($125 billion) of which went to nine major American financial institutions namely: Citigroup, Wells Fargo, JP Morgan, Bank of America, Goldman Sachs, Morgan Stanley, State Street, Bank of New York and Merrill Lynch.\footnote{851}{ibid} These recipients were chosen because they were considered ‘too big to fail’ due to their size, interconnectedness and systemic importance.\footnote{852}{Baird Webel, ‘Troubled Asset Relief Programme (TARP): Implementation and Status’ (CRS, 27 June 2013) <www.fas.org/sgp/crs/misc/R41427.pdf> accessed 19 May 2016}

As a result, these institutions were not subjected to the formal scrutiny and evaluation process required by the TARP guidelines.\footnote{853}{ibid}

As the crisis evolved, it became apparent that focusing on the toxic assets on banks’ book alone was not sufficient to resolve the problems in the industry. Consequently, the original mandate of TARP was expanded to include the provision of funds to strengthen bank capital through stock purchase.\footnote{854}{ibid} This measure enabled banks to resume lending to the private sector and helped reduce the pressure on banks to contract their lending.\footnote{855}{Henry M. Paulson Jr, ‘Financial Rescue Package and Economic Update’ (Remarks by Treasury Secretary at Press Briefing 11 December 2008) <www.treasury.gov/press-center/press-releases/Pages/hp1265.aspx> accessed 20 July 2016}
Supporters of TARP posit that the injection of $125 billion into the nine biggest banks in the US marked a turning point in government attempt to mitigate the effects of the GFC. This intervention helped to improve the liquidity of financial institutions and other entities whose operations have been hampered by difficulties in mortgage-related assets, thus avoiding an imminent collapse of the entire financial system.\textsuperscript{856} In that respect, TARP is considered an effective policy response because it enabled government to buy distressed assets from financial institutions, eased the credit freeze and encouraged such institutions to resume lending again.\textsuperscript{857}

The scope, authority and powers of TARP were broadly defined and went beyond capital injection into financial institutions. Although congress did not pass a specific legislation in respect of the automobile industry, the Treasury recognised the need to provide financial support for the automobile industry that was at the brink of collapse following GFC.\textsuperscript{858} In total, TARP funds provided an $80 billion assistance package to the automobile industry.\textsuperscript{859} The initial programme targeted General Motors (GM), GMAC/Ally Financial, Chrysler and Chrysler Financial in response to the immediate needs of these firms.\textsuperscript{860} This was followed by preferred share purchase in GM and Chrysler to ensure their long-term financial viability. Under the programme, GM received $50.2 billion while Chrysler got $10.9 billion.\textsuperscript{861} Similarly, GMAC/Ally and Chrysler Financial received $17.2 billion and $1.5 billion respectively.\textsuperscript{862}

The acquisition of majority shares in GM and minority shares in Chrysler raised serious corporate governance issues. The programme resulted in majority government ownership of GM (60.8 per cent) and minority government ownership of Chrysler (9.9 per cent).\textsuperscript{863} In return, the government not only exercised managerial control over these firms, it also designated ten

\begin{itemize}
\item\textsuperscript{856} Fairfax (n 827).
\item\textsuperscript{857} Bainbridge (n 105) 9.
\item\textsuperscript{858} Black (n 848).
\item\textsuperscript{859} Canis and Webel (n 849).
\item\textsuperscript{860} ibid
\item\textsuperscript{861} ibid
\item\textsuperscript{862} ibid
\end{itemize}
of the thirteen directors of GM and in the case of Chrysler government designated four of the nine directors.\textsuperscript{864} Consequently, government effectively became a reluctant but controlling shareholder in these firms; made possible by government’s ability to cause the removal of the CEO as well as effect changes in the composition of the board of directors.\textsuperscript{865} It must be acknowledged that although exercising managerial control is not the stated goal of TARP, it is necessary to protect and compensate tax payers for the assistance given to these companies.

Outlining the principles to guide the management of government ownership stakes, President Barack Obama explained that government had no desire to own equity any longer than necessary and will dispose of its ownership interests as soon as practicable, emphasising: ‘The financial crisis has put our government in the unwelcome position of owning large stakes in private companies for the simple and compelling reason that their survival and the success of our overall economy depend on it.’\textsuperscript{866} Admittedly, the revival and the long-term survival of the US economy depends on providing the necessary support for both financial and non-financial firms through public-funded programmes.\textsuperscript{867} Unlike financial institutions whose bailouts were driven by fears of the impact on the financial markets, the decision to rescue GM and Chrysler was informed by the strategic importance of the automobile industry as a major employer.\textsuperscript{868} From this standpoint, it becomes apparent that the motivation for the GM and Chrysler bailout is to protect American jobs especially in the industrial Midwest, an area hard hit by the GFC.\textsuperscript{869} Indeed, one of the conditions for providing the financial support is the commitment by GM and Chrysler to produce a substantial portion of their cars in the US. Government assistance was also made conditional on the company’s acceptance to reduce compensation paid to US

\begin{footnotes}
\item[864] ibid
\item[865] Black (n 848).
\item[867] ibid
\item[868] Bayazitova and Shivdasani (n 863).
\item[869] ibid
\end{footnotes}
employees to levels comparable with compensation paid by other car producers such as Honda, Nissan or Toyota at their US facilities.  

Administration officials view the bailout package for financial institutions and the automobile industry as necessary and appropriate, arguing, that but for this intervention the financial crisis would have degenerated into a full recession. It has further been argued that a worsening economy would have also imposed other costs such as providing unemployment benefits for displaced workers on taxpayers. According to the Treasury Department, a total of 700 institutions and firms in the automobile industry have benefited directly from this programme.

In fact, US government ownership in GM has reduced from 60.8 per cent in 2008 to 33 per cent following public share offering in December 2010; an indication that the investment made in GM had started paying off. Also, by the middle of 2010, government’s investment (shares) in most of these bailed institutions had reduced dramatically as banks and firms that received TARP funding returned to profitability and repaid their loans before schedule.

The rescue package for the banking and automobile industry has several critics most of whom have expressed serious concerns not just about government intervention in the financial markets, but more crucially, the overall impact and efficacy of the programme. For example, Diamond and Rajan argue that propping up weak institutions with toxic assets through capital injections as a means of stabilising the economy is counter-productive. Rather than stabilising the economy, capital injections into failed/failing institutions tend to increase the

870 Black (n 848).
871 ibid
872 ibid
873 Canis and Webel (n 849).
874 ibid
875 ibid
incidence of asset fire sales that can cause liquidity to dry up and worsen an already volatile situation.  

Furthermore, government intervention with capital injection sends the wrong signal to both the markets and the financial institutions. Arguably, such intervention can create an increase in the market’s expectation of future intervention and regulatory seizures thereby potentially impeding recovery in the financial sector. As Hoshi and Kashyap explain, the goal of financial rescue plan is to assure investors that the institutions are financially sound. The reality however, is that more often, capital injection generates an adverse signal that the recipient institution is expected to experience future losses. This has a deterrent effect on potential investors which makes it more difficult to raise new capital from outside investors.

Finally, it raises the question whether the bailout package for these failing firms and institutions addresses the issue of corporate purpose and whose interest they should serve. Apparently, while government recognises the need to intervene with public money to rescue these firms, their purposes were defined in terms of maximising shareholder value. Apart from the changes in the management and governance structures, there have been no fundamental changes in the underlying philosophy of the nature and purpose of the corporation. This is not surprising, because American corporate governance has become hostage to what Black describes as ‘dictatorship of shareholder primacy’.

4.2.1.2 Preserving Homeownership

With the onset of the crisis, it became apparent that the right of mortgage holders (homeowners) to stay in their homes came to depend on their ability to refinance the ever-increasing debts.

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877 ibid
878 ibid
880 ibid
881 Black (n 848).
Banks and other financial institutions were unable to provide the credit at the time when it was most needed resulting in 4 million families losing their homes to foreclosures,\(^\text{882}\) while another 4.5 million have slipped into the foreclosure process or are behind on their mortgage payment.\(^\text{883}\)

Therefore, the introduction of the Homeownership Preservation Scheme (HPS) under TARP is arguably, a timely intervention and appropriate response by government to mitigate the social and economic consequences of the housing crisis.\(^\text{884}\) The problems arising from the failure of financial institutions were so severe that it became necessary for the Treasury Department to act swiftly to reduce panic in the housing market and more importantly prevent foreclosures.\(^\text{885}\)

Consequently, congress enacted section 110 of EESA mandating the Federal Housing Finance Agency (FHFA), the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve Board (FRB) to develop and implement a plan of action aimed at providing the necessary assistance for homeowners.\(^\text{886}\) It further tasked these agencies to use their authority to encourage mortgage lenders to take full advantage of the newly-established programme for homeowners (HOPE) in order to avoid or minimise foreclosures.\(^\text{887}\) In the case of residential mortgage loans, such modifications included reduction in interest rates, reduction in the principal and other similar modifications.\(^\text{888}\) The Act thus, empowers these agencies to modify troubled loans many of which have been contracted under questionable circumstances, and to a large extent, predatory lending practices.\(^\text{889}\) It also directs federal agencies to modify their loan

\(^{882}\) Foreclosure refers to formal legal proceedings initiated by a mortgage lender against a homeowner who has missed a certain number of payments on his/her mortgage.


\(^{884}\) ibid

\(^{885}\) ibid


\(^{887}\) Black (n 848).

\(^{888}\) ibid

\(^{889}\) ibid
agreements with homeowners and provides such agencies with funding to achieve these goals. For instance, in July 2008, Congress authorised the Treasury Secretary to provide financial assistance to Freddie Mac and Fannie Mae to enable them support home owners who would otherwise lose their homes.\textsuperscript{890} Under the homeownership preservation scheme, different models of assistance were initiated and implemented. For example, the Home Affordable Modification Programme (HAMP) supports the payment of mortgage-related services to reduce the financial burden of home owners. Even though a total of $29.9 billion was earmarked for this programme only $2.85 was disbursed as at December 2010.\textsuperscript{891} Similarly, the Hardest Hit Fund (HHF) helps state housing finance agency programmes in States with very high unemployment rates or States that have experienced the steepest declines in home prices. Eighteen States have so far participated in the HHF under which just $ 0.9 billion has been disbursed out of the $ 7.6 billion set aside for that purpose.\textsuperscript{892} In addition to the above, the HOPE establishes the Federal Housing Administration (FHA) Short Refinance programme which aims at promoting refinancing of mortgages on the so called ‘underwater’ properties.\textsuperscript{893} These are properties on which the mortgage balance is far greater than the equity in the house. A comprehensive guideline of this programme was released in August to enable homeowners who owe more than the value of their homes to refinance through the FHA-insured mortgages.\textsuperscript{894} The caveat however, is that this is possible only if lenders agree to write-off part of the principal owed on the mortgage.\textsuperscript{895} Despite the bipartisan consensus on the negative consequences of the housing bubble, there was less agreement as to the level of federal government involvement in preventing or minimising foreclosures.\textsuperscript{896} Proponents posit that enacting policies and using public resources to prevent

\textsuperscript{890} ibid
\textsuperscript{891} Black (n 848)
\textsuperscript{892} Webel (n 852).
\textsuperscript{893} ibid
\textsuperscript{895} Webel (n 852).
\textsuperscript{896} ibid
foreclosures was an economic necessity and a social imperative. Apart from assisting households experiencing difficulties, the measure helps to prevent further damage to home values and disruption to entire communities and has the additional benefit of stabilising the economy.

It can be counter argued, that such intervention is an infraction on the privity of contract principles which state that only parties to a contract can ensure its performance. In this respect, a case can be made that the issue at stake is that of a contractual relationship between the lender and the borrower. It should therefore be resolved between the two contracting parties without government involvement or intervention. There are also serious misgivings about possible abuse by people who may not really need or deserve help but want to take advantage of the programme. Furthermore, opponents object to the use of taxpayers’ money to support people who may be seeking to pass on their losses to the lender or taxpayer or people who knowingly took mortgages they could not afford. Despite the misgivings and controversies surrounding the HPS, the Treasury Department went ahead to commit an amount of $45.6 billion to the programme but only $3.85 billion had been disbursed.

While acknowledging the need to protect and preserve home ownership, it is equally important to recognise that the idea was subject to several flaws which should have been obvious to the Treasury Department. Questions were raised as to the price the Treasury Department would pay for these toxic assets due to the lack of clearly defined guidelines on how much the Treasury is legally bound to pay. The dilemma the Treasury faces is that if it pays what was the true value, the programme would have been deemed to serve its purpose of assisting the banks to

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898 ibid
900 CRS Report (n 894).
901 CRS Report (n 897).
902 Webel (n 852).
903 CRS Report (n 897).
On the other hand, if the Treasury overpays, that would amount to a taxpayer’s gift to the banks in the midst of rising home foreclosures, increasing unemployment and high public resentment towards banks. Notwithstanding the public anger, the US government proceeded to inject more than $200 billion into the banking industry alone, with an initial outlay of $125 billion going to nine major American Banks: a measure that amounts to partial nationalisation never seen before in the US. But by taking semi-ownership of these entities, the Treasury ensured that the shareholder rights were well protected and not diluted. Clearly, this action significantly undermines the credibility of the efficient market hypothesis which has for decades dominated economic thought and practice in the US. In such circumstances, it becomes difficult to reconcile the free market system with government decision to rescue businesses that fail in that system. Admittedly banks seem to be more cautious than they were before the crisis but the reality is that the business practices, governance model and the incentives culture that triggered the financial crisis have not changed. This is not surprising because the philosophy of shareholder primacy as under pinned by free market capitalism still remains engrained in the US economic system.

4.2.1.3 Taxpayer Protection

The response to the crisis ignited the public-private debate regarding the use of taxpayers’ money to bailout privately-owned failing banks and other financial institutions. Consequently, policy makers in the US acknowledge that public-funded bailouts, the

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904 Poole (n 259).
905 ibid.
906 ibid.
907 ibid.
909 Black (n 848).
911 Horn (n 161)172.
912
acquisition of toxic assets or mortgage-backed securities by the Treasury Secretary require some cost-benefits analysis in terms of the cost to taxpayer against the benefits to home owners and the economy.\textsuperscript{913} It was, however, recognised that promoting financial and market stability through the asset purchase programme should be done in a manner that ‘maximises the overall return to the taxpayer’.\textsuperscript{914}

Accordingly, section 113(d) of the Act requires companies selling ‘troubled assets’ to government to provide warrants so that taxpayers will benefit from any future growth that such a company will experience arising from participating in the programme.\textsuperscript{915} The Act further stipulates that the Secretary may not purchase, or make any commitment to purchase any troubled asset unless (a) the financial institution provides a warrant giving the Secretary the right to receive non-voting common stock or preferred stock,\textsuperscript{916} (b) provides a warrant for common or preferred stock or a senior debt instrument from the institution.\textsuperscript{917} By this provision, the recipient firms are required to give the Treasury stock or debt instruments which would provide for the reasonable participation by the Secretary for the benefit of the taxpayer.\textsuperscript{918} The import here is to guard against losses from sale of assets by the Treasury Secretary so as to protect taxpayer investment and maximise overall returns within competing constraints.\textsuperscript{919} In other words, the TARP recipient is expected to remain a competitive enterprise that should retain and recruit talented individuals who will contribute to the future success of the recipient company and ultimately be able to repay its TARP obligations.\textsuperscript{920}

\textsuperscript{913} ibid
\textsuperscript{914} EESA, s 109(a)
\textsuperscript{915} ibid
\textsuperscript{916} EESA, s 113(a)
\textsuperscript{917} EESA, s 113(b)
Obviously, section 11(d) reveals the continuous obsession with maximising overall returns for the benefit of the enterprise which most managers equate with shareholders. Moreover, the requirement to remain competitive reinforces the belief in market fundamentalism as espoused by the shareholder primacy. It is, thus, submitted that despite the attempt to portray a semblance of protecting taxpayer-interest, EESA is implicitly promoting the very idea that led to the GFC.

Despite its imperfections, the TARP has largely protected taxpayers’ interest as most of the monies invested in these programmes have largely been recouped and in some cases profits declared. For instance, the Capital Purchase Programme (CPP) which was designed to assist financially viable institution through the purchase of preferred stock, enabled the Treasury to invest $205 billion in 707 financial institutions in 2009. By August 31, 2015, the department had received $227 billion as repayments and income from the investments made.

Moreover, by the middle of 2010 government investments in business reduced dramatically as many of the firms that received TARP funding made profits and repaid their loans before schedule. For instance, after divesting its shares in Citigroup in June 2010, the Treasury announced a TARP repayment of $ 194 billion exceeding the outstanding TARP funds of $190 billion. Indeed, Bloomberg News captures how TARP not only protected but also benefited taxpayers in its headline: ‘Wall Street Bailout Returns 8.2 per cent Profit, Beating Treasury Bonds’. In other words, taxpayer interest was better served by using public funds to rescue failing Wall Street banks than investing in government bonds during the crisis. This probably explains why the Treasury Secretary, Tim Geithner calls the programme ‘the most maligned yet effective government programme in recent memory’. However, these optimistic assertions purporting to protect taxpayers obscure the inherent flaws requiring firms to give

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921 Calomiris and Khan (n 919).
922 ibid
923 Black (n 848).
924 ibid
925 ibid
stock or debt instrument the receipt of which would ‘provide for the reasonable participation’ of the Treasury Secretary.\textsuperscript{927} But deciding what is reasonable is discretionary which allows the Treasury Secretary to set the price, exercise the warrant and also determine the exceptions to these rules.\textsuperscript{928} Indeed, such vaguely-formulated provision gives too much power to the Secretary and undermines the very meaning, essence and effect of the warrants and the desire to protect the interest of taxpayers.

Further, an evaluation of TARP seems to suggest that the programme was meant to save big banks at the expense of the taxpayer as evidenced by the enormous power granted the Treasury Secretary to determine which bank survived and which could fail.\textsuperscript{929} As it turned out, heavy toxic-loan infested banks like Citigroup and Bank of America were all supported irrespective of the cost to the taxpayer. Meanwhile, smaller banks numbering 132 went bankrupt costing the taxpayer over $1.2 billion. These banks collapsed either due to insufficient support or inability to compete with the bigger banks due to the implicit guarantees the bigger banks received from government with the attendant cheaper cost of borrowing. Admittedly, smaller banks may not pose a systemic risk to the financial system in terms of creating panic; but it does not mean that their failure has no cost to the taxpayer. In fact, the smaller banks in the US are the main source of loans for smaller and medium-sized businesses that create most of the jobs in America. As such their failure has both direct and indirect consequences for the taxpayer.

\subsection*{4.2.1.4 Executive Compensation}

Excessive executive compensation has been identified as one of the major triggers of the GFC. The wide-spread public outrage and criticism directed at the extravagant compensation packages for Chief Executive Officers (CEOs) of publicly-listed companies prompted congress

\begin{footnotesize}
\footnotesize\textsuperscript{927} EESA, s113(d)
\footnotesize\textsuperscript{928} ibid
\footnotesize\textsuperscript{929} ibid
\end{footnotesize}
to respond in the form of legislation.\textsuperscript{930} In responding to these concerns, congress attached conditions to TARP assistance, the most important of which relates to executive compensation to ensure that senior executives are not rewarded by the bailout of these companies. Consequently, section 111 of ESSA restricts compensation for senior executives of financial institutions receiving TARP funding.\textsuperscript{931} Thus, entities receiving TARP assistance became subject to executive compensation requirements and corporate governance provisions. These rules and requirements are, however, not uniform but differ depending upon whether the purchase was done under the Capital Purchase Programme (CPP)\textsuperscript{932} or under Troubled Asset Auction Programme (TAAP).\textsuperscript{933}

First, section 111 subjects financial institutions participating in CPP to a more stringent executive compensation regime so long as the TARP recipient has an outstanding obligation to the Treasury.\textsuperscript{934} This provision requires the institution to comply with guidelines on executive compensation as set forth in the Interim Final Rule on TARP Standards for Compensation and Corporate Governance.\textsuperscript{935} These standards include: a limitation on compensation and incentives regime that encourages senior executive officers (SEO) of financial institutions to engage in risky business practices which threaten the value and stability of such institutions.\textsuperscript{936}

It also prohibits the payment of golden parachute incentives to SEOs of financial institutions that access the TARP facility.\textsuperscript{937} Golden Parachute payment is defined as payment made to or for the benefit of an SEO on account of an applicable severance from employment to the extent

\begin{itemize}
  \item \textsuperscript{930} Black (n 848).
  \item \textsuperscript{931} EESA, s111(a)
  \item \textsuperscript{932} The Capital Purchase Programme (CPP) is the first to be launched by the Treasury Secretary and it involves the direct purchase of toxic assets by the Treasury with no bidding process or market price.
  \item \textsuperscript{933} Troubled Asset Auction Programme (TAAP) refers to the process where troubled assets are sold through an auction.
  \item \textsuperscript{934} Fairfax (n 827).
  \item \textsuperscript{935} Office of the Special Inspector General for the Troubled Asset Relief Programme, ‘Quarterly Report to Congress’ (30 January 2010)
  \item \textsuperscript{936} ibid
  \item \textsuperscript{937} EESA, s 109(d)
\end{itemize}
that exceeds or equals an amount three times the SEO’s basic pay.938 These payments are often made to SEOS on their departure from the company other than payments for services rendered.939 The Golden Parachute Rule as provided for in section 302(b)940 amends section 280(g) of the Internal Revenue Code of 1986 and restricts severance payments which occurs while TARP is still operational.941

The Act further requires the return of unearned bonuses under the ‘claw-back’ clause.942 Claw-back refers to the recovery of bonuses or other incentive-based compensation paid to SEOS based on earnings which are later proven to be materially inaccurate.943 The standards and requirements of the ‘claw-back’ under the CPP is significantly broader in scope in that apart from the CEO and CFO, they also apply to the three most highly compensated executive officers. Even more significant is the provision that the requirements apply to both public and private financial institutions and are not exclusively triggered by an accounting restatement. Finally, unlike previous provisions contained in the Sarbanes-Oxley Act 2000 (SOX)944 which was limited to twelve months, the current provisions do not place a time limit on the period of recovery.

To facilitate the effective implementation of these provisions, the Treasury created the Office of Special Master (OSM) for TARP executive compensation and charged it with the responsibility to review and approve executive compensation for TARP recipients. In carrying out these responsibilities, the OSM is guided by the two basic principles namely: the need to minimise risk and ensure taxpayer return.945 This is to avoid incentives that encourage employees to take unnecessary or excessive risks that are likely to threaten the value of the

938 ibid
939 EESA, s 111(b)
940 EESA, s 302(b)
941 Internal Revenue Code 1986, s 280(g)
942 ibid
943 Hoecke (n 41).
944 Sarbanes-Oxley Act of 2000
945 ibid
Chapter 4

TARP recipient. At the same time, the compensation structure must reflect the need for the TARP recipient to remain competitive to be able to fulfil its repayment obligations to TARP.946 Critics have questioned the motives for the restrictions on executive compensation because section 111(d) could seriously restrict an institution’s ability to pay competitive salaries, cash bonuses or provide equity incentives. In effect, financial institutions burdened with government restrictions and close oversight after accepting TARP funds, would be unable to recruit new CEO because these restrictions constitute an obstacle to finding the best possible CEO candidate.

Another worry is that the expansion of the limitation on tax deductibility under section 320 of ESSA947 has the potential to constrain corporate strategy.948 Arguably, the restrictions effectively direct the affected financial institutions away from performance-based incentives towards incentives that are earned based exclusively on continued service. Many of the financial institutions considered these conditions so overly burdensome that they found incentives to repay the TARP funds in order to get out of this restrictive regime.949 For example, as of June 2010, most large TARP recipients including Bank of America (Boa), Goldman Sachs, JP Morgan Chase & Co and Morgan Stanley repaid their TARP fund to extricate themselves of these restrictions.950 The Bank of America was more explicit by making it clear that the rationale for the repayment of the $45 billion bailout funds was to enable the Bank to have a free hand to recruit a new CEO. This, according to the Bank, removes the stigma attached to the restrictions and makes the company more attractive to potential CEO candidates.951

946 ibid
947 EESSA, s 320(a)
948 Black (n 848)
These provisions may seem restrictive, but they should be understood within the context of the recent GFC and the attempt to prevent its reoccurrence. Arguably, the imposition of these additional requirements and restrictions were meant to protect the taxpayer and increase transparency. Indeed, this restrictive approach reflects congress and public anger over large compensations paid to executives of rescued/failed institutions; especially at a time of rising foreclosures and high unemployment in the US.\footnote{Dennis Bradley and David Cho, ‘Rage at AIG Swells as Bonuses Go Out’ \textit{The Washington Post} (Washington, 17 March 2009) \texttt{<www.washingtonpost.com/wp-dyn/content/article/2009/03/16/AR2009031602961.html>} accessed 24 May 2016}

Moreover, as the GFC reveals, performance-based incentives encourage managers to engage in excessive risk-taking by focusing on stock price as a measure of performance. It thus, stands to reason that the restriction on executive compensation is intended to mitigate the culture of excessive risk-taking. This is to ensure that executives who make bad decisions are not allowed to take advantage of the TARP facility; dump their toxic assets on the tax payer and then be allowed to walk away with millions of dollars in bonuses.\footnote{ibid} For instance, the decision by management of AIG to make retention payment totalling $600 million to its employees at a time when it was receiving TARP assistance reinforces the need for a more stringent executive compensation regime.\footnote{ibid} Indeed, given the extraordinary situation where the US taxpayer has become a reluctant shareholder in these corporations in which government has acquired substantial equity interests, a responsibility is imposed on government to protect the public interest.\footnote{James Kwak, ‘Why Did Bank of America Pay Back the Money ‘\textit{The Baseline Scenario} (New York, 4 December 2009)}

The adoption of TARP has without doubt, helped to reduce panic in the banking sector, stabilised the financial system and avoided a full recession. That notwithstanding, this thesis
argues that the changes introduced under TARP first, do not go far enough and second fail to address some of the crucial challenges posed by the GFC.

First, a critical examination of the rules relating to executive compensation reveals that these rules are less restrictive in both content and application than originally envisaged. For example, with respect to golden parachutes, the ban would apply to the top five senior executives as opposed to ten. Further, instead of an outright and complete prohibition on golden parachutes, the Act provides that the amount received by company executives would be restricted to an amount not greater than one year’s annual compensation.

Secondly, the law establishing TARP assigned too much power to the Treasury Secretary as a result congress lost control in the implementation of the law and thus, denied congress of its constitutional obligation to oversee and check the other branches of government. For instance, the initial mandate of the Treasury was the purchase of troubled assets, but the Treasury expanded this authority and quickly switched to recapitalising banks without violating ESSA. This indicates the breath of discretionary powers that the Treasury enjoys. In fact the Act authorises the Treasury Secretary to purchase any financial instrument that may, in his view, contribute to financial stability. This provision confirms the unrestrained discretionary power accorded the Treasury Secretary to execute TARP.

Furthermore, although TARP was meant to provide relief and assistance to homeowners by addressing the problems of foreclosures, the programme failed to live up to its stated goals. According to Adler, TARP offers very little relief regarding the large numbers of foreclosures estimated at 140,000 per day till January 2009. It is further revealed that foreclosure fillings

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957 Black (n 848)

were reported on 2.8 million properties in 2009 representing an increase of 81 per cent from 2008.\textsuperscript{959}

The key reasons for the failure to come to the rescue of home homeowners are two-fold. The first is that the prices of the original mortgages exceed their present value. Unfortunately, both the Treasury and the banks holding these mortgages have so far failed to address this issue because they are unable to identify and give realistic prices to these mortgages.\textsuperscript{960} Secondly, the majority of the mortgages have been re-engineered, repacked, securitised or sold as new complex financial products. Subsequently, it has become even more complex for banks and other financial institutions to identify which set of mortgages have been used as collateral.\textsuperscript{961} This makes it difficult for both the Treasury and the banks concerned to engage in any meaningful negotiations in that regard.\textsuperscript{962} Interestingly, it is this very practice of securitisation and repackaging of complex financial products among other factors, that ignited the GFC although shareholder primacy remains the underlying cause.

A major challenge hindering the effective implementation of TARP is the multiplicity of oversight bodies which raises the possibility of overlap in the execution of their duties and responsibilities. For example, there exists an overlap in the duties and responsibilities of FSOB and COB both in general and specific terms. Under the Act, the two bodies are specifically required to review and examine the actions of the Treasury Secretary and the effects of such actions on homeownership, financial markets, and costs to the tax payer. The overlapping functions and the accompanying turf wars not only create bureaucratic hurdles, but they also impose additional costs in terms of implementation. It is therefore, not surprising that some

\textsuperscript{959} ibid
\textsuperscript{961} ibid
\textsuperscript{962} ibid
TARP recipients complain about having to account to a variety of federal agencies with competing and conflicting demands.

TARP is admittedly, the largest financial rescue plan in US history. But it is a plan that has turned out to have lost its focus and in the end failed to provide the vital policy response to the GFC. Instead of addressing the capital challenges of financial institutions according to their needs, TARP became a rescue package for a few selected banks, failed to mitigate foreclosures and became hostage to the dictates of financial markets. This is not surprising because the shareholder primacy with its proposition of the efficient market hypothesis and deregulation is so deeply engrained in the US economic system to the extent that it would have been unthinkable if TARP was implemented differently. With all its attempts at reform, the EESA has left untouched the shareholder primacy that has dominated corporate governance thinking and practice for many years.

The short-comings identified particularly in TARP and EESA in general, prompted the introduction of new legislation to ‘promote systemic regulatory reform’ that ensures more prudent governance and compensation regime and perhaps importantly, promotes long-term value and growth. The legislation became known as the American Recovery and Reinvestment Act 2009 which forms the next section of the discussion.

4.3 The American Recovery and Reinvestment Act of 2009 (ARRA)

The American Recovery and Reinvestment Act 2009 (The Reinvestment Act) was signed into law on February 19 2009 ostensibly to remedy the deficiencies in the Emergency Economic Stabilisation Act of 2008. Like its predecessor, the Reinvestment Act (ARRA) provides a $787 billion economic stimulus package of which $288 billion was meant for federal tax cuts.

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965 AARA (n 963)
while the remaining $499 billion was devoted to federal government spending.\footnote{ibid} ARRA was designed primarily to stimulate the stagnant US by providing tax relief for individuals and small businesses.\footnote{ibid} The Act also focuses on job creation, expansion of unemployment and social welfare benefits, assistance for education, health care, infrastructure and energy.\footnote{ibid} Although, stimulating the economy remains the cardinal policy objective of ARRA, it nonetheless sought to address some of the deficiencies identified in the previous legislations.\footnote{ibid} Consequently, beyond amending the Stabilisation Act, ARRA broadens the limits on executive compensation by introducing more comprehensive and stringent provisions.\footnote{ibid} It adopts most of the restrictions suggested by the Treasury Guidelines and makes it mandatory for TARP beneficiaries to have a shareholder ‘say-on-pay’ vote.\footnote{ARRA (n 963) s 7001(e) (1)} This vote is, however, non-binding and management are at liberty to accept or reject it. Nonetheless, it gave shareholders a voice and a sense of empowerment on how senior executives are compensated.

Furthermore, it sought to minimise some of the questionable executive compensation practices associated with the pre-crisis period by reinforcing the Treasury Guidelines on claw-back provisions. This relates to the top five senior executives and the next top twenty most highly compensated executives.\footnote{ibid} Under ARRA, the Claw-back clause is applicable to such executives irrespective of their knowledge of material inaccuracies upon which the payment of these bonuses or awards were based.\footnote{ibid} It thus ensures the possible recovery of any excess payment received by executives whether or not there was misconduct.\footnote{ibid} This provision may seem stringent, but it is a necessary and significant improvement on previous legislations in


\footnote{Fairfax (827) }

\footnote{ARRA (n 963) s 7001(e) (1) }

\footnote{ARRA (n 963) s 7001 (b) (3) B}

\footnote{ibid}

which the claim of lack of knowledge was enough to exonerate senior executives. The danger however, is that some ‘innocent’ SEOs may be wrongly penalised for actions of which they have no knowledge. As Fried rightly argues, the inadvertent receipt of excess pay is quite common as such ‘excess pay is not always the result of misconduct’.

ARRA further requires the establishment of company-wide policy on the approval of excessive expenditures by establishing a compensation committee made up entirely of independent directors. Their mandate is to develop compensation policies to ensure prudent use of corporate resources and reduce unnecessary and excessive risk-taking. Moreover, the Chief Executive Officer (CEO) and the Chief Finance Officer (CFO) of publicly-listed companies are obliged under the Act to certify in writing that they have complied with these provisions in their annual reports to the SEC.

Finally, the Act directs the Treasury Secretary to review bonuses, retention awards and any other compensation paid to senior executives including the next twenty most highly compensated officials. The purpose is to determine if such payments are inconsistent with the provisions of TARP or against public interest. After making such a determination, the Treasury Secretary is required to negotiate with the TARP recipient for the reimbursement of the monies paid. This, ostensibly, is to prevent manipulation by executives of TARP beneficiaries who may deliberately inflate earnings or other metrics to boost their own pay outs to the detriment of the taxpayer.

Collectively, these legislations have been marketed as having created 3 million jobs, helped to avoid full scale recession and introduced radical corporate governance reforms including

976 Tomasic and Akinbami (n 11) 238.
977 AARA, s 701(b) (4)
979 ibid
980 See TARP Standards for Compensation and Corporate Governance, 74 Fed. Reg (15 June 2009)
981 Fried and Shilon (n 975).
982 Michael Grunwald, ‘How the Stimulus is Changing America’ Time Magazine (New York, 26 August 2010)
claw-back, pay-on-say and compensation committees.\textsuperscript{983} It has further been argued that beyond stabilising the US financial system, these interventions also fulfil the legislative intentions of preventing a disruption to the economy at large as well as the protection of the taxpayer.\textsuperscript{984}

Admittedly, these changes emanate from public anger towards excessive compensation packages for CEOs and other senior officials. They therefore, reflect the determination of other corporate constituents to demand for transparency, accountability and prudent use of corporate resources. In that respect, it may be said represent government attempt to appease public opinion and not a sincere determination to radically reform the present shareholder-oriented governance model. Moreover, it can be argued that these rescue plans are big but unnecessary government intervention programmes that failed to prevent foreclosures and rising unemployment despite a massive expansion of the deficit.\textsuperscript{985} It is therefore, difficult to accept the argument that these initiatives were intended to serve the public interest. In fact, they amount to the nationalisation of failed institutions through the back door.\textsuperscript{986} As it turned out, the battle over the short-term rescue package obscures the long-term push to address the underlying causes of the GFC.\textsuperscript{987}

What is, perhaps, more problematic is that the legislative response to the crisis enabled the US government to exchange capital for equity in banks which, in effect grants government a stake in these private institutions. For example, the US under TARP injected more than $200 billion into the banking system with an initial outlay of $125 billion going to America’s nine largest banks in return for equity. This arguably, represents a partial nationalisation never seen before in the US.\textsuperscript{988} Indeed, the decision to acquire significant stakes in banks particularly, Bank of

\textsuperscript{983} ibid
\textsuperscript{984} ibid
\textsuperscript{985} ibid
\textsuperscript{986} Barr (n 964)
\textsuperscript{987} ibid
America and Citigroup makes government the largest shareholder underlies a reality which critics have referred to as ‘shadow nationalisation’.  

Outside the banking industry, government also intervened in other sectors by taking control of Fannie Mae and Freddie Mac, two important private mortgage companies in the US. By this takeover, the government of the US became the owner and guarantor of nearly 42 percent of all American mortgages, making it ‘one of the most sweeping government interventions in private financial markets in decades’. Similarly, government intervened in AIG by injecting as much as $178 billion into the trouble-ridden insurance company, following which government became nearly 80 percent shareholder in a private company. Under the auto plan, government acquired major shares in two auto companies where the stakes were equally substantial as those acquired in the banking sector. Following the de facto nationalisation of the auto industry, government placed restrictions on the payment of dividends and executive compensation. Consequently, CEOs of these auto companies were required to submit restructuring plans that have been agreed with stakeholders. It may be argued that the ‘nationalisation of Detroit,’ amounts to an implicit rejection of market-based solutions in favour of government-controlled responses. This invariably reflects a ‘preference for orderly as opposed to market solutions’.

Finally, the bigger question is whether the different stimulus packages were the appropriate responses to the GFC. It should be stressed that the stimulus packages failed to address, and conveniently avoided the issues relating to the systemic problems that have characterised the
banking system and entire economic architecture in America. Instead of providing solutions to the issues raised by the crisis, the responses have in fact, become rescue packages for ‘failing banks and automobile companies’. 994

Contrary to assurances by government, banks and other institutions that had received billions of public money to guarantee their liquidity still went ahead to pay huge bonuses. 995 In that respect it is submitted that TARP has been explicitly used to support and prop-up ‘massive transfer of tax-payers’ money to the management and shareholders of well-connected institutions’. 996 In view of this, it can be argued that these measures were simply not the right solutions to the problems confronting the American economy and the stability in the financial markets. 997 It is therefore, a major policy mistake to bail out banks without reforming the dysfunctional financial system and corporate governance regime which overemphasises shareholder primacy and market fundamentalism. 998

In response, the Dodd-Frank Act of 2010 was passed and signed into law by President Barrack Obama to rectify some of these shortcomings. 999 The next section examines the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, its evolution, strengths, weaknesses and asks whether it addresses the underlying cause of the GFC.

4.4 *Dodd-Frank Wall Street Reform and Consumer Protection Act 2010*

As already explained, the US sought to prevent the crisis from developing into a full-scale recession, by enacting the Economic Stimulus Act. This Act established the $700 billion relief

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995 Horn (n 161).
996 ibid
997 ibid
998 Torres (n 811).
package under the Troubled Assets Relief Programme (TARP) which was later followed by an additional $787 billion economic stimulus through the American Recovery and Reinvestment Act. The failure by these earlier legislations to resolve the governance and regulatory issues made a compelling case for a new legislation that would help stabilise the situation, address the underlying cause of the GFC and the losses that followed. These massive losses with the attendant disruptions in the finance industry put political leaders under intense pressure to enact radical reforms and regulatory changes to meet the challenges posed by the crisis. Reflecting the mode of the country at the time, an editorial in the New York Times called for drastic measures to effect changes in the governance and regulation of the financial services industry. According to the Paper, ‘anything less than a new rule-based regime would be inadequate for the task of restoring confidence and eventually, reviving the economy’. The situation preceding the enactment of Dodd-Frank as Ludwig explains, was one of ‘political urgency and economic anxiety’. Also Senator Christopher Dodd, Chairman of the Senate Banking Committee and one of the architects of the Act notes that:

[T]he stakes are too high, and the American people have suffered far too greatly, for us to fail in this effort. The legislation will not stop the next crisis from coming; no legislation can, of course. But by creating a 21st century regulatory structure for a 21st century economy, we can equip coming generations with the tools to deal with the crisis and to avoid the kind of suffering we have seen in this country.

It was in this environment that congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act which was finally signed into law in July 2010 by President Barack

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1000 TARP was created under the Emergency Economic Stabilisation Act of 2008 (EESA). TARP was set up with the specific goal of stabilising US financial system and preventing a systemic collapse.  
1001 The American Recovery and Reinvestment Act of 2009 became law on February 2009. It is aimed at stimulating the economy and creating jobs.  
1004 Ludwig (n 1002).  
Obama. While proponents consider it as heralding the most dramatic changes in financial regulation and corporate governance since the Great Depression, critics view it as preserving and perpetuating much of the existing failed corporate governance regime and regulatory architecture.\textsuperscript{1006} Given the magnitude, complexity and importance of the Act, it is crucial to explore the relevant sections that address the issues of corporate governance and regulation in the financial industry. This entails a critical examination of the strengths and weaknesses of the act with the view to answering some of the unanswered questions.

The financial GFC that led to the enactment of Dodd-Frank reveals several flaws and systemic problems in the financial services industry and how they are governed.\textsuperscript{1007} There was near universal consensus among legislators, regulators and to a large extent, the public that corporate governance failures were to blame for the crisis. For instance, a study commissioned by the OECD attributes the crisis to the ‘failure and weaknesses’ in corporate governance.\textsuperscript{1008} Similarly, the Shareholder Bill of Rights Act of 2009 expressly states that ‘the central cause’\textsuperscript{1009} of the GFC is the result of widespread failures of corporate governance. Consequently, most of the reforms in Dodd-Frank seek to address the corporate governance failures as perceived by legislators and policy makers.\textsuperscript{1010} Against this backdrop, several provisions dealing specifically with issues relating to corporate governance have been incorporated into the Act in response to the GFC and the reforms that need to be undertaken.

\textbf{4.4.1 Strengths of Dodd-Frank}

Although the Dodd-Frank Act is primarily concerned with financial regulation, it nonetheless contains important provisions likely to have significant impact on corporate governance

\textsuperscript{1006}ibid
\textsuperscript{1007} Bainbridge (n 105) 9.
\textsuperscript{1010} Bainbridge (n 105) 32.
practices in the US. The corporate governance and disclosure provisions in Dodd-Frank seek to promote increased accountability, transparency and more importantly, regulate the compensation practices that fuelled excessive risk-taking which eventually triggered the GFC. The major corporate governance reforms introduced by Dodd-Frank include: shareholder vote on executive compensation also known as ‘say-on-pay’, shareholder proxy access, recovery of erroneously awarded compensation (claw-backs) and the establishment of independent compensation committees. These provisions constitute the core aspects of the Dodd-Frank Act in terms of corporate governance and form the focus of the subsequent discussion.

4.4.2 Shareholder Vote on Compensation

Executive compensation in public corporation is a controversial issue that raises a lot of emotions on all sides of the debate. While critics contend that it is excessively high and set by unaccountable and captured boards, supporters on the other hand argue that it reflects a well-functioning market. Commentators including Cotter et al argue that it creates perverse and to some extent dangerous incentives. On the other hand, scholars including Bainbridge argue that if properly structured, it can serve as a reward for doing the right things. In recognition of these challenges, congress incorporated the say-on-pay provision into the Act. The idea of say-on-pay is not new; in fact, it dates to 2002 in the UK and was later adopted in the US in 2006 through the actions of shareholder activists. According to Feri and Maber, Australia adopted it in 2004 while the Dutch did so in 2005; but the Dutch law calls for a binding rather

1012 ibid
1013 ibid
1015 ibid
1016 Bainbridge (n 105) 56.
1017 Dodd-Frank Wall Street Reform and Consumer Protection Act 2010
than a mere ‘advisory’ role.\textsuperscript{1018} The purpose of the say-on-pay principle is to give shareholders an advisory role in determining the pay of the company’s top five executives.\textsuperscript{1019}

\textbf{4.4.3 Say-on-Pay}

Say-on-Pay refers to an agreement where shareholders are granted a non-binding vote in respect of executive remuneration.\textsuperscript{1020} Section 951 of the Dodd-Frank Act requires public companies to include a non-binding shareholder vote on the compensation arrangements of named executive officers.\textsuperscript{1021} This vote, as provided for in the Act is expected to take place not less than once in every three years. The Act further requires companies to hold a non-binding shareholder vote at least once every six years to determine whether say-on-pay vote should be held on annual, biannual or triennial basis. Both votes and the frequency of their occurrence must to be included in the Company’s proxy statement during the first annual or other subsequent meetings of shareholders.\textsuperscript{1022}

The effectiveness of say-on-pay as a means of resolving the corporate governance failures and by extension the financial crisis is highly contested.\textsuperscript{1023} A report by the Senate Committee notes that the UK’s experience regarding say-on-pay has been very optimistic and suggests that say-on-pay legislation would have a positive impact on corporate governance in the US. The report admits however, that while the two legal contexts may not be identical, there is nothing to suggest that the ‘differences would turn what would be a good idea in the UK into a bad one in the US’.\textsuperscript{1024}

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\textsuperscript{1018} Fabrizio Feri and David A. Maber, ‘Say-on-Pay Votes and CEO Compensation: Evidence from the UK’ (2013)17(2) Review of Finance 527.
\textsuperscript{1019} Cotter \textit{et al.} (n 1014) 970.
\textsuperscript{1020} Horn (n 161).
\textsuperscript{1021} Dodd-Frank Act 2010, s 951
\textsuperscript{1022} ibid
\textsuperscript{1023} Bainbridge (n 105) 132.
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It can be argued, however, that the UK experience with say-on-pay has been saddled with its own problems which render it a ‘dubious choice’.

First, individualised review of compensation schemes of companies exacts a heavy cost that will probably force institutional investors to focus on a narrow range of compensation programmes that are akin to ‘a one-size-fits all’ approach. Second, because most institutional investors tend to rely on proxy advisory firms, a very minute number of Gatekeepers will end up exercising undue influence in matters of compensation. Moreover, as earlier indicated, corporate governance is path-dependent, as a result the UK’s experience cannot be transplanted whole sale to fit into the US context in view of the vast differences in institutional arrangements, societal norms and cultural practices.

4.4.4 Say on golden parachutes

Another important innovation of the Dodd-Frank Act is the introduction of the ‘golden parachute arrangement’. Under these new rules, companies are required to make additional disclosure in respect of compensation arrangements with executive officers regarding mergers, acquisition, consolidation, proposed sale or other disposition of all or substantially all assets. This requires disclosure of all agreements and understandings that have been reached between the acquiring companies, target companies and the executive officers of both entities. The shareholder approval must disclose in clear and simple terms any compensation arrangements that have been reached and should encompass the aggregate total of all such compensation that may be paid. The ‘golden parachute’ concept also applies to other transactions including, going-private transactions as well as third-party tender offers. This is to ensure that information is

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1026 ibid
1027 ibid
1029 ibid
made available to shareholders irrespective of the structure of the transaction.\textsuperscript{1030} It should be stressed, however, that the shareholder vote is not binding on a company’s board of directors and a negative vote cannot overrule any decision of the board.\textsuperscript{1031} Consequently, the Act does not change or create any fiduciary duties for the company or the board\textsuperscript{1032} even though shareholders are allowed to submit executive compensation proposals for inclusion in the company’s proxy materials.\textsuperscript{1033}

Admittedly, the provisions on say-on-pay appears to be forward looking corporate governance reforms that can help minimise the effects of future financial crisis. The say-on-pay rule, provides shareholders of public companies with a mechanism to either support or oppose a company’s pay policies and practices.\textsuperscript{1034} The expectation is that company boards and compensation committees will be inclined to consider and possibly response to the shareholder vote on executive compensation packages.\textsuperscript{1035} This, arguably, promotes transparency and accountability which would in the final analysis lead to greater efficiency, improvement in corporate governance and reduced risk.\textsuperscript{1036}

It is further argued, that with the introduction of say-on- pay under Dodd-Frank, shareholders would be in a better position to identify companies with poorly-designed pay packages and vote against them. The policy rationale is that giving shareholders a say on executive compensation packages would invariably strengthen the relationship between pay and performance, and thus, reduce the payment of excessive bonuses and incentives in the future.\textsuperscript{1037}

\textsuperscript{1030} ibid
\textsuperscript{1031} ibid
\textsuperscript{1032} ibid
\textsuperscript{1033} ibid
\textsuperscript{1035} ibid
\textsuperscript{1036} ibid
\textsuperscript{1037} Cotter \textit{et al.} (n 1014).
Moreover, it has been argued the provision on say-on-pay would result in shareholder empowerment. According to this school of thought, it would strengthen the hands of boards by enabling them to negotiate pay packages with CEOs more effectively on behalf of shareholders.\textsuperscript{1038} This is critical in view of the general consensus that unrestrained and excessive compensation packages paid to executives of public corporations have been some of the major triggers of the GFC.\textsuperscript{1039} In its Annual Report of 2010, the Bank for International Settlements (BIS) identifies excessive pay as some of the structural weaknesses pertaining to the GFC.\textsuperscript{1040} According to the Bank, apart from being grossly misaligned, the pay and incentive packages are ridiculously excessive.\textsuperscript{1041} In this respect, it is submitted that the introduction of say-on-pay which seeks to address some of these structural weaknesses is a welcome development.

\textbf{4.4.5 Recovery of Wrongly-Awarded Compensation (Claw-backs)}

Following the GFC, one issue that gained prominence is the excess payments received by executives in the form claw-backs. Fried and Shilon define claw-back as the recovery of certain payments made to executives based on financial results which turn out to be false and require a restatement.\textsuperscript{1042} To address the public outrage concerning executive compensation, section 954 of the Dodd-Frank Act specifically requires public corporations to adopt a policy that ensures the recovery from current and former executive officers any excess compensation that have been erroneously awarded.\textsuperscript{1043} The Act compels the affected firms to recover payments made to executives on

\textsuperscript{1038} ibid
\textsuperscript{1039} William Sun, Jim Stewart and David Pollard, \textit{Corporate Governance and the Global Financial Crisis: International Perspectives} (CUP 2011) 115.
\textsuperscript{1040} BIS, 80\textsuperscript{th} \textit{BIS Annual Report 2009/10} (Basel, 28 June 2010) < \url{www.bis.org/publ/arpdf/ar2010e.htm} > accessed 20 July 2015
\textsuperscript{1041} ibid
\textsuperscript{1042} Fried and Shilon (n 975).
\textsuperscript{1043} Dodd-Frank Act 2010, s 954
the basis of financial results that eventually turn out to be false and needs restatement. The ability to recoup, however, requires that two major hurdles must be overcome; namely the misconduct requirement and the restatement requirement.

Interestingly, although Dodd-Frank removes the misconduct requirements, majority (67 per cent) of S&P 500 firms with such policies do not require a claw-back in the absence of misconduct on the part of the executive. For example IBM’s 2010 claw-back policy states that the company will recoup any bonus or incentive paid to an executive under the following conditions (a) if the amount paid was based on the achievements of financial result that were subsequently the subject of restatement (b) the board determines that the officer concerned engaged in misconduct resulting in the obligation to restate and (c) lower payments would have been made to the officer based on the restated financial results. From this, it becomes obvious that IBM commits itself to recouping inflated bonus and incentives only if the misstated financial outcomes were a result of misconduct. In the absence of a stated misconduct, the executive would be permitted to get away with the excess payment.

Other companies have more stringent regimes which make it even harder to claw back excess pay. Another example is 3 M’s proxy of 2010 which adopts a policy requiring the reimbursement of excess pay if the executive’s intentional misconduct caused the need for the restatement. In effect, the recoupment of excess pay under this policy can only be triggered upon prove of intentional misconduct. Hence, a 3M executive who engages in unintentional misconduct is free to keep the excess pay.

1044 ibid
1045 ibid
1047 Fried and Shilon (n 975) 740.
1048 ibid
1049 3M, Annual Reports and Proxy Statement 2013 (24 March 2013)
1050 ibid
1051 Fried and Shilon (n 975)742.
Chapter 4

Notwithstanding these deficiencies, it may be argued that the provisions in section 954\(^{1052}\) are necessary to avoid imposing costs on the company and its shareholders.\(^{1053}\) Indeed, the receipt of excessive pay whether accidental or results from misconduct, has the effect of value diversion and value destruction.\(^{1054}\) Mintzberg goes beyond the value destruction and value diversion hypothesis and puts it rather bluntly that; ‘Executive bonuses, especially in the form of stock and option grants represent the most prominent form of legal corruption that has been undermining our large corporations and bringing down the global economy’.\(^{1055}\)

This became evident during the GFC when several brand names such as Lehman Brothers, Citigroup, Bear Sterns and Royal Bank of Scotland witnessed an unprecedented destruction of the value of those firms. Against this backdrop, it is submitted that the claw-back provision in Dodd-Frank is an important but very minor step towards addressing the problem of excessive compensation.\(^{1056}\)

It is however, doubtful whether this provision alone is enough to prevent the several instances of excessive compensation payments and the subsequent restatements witnessed prior to the GFC. Arguably, having the provision in the statute books is not an antidote because the Sarbanes-Oxley Act of 2002 which was enacted following the Enron scandal, contains similar provisions in section 304.\(^{1057}\) But that alone could not avert the excesses witnessed and the subsequent crisis that occurred in 2008.\(^{1058}\) In that respect, it is submitted that no fundamental difference exists between Sarbanes-Oxley and Dodd-Frank in terms of recovering excess

\(^{1052}\) Dodd-Frank Act, s 954


\(^{1054}\) Value diversion occurs as excessive pay reduces the amount available to the company and its shareholders while value destruction arises because the misconduct to generate the excessive pay destroys far more value than the amount of excess remu envisaged or received.


\(^{1056}\) Fried and Shilon (n 975).

\(^{1057}\) Sarbanes-Oxley Act, s 304, 15 U.S.C

\(^{1058}\) ibid

Much as this argument may have some merit, it is equally true that Dodd-Frank differs from the Sarbanes-Oxley excess executive compensation recovery provisions in two important respects.1060 First, under Dodd-Frank, each firm is required to recover excess pay/compensation while the Sarbanes-Oxley claw-back provisions can only be invoked by the Securities Exchange Commission (SEC).1061 Second, the SOX claw-back provision can be triggered only if the restatement arises from misconduct which is not the case in Dodd-Frank.1062 Clearly, the claw-back provisions in the two Acts are not the same but differ in many aspects; as such the weaknesses or limitation of SOX is not enough justification to dismiss Dodd-Frank. Indeed, the issue is not about having these well-meaning provisions on the statute books but rather the question is whether the executives and corporate boards have the will and the courage to ensure the effective implementation of the policies adopted.

Questions have also been raised regarding government’s rationale for imposing what is considered unnecessary claw-back requirements on publicly-traded companies.1063 Such mandatory policies, the argument goes, is an undesirable intrusion into the internal compensation arrangements of these firms.1064 Private ordering, they claim, will lead to better outcomes1065 pointing out that over 80 per cent of Fortune 100 firms had voluntary claw-back policies prior to the enactment of Dodd-Frank.1066 In that respect, the enactment of similar provisions under Dodd-Frank is, in effect, unnecessary and redundant.1067

1059 Fried and Shilon (n 975) 722.
1061 Sarbanes-Oxley Act 2002, s 304
1062 ibid
1063 Fried and Shilon (n 975) 723.
1064 ibid
1065 ibid
1066 ibid
While acknowledging that the claw-back requirements under Dodd-Frank represent an improvement in the compensation arrangements of public firms, there are concerns that the provisions do not go far enough.\textsuperscript{1068} The requirements in the Act fail to provide for the mandatory recovery of all types of excess pay but limited to one or two elements of a particular incentive plan.\textsuperscript{1069} Therefore, its scope of application, is to a very large extent rather restricted; a situation which makes it extremely problematic to recover excess payment made under such questionable circumstances.\textsuperscript{1070}

A vital weakness of the provision is that it is conditional and does not compel firms to recover excess pay from executives until a restatement is required.\textsuperscript{1071} In practice, the enforcement of this provision is dependent on a restatement; the absence of which renders it unenforceable and of no effect. In addition to the above defects, the Act also fails to provide for the recovery of excess payment made in respect of the sale of company stock at inflated prices arising from errors.\textsuperscript{1072} Such important omissions cast doubts on the legislative intent of congress in enacting these provision and questions whether the Act is a sincere effort to address the problem of excessive pay or a mere attempt to appease public outrage and discontent.

There are also concerns as to how the claw-back provisions would affect corporate governance practices in the way envisioned by its proponents.\textsuperscript{1073} According to Bainbridge, the Dodd-Frank claw-back policy is ‘unfairly penalizing executives’\textsuperscript{1074} describing such provisions, along with the entire Act as ‘corporate governance quackery’.\textsuperscript{1075}

\textsuperscript{1069} Fried and Shilon (n 975) 743.
\textsuperscript{1071} ibid
\textsuperscript{1072} ibid
\textsuperscript{1073} Bainbridge (n 1067) 76.
\textsuperscript{1074} ibid
\textsuperscript{1075} ibid
Apart from the inherent contradictions and lack of consistency, section 954 of the claw-back provision is over-inclusive as it covers all executive officers irrespective of their responsibility or lack thereof for the financial statement in question.\textsuperscript{1076} As a result ‘some innocent’ executives, it has been argued, would be compelled to forfeit significant amount of pay.\textsuperscript{1077} At the same time section 954 is also under-inclusive in that the definition of an executive officer is very narrow and includes the ‘president, any vice president…..in-charge of a principal business unit, division or function….., any other officer who performs a policy making functions’.\textsuperscript{1078} The Senate Banking Committee acknowledges this limitation and notes that ‘the policy therefore applies only to a very limited number of employees’.\textsuperscript{1079} Similarly, Bhagat and Romano argue that the danger with this limitation is that actions and decisions of some individual proprietary trader, who may not necessarily be an executive officer as stipulated in the Act, can nonetheless, adversely affect or even implode a firm.\textsuperscript{1080}

Beyond the self-contradictory nature of the Act, there is an added risk in terms of the unintended consequences arising from the ambiguity and the apparent lack of clarity of section 954. As Heinemann rightly observes, there are ‘many ambiguities in the legislative language which will have to be clarified by the SEC in implementing the regulation’.\textsuperscript{1081} For instance, the SEC will have to provide clarification as to whether the claw-back is to be retroactive, how to calculate the amount to be recovered and the dates during which the recovery must be sought.\textsuperscript{1082} The fear and indeed, danger is that giving the SEC the power to interpret and also regulate could possibly lead to abuse which in the end defeats the very purpose of the Act.\textsuperscript{1083}

\textsuperscript{1076}ibid
\textsuperscript{1077}ibid
\textsuperscript{1078}Dodd-Frank Act 2010, s 954
\textsuperscript{1079}Senate Banking Committee (Report No. 111-176, 2010) 135.
\textsuperscript{1080}Sanjai Bhagat and Roberta Romano, ‘Reforming Executive Compensation: Focusing and Committing to the Long-Term’ (2009)26 (2) Yale Journal on Regulation 359,366.
\textsuperscript{1081}Heinemann (n 1068)
\textsuperscript{1082}ibid
\textsuperscript{1083}ibid
A key and perhaps, the most important ambiguity in the claw-back policy relates to whether misconduct by persons other than the CEO or CFO could trigger the application of the provision.\(^\text{1084}\) This issue came up for adjudication before a federal district court in \textit{SEC v. Jenkins}.\(^\text{1085}\) In that case CSK Auto Corporation of which Mr Maynard Jenkins was the CEO was obliged to restate its financials following the discovery of massive fraud by some senior officials. Consequently, the SEC initiated legal proceeding asking the court to apply the claw-back provision to the respondent’s (Mr Jenkins) pay. In its ruling, the court agreed with the SEC stating ‘the misconduct of corporate officers, agents, or employees acting within the agency or employment is sufficient misconduct to meet the elements of the statute.’\(^\text{1086}\) Although Mr Jenkins was not charged or fund guilty of any misconduct, the SEC nonetheless, was able to invoke the claw-back provision and the Respondent’s pay was eventually clawed back.

Unsurprisingly, this decision was heavily criticised because it encompasses all executive officers without considering their level of involvement/responsibility in respect of the financial restatement in question.\(^\text{1087}\) In effect, what the Act does is to impose strict liability on executive officers in the event of a restatement. The unintended consequence arising out of this legislative misjudgement is that some innocent executives will have to forfeit a significant amount of well-deserved pay.\(^\text{1088}\)

\textbf{4.4.6 Governance of Credit Rating Agencies}

As earlier mentioned, CRAs have been widely criticised for their role in the GFC.\(^\text{1089}\) Questions have been raised concerning the quality and clarity of rating data, particularly the misaligned

\(^{1084}\) Bainbridge (n 1067) 130.
\(^{1086}\) ibid
\(^{1087}\) Bainbridge (n 105)
\(^{1089}\) ibid
incentives and the conflicts of interests which led to poor lending standards. Against this backdrop, the US congress enacted the Dodd-Frank Act containing several useful provisions that seek to reform the governance and regulation of CRAs.\textsuperscript{1090} The provisions focus largely on the structure, oversight, and liability of CRAs.\textsuperscript{1091} Consequently, Dodd-Frank specifically creates a new SEC Office of Credit Ratings to administer SEC rules, examine nationally recognised statistical rating organisations (NRSRO) and issue a report. Under this arrangement, the report is required to identify any material deficiencies and state if previous SEC recommendations have been complied with or not.

A key component of the new provision focuses on the organisational structure of the rating agencies which must have a board of directors, half of whom should be independent. The board is charged with an oversight role in respect of policies and procedures for determining ratings, compensation and promotions as well as managing conflicts of interest within the organisation. To full fill this mandate, the Act requires CRAs to adopt ‘an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit rating’.\textsuperscript{1092} Another vital governance provision is the requirement that CRAs establish procedures to determine the existence of conflict of interests in respect of persons doing the rating who later become employee of the issuer, sponsor or underwriter as the case may be.\textsuperscript{1093} The Act per this provision, empowers the SEC to revoke the registration of a CRA if it turns out that ‘sales and marketing considerations’\textsuperscript{1094} influenced the agency’s ratings.

\textsuperscript{1091} ibid
\textsuperscript{1092} Dodd-Frank Act 2010, s 932(a)
\textsuperscript{1093} Dodd-Frank Act 2010, s 932(a)(4)
\textsuperscript{1094} Dodd-Frank Act 2010, s 932(t)
4.4.7 Private Right of Action against Credit Rating Agencies

Another innovation of the Dodd-Frank is the changes it introduces in the SEC Act which makes it possible for CRAs to be held liable for their ratings. Following the GFC, it was recognised that shareholder litigation could play a vital role in reforming some of the deceptive practices associated with CRAs but for which they could not be held accountable. Consequently, Dodd-Frank repealed Rule 436(g) of the Securities Act which hitherto exempted CRAs from liability under section 11 of the Securities Act. The repeal of this exemption clause, effectively means that statements made by CRAs are subject to liability in the same manner as accountants and investment analysts under the federal securities laws. In addition to the strict liability, the Act also reduces the pleading standards in section 10(b) and Rule 10(b) 5 of the Private Securities Litigation Reform Act (PSLRA). Under the new regime, a plaintiff must plead with ‘particularity of facts giving rise to a strong inference’ that the defender acted with scienter which was not the case under the previous arrangement. The new provision only requires a Plaintiff to state the facts giving strong inference that a particular CRA knowingly and recklessly failed to exercise due diligence in the conduct of its ratings in respect of the elements relied upon and the methodology used in the evaluation process. Second, the plaintiff must demonstrate that the rating agency failed to obtain reasonable verification of such factual elements. Moreover, Dodd-Frank subjects CRAs to section 18 of the Exchange Act by holding persons liable for filing false and misleading statements with the SEC. Consequently, false and misleading ratings are now actionable under the Exchange Act. This is very significant because the absence of strict liability as obtained in the past meant that CRAs

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1096 The Securities and Exchange Act 1934, s 11
1097 ibid
1098 Private Securities Litigation Reform Act of 1995 (P.L 104-67;109)
1099 Hemraj (n 1095) 289.
1100 ibid
1101 The Securities Exchange Act 1934, s18
had no compelling reason to exercise extra caution and due diligence in issuing their ratings.\textsuperscript{1102} Against this backdrop, it is submitted that with a credible threat of liability, the new regime tends to be more effective in compelling CRAs to be more vigilant and avoid negligent and reckless practices as was the case prior to the GFC.\textsuperscript{1103}

Further, Dodd-Frank streamlines the filling process by requiring CRAs to provide comprehensive information covering performance measurement in the data over short, medium and long-term. It also includes the policies adopted, their implementation, the organisational structure and the absence or presence of code of ethics.\textsuperscript{1104} This marks a significant departure, because in the past CRAs were not subjected to such a stringent regime. Previously, CRAs had to only furnish certain information to the SEC and that was enough to be registered as a nationally recognised rating agency.\textsuperscript{1105} In this respect, it is stands to reason that the corporate governance provisions relating to CRAs represent an ambitious attempt to address one of the major triggers of the GFC. Obviously, the changes introduced by Dodd-Frank increase internal controls and provide greater procedural transparency in respect of CRAs.\textsuperscript{1106}

Admittedly, Dodd-Frank makes some positive contribution towards the regulation and governance of CRAs. But it is equally true that Dodd-Frank ultimately fails to address a fundamental problem peculiar to CRAs which contributed immensely to the crisis. The legislation either by design or omission fails to alter the ‘issuer pays’ model of rating agencies.\textsuperscript{1107} Under this model the issuers themselves are the very entities that pay for the securities to be rated. This inevitably raises issues about potential conflict of interests and

\textsuperscript{1102} Hamraj (n 1095) 291.
\textsuperscript{1103} ibid
\textsuperscript{1104} Dodd-Frank Act of 2010, s 11
\textsuperscript{1105} Dodd Frank Act of 2010, s 11(c)
\textsuperscript{1107} ibid
probably that of possible corruption. Unfortunately, Dodd-Frank does not address this issue which is at the heart of CRAs business model and central to the GFC.\textsuperscript{1108}

Also, the current credit rating system is something of a paradox and remains in the words of Schwarz, ‘one of capitalism’s strangest hybrids’.\textsuperscript{1109} Indeed, this strange arrangement has enabled profit-making entities to perform what is essentially a regulatory role.\textsuperscript{1110} The Dodd-Frank Act therefore achieves very little in addressing these inherent weaknesses in the credit rating system. Instead of a complete overhaul of the present defective system, the Act simply calls for research on the independence and alternative business model for CRAs without providing specifics as to how this is to be achieved.\textsuperscript{1111}

\textbf{4.5 An Evaluation}

Financial crisis provides an opportunity for major reforms to be undertaken as such ‘good crisis should never go waste’.\textsuperscript{1112} US financial history confirms this assertion and the passage of the Securities Act of 1933 and the Securities Exchange Act of 1934 were all in response to the Great Depression of 1929.\textsuperscript{1113} Similarly, the collapse of Enron in 2001, WorldCom in 2002 and other corporate failures prompted the passage of the Sarbanes-Oxley Act of 2002 (SOX).\textsuperscript{1114} In the same vein the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 was enacted to remedy the weaknesses in the US governance and regulatory system that triggered the recent GFC.\textsuperscript{1115}

\begin{itemize}
  \item \textsuperscript{1108} ibid
  \item \textsuperscript{1110} ibid
  \item \textsuperscript{1111} ibid
  \item \textsuperscript{1113} ibid
  \item \textsuperscript{1114} ibid
  \item \textsuperscript{1115} ibid
\end{itemize}
Obviously, Dodd-Frank is primarily concerned with addressing the challenges facing the financial system. Nonetheless, it introduces important changes that impact on corporate governance.\footnote{Hristova (n 1011) 516.} The broader question, however, is whether Dodd-Frank resolves the problem of shareholder primacy, which arguably, underpins the GFC. To answer this question requires an evaluation of the major corporate governance-related provisions in Dodd-Frank and to what extent they constitute the necessary and appropriate response. Such an evaluation forms the next section of this thesis.

The Dodd-Frank Act, arguably, represents the most sweeping change in financial regulation and how corporations are governed and controlled in the US.\footnote{Sewell Chan, Cyrus Sanati and Edward Wyatt, ‘Reform Bill Add Layers of Oversight’. New York Times (New York, 16 March 2010)} It is a legislative response which seeks to restructure the financial system, reform the governance of corporations and restore investor-confidence in the US economy.\footnote{ibid} There is no doubt that Dodd-Frank heightens prudent standards and enhances a more transparent disclosure regime capable of constraining excessive risk-taking, thereby, making the financial system more stable.\footnote{ibid} A critical look at the Act reveals however, that at best what it does is to preserve much of the existing regulatory architecture and governance system. Consequently, it is argued that Dodd-Frank would only diminish but cannot eliminate the likelihood of future crisis for the following reasons.\footnote{ibid}

First, almost all provisions of Dodd-Frank depend on other agencies and regulatory bodies for enforcements and implementation. For instance, section 971 authorizes the SEC to adopt rules permitting the use of proxy access material by shareholders.\footnote{Dodd-Frank Act 2010, s 971} This arrangement renders Dodd-Frank an imperfectly-designed Act and makes it difficult and to some extent, impossible...
to implement. A greater problem is that, it relies heavily on administrative implementation which more often can be frustrated by ‘equivocal agency rule-making, judicial hostility and timid under-enforcement regime’.\textsuperscript{1122}

This is further complicated by what Olson describes as the logic of collective action and interest group politics.\textsuperscript{1123} According to Olson, smaller, better organised groups tend to dominate larger but more diffused groups with much greater membership when it comes to influencing the implementation of legislation or regulatory policy.\textsuperscript{1124} At the stage of implementation, the more organised groups, with their huge financial resources and political influence are able to extract concessions, exemptions or outright repeal.\textsuperscript{1125} Arguably, the decision by congress to delegate the implementation to administrative bodies is a major defect which effectively enables powerful group of policy entrepreneurs to pursue an agenda that tends to undermine the efforts aimed at the effective implementation of the Act.\textsuperscript{1126} Hence, rather than idealising this legislation, it must be acknowledged that some of its reforms are flawed, inconsistent and fail to provide the remedies that would prevent future crisis.\textsuperscript{1127} Of course, like most legislations, parts of the Dodd-Frank provisions may be inconsistent, poorly designed or ill-conceived. Nonetheless, it must be recognised that in the real world, legislations will always be incomplete and imperfect and often require administrative bodies to ensure implementation.\textsuperscript{1128} It is therefore, fair to say that the Dodd-Frank Act is no exception and should therefore, not be viewed differently. The authorities in the US consistently maintain that the enactment of the Dodd-Frank Act is an attempt to contain the damage and minimise the effects of future crisis by adopting governance rules with much wider implications for both Wall Street and Main

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\textsuperscript{1122} Coffee (n 1112).
\textsuperscript{1123} Mancur Olson Jr, \textit{The Logic of Collective Action} (Harvard University Press 1965) 128.
\textsuperscript{1124} ibid
\textsuperscript{1125} ibid
\textsuperscript{1126} Coffee (n 1112).
\textsuperscript{1127} ibid
\textsuperscript{1128} ibid
\end{footnotesize}
\end{flushright}
Street corporations. In that respect, Dodd-Frank appears to be far more ambitious than previous legislations.

A critical weakness, however, is that it seeks to revise the financial regulation and governance regime in its entirety without due regard to the peculiarity of each corporate entity. As a result, the Act mistakenly adopts a ‘one size fits all’ approach to corporate governance, which analysts admit, is a serious policy flaw. This is because the corporate governance challenges facing Main Street and Wall Street companies differ significantly in terms of solutions. The business model of financial institutions often entails complex lending, underwriting arrangements and complicated investments which differ from other publicly-traded entities. Consequently, management of financial institutions are tasked with managing the risk exposure that these sophisticated transactions entail. Unfortunately, the response of Dodd-Frank to the GFC clearly shows an overreliance on the ‘one size fits all’ approach which does not address the unique governance needs of the different corporate entities.

Moreover, the GFC shifted the corporate governance game into a new playing field, created a new environment in which new players have come to prominence. Prior to the crisis, new financial instruments such as credit default swaps (CDS) and collateralised debt obligations (CDOs) were developed and marketed to the extent of ‘dwarfing the real economy’. This, inevitably, calls for a legislative measures and a governance regime capable of responding to the needs and requirements of these new financial products and the corporate entities.

\[\text{References}\]

\[\text{ibid}\]

\[\text{ibid}\]

\[\text{Coffee (n 1112).}\]


\[\text{ibid}\]

\[\text{ibid}\]

\[\text{ibid}\]

\[\text{Coffee (n 1112).}\]

\[\text{Thomas Clarke, ‘Rethinking Corporate Governance ‘in William Sun, Jim Stewart and David Pollard (eds), Corporate Governance and the Global Financial Crisis: International Perspectives (CUP 2012) 37.}\]

\[\text{ibid}\]
Dodd-Frank however, fails to provide the necessary legislative and regulatory response to the new exotic financial instruments that triggered the GFC. In that regard, Dodd-Frank is bound to achieve only minimal success because ‘the risk is that such poorly designed governance approach may make the next crisis more likely and potentially more severe’.

This is because the conditions that enabled financial innovation to outpace legislative prowess have not been addressed by the Act.

The Dodd-Frank Act, is undoubtedly a bold initiative which seeks to reform the dysfunctional corporate governance system that triggered the GFC. In adopting Dodd-Frank, congress took the view that shareholder empowerment was the preferred option to reduce agency costs and perhaps, more importantly, address the underlying cause of the GFC. It is however, unclear whether such an approach remotely appreciates and indeed, provides any answers to the fundamental cause of the GFC. As mentioned earlier, shareholder primacy considers profit maximisation for shareholders to be the primary objective of the corporation. In practice the principal sphere of the activities of corporate management is defined by their obligation to shareholders. All other responsibilities ‘are very much secondary or derivative’. Against this background, it is submitted that rather than providing solutions, the corporate governance reforms in Dodd-Frank have themselves become the problem as they tend to strengthen and empower shareholders. Although, the Act introduces some

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1138 ibid
1139 ibid
1140 ibid
1141 ibid
1142 Torres (n 811) 227.
1145 ibid
1146 Dodd-Frank Act 2010
1147 Keay (n 1144).
positive reforms, they are unlikely to mean much because of the continuous adherence to the shareholder primacy concept.\footnote{\textit{ibid}}

Viewed from another perspective, the non-binding nature of the provision regarding say-on-pay is largely driven by the attempt to protect executive compensation, high leverage and managerial discretion.\footnote{\textit{ibid}} Thus, the non-binding nature of the provision effectively makes it a ‘tooth-less bull dog’\footnote{\textit{ibid}} that can only back but cannot bite. Indeed, of what use is a legislative Act that can neither be enforced nor has any legally binding effect? In answer to this question, one can only state that the reforms reflect the reinforcement of the more shareholder-centric status quo.\footnote{\textit{ibid}} From that perspective, it is submitted that Dodd-Frank has failed to respond to and provide an antidote to a vital aspect of the corporate governance defects underlying the GFC.

A further interrogation of the Dodd-Frank Act makes very interesting and important revelation with respect to how the legislation was enacted and passed. Although the crisis erupted in 2007, it took almost three years and the collapse of major US corporations before the government could enact Dodd-Frank.\footnote{\textit{ibid}} Giving the initial ad-hoc and inconsistent responses, it may be argued that Dodd-Frank is more a belated reaction to the GFC than a genuine attempt to confront the fundamental flaws in the US corporate arrangements.\footnote{\textit{ibid}} This is not surprising because legislators and policy makers were in fact reacting \textit{ex-post} to the crisis rather than a conscious effort aimed at preventing it \textit{ex-ante}.\footnote{\textit{ibid}}

Even more troubling is the fact that Dodd-Frank was enacted following the media clamour for action driven mainly by populist anti-corporate sentiments and emotions. Of course, when

\footnotesize{\textit{ibid}}

\footnotesize{\textit{ibid}}

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\footnotesize{\textit{ibid}}

\footnotesize{\textit{ibid}}

\footnotesize{\textit{ibid}}

\footnotesize{Dibadj (n 1106).}

\footnotesize{ibid}
reform is rushed and hastily framed under intense political pressure as was the case under Dodd-Frank, two outcomes can be expected. First, the policy formulation is often frustrated by suspect policy entrepreneurs whose arguments may not necessarily be clear or helpful. Second, it discourages taking time to conduct careful cost/benefits analysis of the legislation as witnessed during the passage of the Dodd-Frank Act. Unsurprisingly, little attention was paid to the critical analysis of the underlying cause of the crisis due to the mounting pressure exerted by financial industry lobby groups. This effectively renders Dodd-Frank a rather weak legislation that merely focused on the symptoms instead of the causes of the GFC.

Apparently, vital corporate governance provisions in the Act became weakened and downsized at the implementation stage because; (a) advocates of radical corporate governance reforms had no natural allies among the major political players and (b) the high implementation cost to the financial industry led to a watered down version of the Act. For the above reasons, the profit maximising interests of the financial industry were well aligned in opposing the needed corporate governance reforms as initially envisaged by congress.

Proponents however, advocate for the need to consider the power struggle that usually characterises the passage of reform legislations. This arguably, is understandable and to some extent unavoidable in the real world where policy makers come under immense pressure to satisfy different and often competing interests. In fairness to Dodd-Frank, it is submitted that although it was an imperfectly-designed piece of legislation, it cannot be said be exceptionally unique when it comes to interest group influence and pressure politics on legislation in the US.

1155 ibid
1156 ibid
1157 ibid
1158 Coffee (n 1112).
1159 ibid
1160 Wilmarth, (n 1090).
1161 Horn (n 161).
1162 Coffee (n 1112).
Another promising corporate governance reform introduced by Dodd-Frank is contained in section 955 which specifies the structure and composition of the board of directors.\footnote{Dodd-Frank Act 2010, s 955} This provision seeks to alter board organisation and composition including requiring boards to appoint compensation, governance and audit committees made up of independent members. The new rules requiring board of directors of listed companies to be independent of management, is intended to improve corporate governance and minimises some of the risk factors that triggered the GFC. There is, however, little evidence to suggest that director independence is the solution to the ills of corporate governance.\footnote{Bainbridge (n 105).} A study conducted by MacAvoy concludes that board composition did not in any way affect firm performance and profitability.\footnote{Paul MacAvoy, Principles of Corporate Governance and Structure: Restatement and Recommendations (American Law Institute 1983) 21.} Similarly, Klein in his research found no evidence of a link between firm performance and board composition.\footnote{April Klein, ‘Firm Performance and Board Committee Structure’ (1998) 41 (1) Journal of Law & Economics 275.} Another study by Bhagat and Black in 1999 also concludes that ‘there was no convincing evidence that firms with a majority of independent directors outperform other firms’.\footnote{Sanjai Bhagat and Bernard Black, ‘The Uncertain Relationship Between Board Composition and Firm Performance’ (1999) 54 (3) The Business Lawyer 921,922.} For her part, Fairfax disputes the proposition that the appointment of independent directors leads to better corporate governance outcomes.\footnote{Lisa M. Fairfax, ‘The Uneasy Case for the Insider Director’ (2010) 96 (127) Iowa Law Review 130.} The reason, she argues, is that the definition of independence has remained ‘elusive as cognitive biases limit directors’ ability to act so as to make decisions in a manner consistent with a theoretical perception of independence’.\footnote{Ibid} Apart from the lack of empirical evidence to justify the proposition regarding director-independence, the provisions in Dodd-Frank are arguably, redundant at best.\footnote{Johnson (n 1132)58.} This is because prior to the enactment of Dodd-Frank, similar rules were already in existence in the National
Security Exchange regulations which require publicly listed companies to have independent directors. In fact, all three major exchanges namely: the New York Stock Exchange (NYSE), NASDAQ\textsuperscript{1171} and the American Stock Exchange (AMEX) had provisions requiring a majority of the board of directors of listed companies to be independent. Section 303A of the NYSE\textsuperscript{1172} Companies Manual requires listed companies to appoint only independent directors. In the same vein, section 5605(d)\textsuperscript{1173} of the NASDAQ’s listing standards require listed companies to appoint independent directors. But, the appointment of independent directors per se was not enough to avert the corporate failures involving WorldCom, Enron and the GFC from occurring.\textsuperscript{1174}

Against this backdrop, it is submitted that the Dodd-Frank provision which seeks to make the appointment of independent directors the centre piece of corporate governance reform is not only redundant but an exercise in futility. First, the appointment of independent directors is a mechanism that tends to strengthen the position of shareholders and protect their interest at the expense of other constituents. Second, the problem that led to the collapse of corporate entities in the early 2001, 2002 and 2008 goes beyond the appointment of independent directors as such these provisions cannot, by any measure, be the appropriate remedy or response to the GFC.

Moreover, the ‘fetish for independence’\textsuperscript{1175} in fact contributed to the recent GFC. Apparently, the strict adherence to conflict of interest rules as contained in the definition of independence makes it difficult for financial institutions to attract and maintain directors with the requisite expertise in that industry.\textsuperscript{1176} This lack of expertise renders such boards ineffective in performing the monitoring role that could have otherwise averted some of the questionable governance practices that triggered the GFC. In that regard, it seems fair to suggest that more

\textsuperscript{1171} NASDAQ, Listed Company Standards r. 5605 (d)
\textsuperscript{1172} NYSE, Listed Company Manual r.303A.07(a)
\textsuperscript{1173} The Glass-Steagall Act (n 229).
\textsuperscript{1174} Bainbridge (n 1067).
\textsuperscript{1175} Kirkpatrick (n 1008).
\textsuperscript{1176} ibid
expert boards would have been better placed to identify the weaknesses and challenges in the system.\footnote{1177}

### 4.6 Conclusion

The recent GFC not only revealed the dysfunctional nature of the financial system but also prompted the reconsideration of a new corporate governance approach.\footnote{1178} In responding to the threats posed by the crisis, the US government embarked on a series of actions including bank bailouts which turned out to woefully inadequate.\footnote{1179}

Realising that additional measures were required to deal with the rapidly deteriorating situation, the US authorities enacted the Economic Stimulus Act which received by-partisan support and finally became law in October 2008. This was subsequently followed by the Emergency Economic Stabilization Act 2008, the American Recovery and Investment Act 2009 and the Dodd-Frank Act of 2010, which was considered far more ambitious than previous legislations. Admittedly, Dodd-Frank governance rules tend to be much broader in application as it covers both Wall Street and Main Street public corporation. As this chapter demonstrates, Dodd-Frank provides the tools that seek to strengthen corporate governance and stabilise the financial system.\footnote{1180} In that respect, it is submitted that Dodd-Frank is very likely to have some positive impact on corporate governance in the US.\footnote{1181}

Extensive as the Act may seem, it is doubtful just how effective it has been in addressing the fundamental problem of shareholder primacy.\footnote{1182} In fact, some of the provisions in the Act seek to empower shareholders in financial and non-financial public companies. This is based on the mistaken assumption that it would enable shareholders to contain reckless managers and align

\begin{footnotesize}
\footnotetext{1177}{ibid}
\footnotetext{1178}{Torres (n 811).}
\footnotetext{1180}{Bruner (n 23).}
\footnotetext{1181}{ibid}
\footnotetext{1182}{ibid}
\end{footnotesize}
the interest of shareholders with that of managers.\textsuperscript{1183} For example the corporate governance provisions and executive compensation provisions, all of which purport to emphasise and promote transparency and accountability, are in fact emblematic of shareholder protection.\textsuperscript{1184} As Horn rightly notes, the legislative responses and governance reforms have ‘mainly aimed at increasing the information and control of shareholders over management’.\textsuperscript{1185}

Furthermore, the proxy access provisions, together with the advisory role on executive compensation constitute an empowering device for shareholders which inevitably impacts on how corporations are directed and controlled. In effect, Dodd-Frank’s provision and for that matter the other legislative measures introduced post 2008 in the US have become mechanism through which shareholder power is ‘reproduced and perpetuated’.\textsuperscript{1186} Against this backdrop, the conclusion can be drawn that the reform programmes undertaken by the US in response to the crisis have themselves become the problem rather than the solution to the underlying cause of the GFC. According to Brunner, the corporate governance reforms post 2008 are ‘an ambitious attempt to empower shareholders and give meaning to the shareholders’ claim to ownership of the company’.\textsuperscript{1187}

As has been argued throughout this thesis, the unquestioned belief in the prevailing shareholder primacy theory, with its short-termist approach is what has created the worst GFC in recent times.\textsuperscript{1188} There is, however, no indication that policy makers and legislators in the US and indeed, elsewhere have learnt any lessons. Rather, congress through various legislative measures especially in Dodd-Frank, seem determined to continue to do ‘business as usual perhaps with a few cosmetic tinkering but not fundamental reform’.\textsuperscript{1189} This is not surprising

\begin{thebibliography}{99}
\bibitem{1183} ibid
\bibitem{1184} Black (n 848) 566.
\bibitem{1185} Horn (n 161).
\bibitem{1186} ibid
\bibitem{1187} Bruner (n 23).
\bibitem{1189} ibid
\end{thebibliography}
because policy makers in the US continue to look at the crisis from the perspective of principal-agent conflict which can be resolved by aligning the interest of shareholders and managers. They tend to achieve this through governance arrangements such as independent boards, audit committees, remunerations committees, transparency and accountability, all of which tend to give practical meaning to the shareholder primacy theory. These measures are adopted in the expectation (albeit false) that they would constraint excessive risk-taking by corporate managers for short-term profits. The reality, however, remains that ‘there is little point in fixing executive short-termism if we don’t fix shareholder short-termism’.\textsuperscript{1190} In the face of these glaring defects in the reform agenda, it is submitted that the Dodd-Frank Act and the other legislations may actually make the next crisis more likely and potentially more severe.\textsuperscript{1191} Although it is impossible to predict with certainty when this will occur, one thing that is certain is that driving this reform process is the same perverse incentives, short-term management approach, market pressure for higher leverage and greater risk-taking, all in the name of maximising profits to satisfy shareholder interest.\textsuperscript{1192} In conclusion, while they provide immediate and temporary solution to the GFC, the legislative and governance reforms left intact the problem of how to deal with the issue of shareholder primacy in the long term. The reforms did not alter the pre-crisis position but tend to tilt strongly towards compelling corporate executives and board of directors to focus on satisfying shareholder interests. In view of this, it is submitted that policy makers, governments and legislatures need to reconceptualise the shareholder-centric model of corporate governance and recognise that other models with different underlying assumptions in which social values and long-term relationship get more

\begin{footnotesize}
\begin{enumerate}
\item\textsuperscript{1190} ibid
\item\textsuperscript{1191} Bainbridge (n 105).
\item\textsuperscript{1192} Coffee (n 1112).
\end{enumerate}
\end{footnotesize}
attention exist.1193 The next chapter considers how authorities in the UK responded to the crisis in terms of the legislative, regulatory and governance reforms.

1193 Rötheli (n 1189).
UK Government’s Response to the Global Financial Crisis

5.1 Introduction

As noted in the previous chapters, even though the 2008 GFC originated in the US, its effects were very severe and global. Consequently, designing an effective and relevant policy response became the number one priority of governments and policy makers around the world. Like other countries that have been similarly affected by the GFC, the UK government introduced several policy responses to prevent the financial sector from imminent collapse and curtail the downward spiral of the entire economy.

The problems of financial institutions, particularly in the banking sector had a severe impact on the country’s economic prospects, prompting immediate government intervention. These government interventions have raised questions about many of the ideas that have been advocated in the last decade regarding the self-regulating nature of the market. These ideas have turned out to be untenable and in need of revision or replacement, because as the current GFC demonstrates, financial markets do not always manage risk effectively on their own.

Following the recent GFC, scholars and policy makers have sought to debate the most effective policy tools capable of addressing the challenges posed by the GFC. Several critical issues have come to the fore in respect of the causes of the GFC and the optimum regulatory and governance responses needed to minimise or possibly prevent future occurrences.

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1194 Rötheli (n 1189).
1195 ibid
1196 Goddard et al. (n 236).
1198 ibid
Against this backdrop, section one (1) of this chapter examines the corporate governance regime in the UK prior to the crisis with the view to contextualising how and why the crisis occurred. The central argument is that the GFC has been caused not by corporate governance failures per se but by a management theory that has developed and served ‘the intellectual and moral bulwark for shareholder primacy’. This was made possible by an array of institutional arrangements including: the legal, social and political institutions which together oriented managers towards shareholder value maximisation and short-termism. Section two (2) considers the immediate and short-term fiscal policy responses initiated by the UK government and the rationale behind them. Section three (3) argues that the legislative/regulatory responses, which on the surface seem progressive, have failed to address the fundamental cause of the crisis. Apparently, most of the reforms tend to tilt strongly towards compelling corporate executives to focus on maximising shareholder value rather than on all other stakeholders. Section four (4) offers some concluding remarks and recommends that the focus should rather be on redefining the corporate purpose beyond the shareholder primacy theory which arguably, has been the underlying cause of the GFC.

5.2 Foundation of UK Corporate Governance

Corporate governance systems are often tightly coupled with path-dependent regulatory and legal traditions. It is therefore, difficult to isolate corporate governance systems from other institutional arrangements, particularly within the area of banking law, labour law and competition law. Such institutional arrangements are directly related to the way governments and firms respond to crisis, formulate business strategies and compete in the global economy.

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1199 Gerald F. Davis, Managed by the Markets (OUP 2009) 54.
1200 ibid
1201 ibid
1202 Guillen (n 56).
1203 ibid

The current UK corporate governance model emerged from a specific social, economic, ideological and law making (regulatory) tradition. It has since been under constant evolution reflecting the needs and challenges confronting companies in the process.\textsuperscript{1204} Starting from the 1980s, corporate governance in the UK has witnessed a dramatic shift from a system of managerialism to the shareholder-oriented system.\textsuperscript{1205} The market-driven approach encouraged management to further the interests of shareholders, made possible through the instruments of stock options and the maximisation of company’s share price.\textsuperscript{1206} Following the relentless emphasis on the importance of the shareholder value, the broader stakeholder concerns of the 1980s were overshadowed and relegated to the background.\textsuperscript{1207} In its place, the market-driven and growth-oriented attitudes engineered by the economic policies of Reagan and Thatcher became the dominant policy options.\textsuperscript{1208}

The drive to turn state-owned enterprises into profit-maximising entities became the justification for the outright sale and privatisation of strategically important state-owned enterprises such as Rail, Gas, Electricity and Water.\textsuperscript{1209} Advocates of the market-driven policies of the Thatcher era argue that the UK has a well-developed market with a diverse shareholder base made up of institutional investors, financial institutions and individuals.\textsuperscript{1210} Contrary to these assertions, the corporate governance regime in the early 1990s started showing signs and weaknesses associated with the separation of ownership and control of a company (the agency problem).\textsuperscript{1211} Indeed, the numerous corporate failures that characterised the late 1990s and the early part of 2000 attest to the inherent dangers and difficulties that the agency problem poses

\begin{itemize}
  \item \textsuperscript{1204} ibid
  \item \textsuperscript{1206} ibid
  \item \textsuperscript{1207} ibid
  \item \textsuperscript{1208} Tricker (n 184)21.
  \item \textsuperscript{1209} ibid
  \item \textsuperscript{1210} Malin (n 214).
  \item \textsuperscript{1211} ibid
\end{itemize}
to corporate governance. These weaknesses became evident in corporate failures such as the Polly Peck\textsuperscript{1212} Robert Maxwell Communications\textsuperscript{1213} and BCCI.\textsuperscript{1214}

The evolution and subsequent development of the next phase of corporate governance in the UK was initially, and to a large extent, driven by these corporate failures and financial scandals.\textsuperscript{1215} Indeed, the Pension Act 1995 (C.26)\textsuperscript{1216} was enacted to review and improve the governance of the Pension Scheme following the Mirror Group Pension scandal. This case highlights directors’ duty of care and further illustrates the importance of the ‘proper purpose doctrine’\textsuperscript{1217} as it applies to the powers of directors and management of companies.

Similarly, the PPI crisis was one of the main corporate failures that triggered the Cadbury Report which now forms the foundation of the modern UK corporate governance regime.\textsuperscript{1218} In response to the PPI failure, the Cadbury report recommended the separation of the roles of the chairman and the CEO and advocated for a majority of non-executive directors.\textsuperscript{1219}

As already indicated, the development of corporate governance in the UK has its roots in the work done by various committees starting with the Cadbury (1992)\textsuperscript{1220} Committee through to

\textsuperscript{1212} Polly Peck International (PPI) collapsed in 1991 following the unauthorised transfer of money from the Company’s account by the CEO Mr Asil Nadir into his private account which made it impossible for PPI to meet its debt obligations to creditors. It was put into administration in 1990

\textsuperscript{1213} The Robert Maxwell scandal involved the fraudulent misappropriation of the Mirror Group Pension Fund by the CEO of the Company Mr Robert Maxwell. The scandal was uncovered after the death of the CEO and involved an amount of £200 million out of which £100 m was paid from the public purse.

\textsuperscript{1214} The BCCI disaster arose from widespread fraud and manipulation including a massive money laundering scheme set up deliberately to avoid regulatory oversight. A Luxemburg court finally ordered BCCI to be liquidated in 1991 because it was insolvent

\textsuperscript{1215} ibid

\textsuperscript{1216} The Pension Act 1995 (C 26)


\textsuperscript{1219} ibid


Three reasons explain the UK’s continuous obsession with the light-touch and self-regulatory approach to corporate governance.\footnote{ibid} First, the ideological belief in the inherent superiority of self-regulation and the \textit{laissez- faire} economic thinking became deeply entrenched in both public and private sectors. This created a situation where effective public oversight, supervision and monitoring of financial markets were undermined.\footnote{ibid} The second reason is that due to this ideological inclination, the need for government to engage in the monitoring of these markets was relegated to the background. Consequently, most financial institutions and other corporate
entities in the UK enjoyed what Young and Thyil aptly describe as a ‘regulatory holiday’ prior to the GFC.1229

Third, the role of politics cannot be discounted because the political imperative to develop London as a major financial centre meant that political pressure could be brought to bear against intrusive legislation or regulation.1230 Indeed, the City of London had powerful political allies including the then Chancellor of the Exchequer Mr Gordon Brown to champion its cause by reaffirming the ‘light touch’ regulatory environment that London provides for both local and international businesses to grow and flourish. Asserting the success of this regulatory model, Mr Brown in his 2007 Mansion House Speech stated:

[I] have been able year by year to record how the City of London has risen by your efforts, ingenuity, and creativity to become a new world leader. Now today over 40 per cent of the world’s foreign equities are traded here, more than New York… So, in celebrating the success of the talents, innovations and achievements of the City let us look forward to working together for even greater success in the future.1231

Ironically, the Chancellor made these remarks in 2007 on the eve of the financial crisis. Just three weeks after this speech, the weaknesses of the system became apparent with the collapse and subsequent nationalisation of several renowned British financial institutions.1232 Notable among them were Northern Rock Plc, Bradford & Bingley, Royal Bank of Scotland (RBS) and Halifax Bank of Scotland (HBOS).1233

The Chancellor was not alone in demonstrating this exuberant and optimistic attitude. Both government and the business community have come to accept that allowing businesses to

1229 Young and Thyil (n 178) 365
1230 ibid
1231 Speech by the Chancellor of the Exchequer, Rt Hon. Gordon Brown MP, to Mansion House (City of London 20 June 2007)
1232 Mishkin (n 7) 57.
operate with minimal government intervention was more efficient and produce better results. This, self-regulatory approach, it has been argued, explains why London continues to attract investors globally.

On the other hand, the political appeal of hosting a major financial centre such as London without an effective regulatory framework has its own risks and challenges. Arguably, the risks created by the excesses in these financial centres often lead to the imposition of financial burdens on taxpayers as the GFC illustrates. As witnessed during the GFC, the UK government had to intervene with taxpayers’ money to rescue failed financial institutions with the justification that the survival of these systematically-important institutions was essential to maintain the stability of the financial markets.

There may be good reasons for adopting this optimistic attitude. But it is important to recognise that an effective corporate governance regime depends on the commitment of the corporate players to adhere to the appropriate governance standards and values as part the corporate culture. Just as it would be unrealistic to depend solely on the markets, it is equally important to ensure that the role of government is not reduced to a passive bystander or ‘a cheer leader on the side lines of the market place’.

Notwithstanding the preponderance of the supposedly inherent rationality of markets, some critical voices began to denounce the deregulatory movement, the laissez-faire rhetoric and the efficient market hypothesis. Minsky, Kindleberger and A liber have argued without success, that financial markets are prone to certain inherent weaknesses which make them

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1234 Mishkin (n 7).
1235 ibid
1236 ibid
1237 ibid
1238 ibid
susceptible to failures especially in times of speculative boom. According to Minsky, the over reliance on private sector bodies such as CRAs and other professional Gatekeepers as alternatives to governmental regulation creates additional problems due to possible conflict of interests. It is further argued, that the failure by CRAs and other professional Gatekeepers to undertake a critical evaluation of financial products and restraint abuses was key in triggering GFC.

It becomes apparent that the UK corporate governance model was largely influenced and shaped by an unquestioned belief in shareholder primacy with its focus on efficient market hypothesis that has been largely driven by ideological and political considerations. The self-regulatory model of corporate governance relied on companies to self-regulate using the concept of ‘comply or explain.’ The next section examines the evolution of the concept and how it has shaped corporate governance thinking and practice in the UK.

5. 3 Comply or Explain

The corporate failures of the early 1990s that were triggered by excesses on the part of corporate entities led to a loss of public confidence in the ability of these corporations to self-regulate. For many observers, the history of corporate governance and the need to regulate corporations can best be described as a contest between two opposing ideas. On the one hand, there are institutional investors, shareholders and management favouring the preservation of operational flexibility while the state on the other hand, strives to ensure public accountability of corporations. The tension between these two regulatory goals becomes obvious in the way publicly listed companies are regulated in the UK. Predictably, the UK, with its history of

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1241 ibid
1242 ibid
1245 ibid
1246 ibid
encouraging free trade and good corporate governance, adopted a self-regulatory regime which emphasises the application of principles to suit the individual and distinct circumstance of each corporate entity. As a result, the system resisted attempts by government to exercise control over corporate affairs while relying on the private regulation of such corporations through the use of codes and principles.

At the heart of this regulatory model is the Combined Code on Corporate Governance with the comply-or-explain principle as its central element. The concept was originally proposed by the Cadbury Committee set up in 1992 to examine and make proposals in respect of the financial aspects of corporate governance. The UK authorities viewed the work of the committee as a practical means of establishing a code of corporate governance while avoiding an inflexible one size fits all approach.

The Code has over the years been reviewed at regular intervals to reflect the changing circumstances and challenges of the times. For instance, the Greenbury Report of 1995 was established to identify good practice in determining directors’ remuneration and prepare a code of practice for UK public listed companies, while the Hampel Report in 1998 examined both the Cadbury and Greenbury Reports which eventually led to the setting up of the Combined Code.

Since assuming responsibility for the Combined Code, the Financial Reporting Council (FRC) has undertaken regular reviews including: the Myers Review, Vickers Report, the Higgs

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1247 FRC, *The UK Approach to Corporate Governance* (November 2006)
1250 Cadbury Report (n 1220) 15.
1252 Greenbury Report (1995) ‘A Report to Identify Best Practice in Determining Directors’ Remuneration and Prepare Code for UK Plcs’ This Committee was prompted by the Public outcry following the questionable activities of Board of Directors of British Gas in respect huge payments made to the Managing Director
Chapter 5

Review and the Turner Review. Following the adoption of the comply-or-explain model, the UK has been able to preserve a set of corporate governance norms and practices that are legally non-binding in form and relatively broad-based in substance. Because this governance model is principle-based, codes of corporate governance principles and indeed, good practices are the main determinants of board responsibilities not the rigid application of laid down rules and regulations.

Keay defines codes as ‘non-binding set of principles, standards or best practices, issued by a collective body and relating to the internal governance of corporations’. Under this arrangement, companies are required to demonstrate compliance with the governance principles as specified in the code or explain why they have not done so. This explains why the model is referred to as comply-or-explain. Self-regulation remains the underlying principle while compliance is voluntary. The model is characterised by the ease and regularity with which these reviews are carried out and underscores the flexibility of this approach. Arguably, this flexibility would have been impossible if a statutory approach had been adopted. This is because finding the legislative time to amend statutory provisions is often very difficult and time consuming. There is also a greater risk that political considerations often exert undue influence particularly, when the proposed changes involve high profile issues affecting powerful interests.

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1253 FRC, The UK Approach to Corporate Governance (London, November 2010)
1254 Tricker (n 184) 155.
1255 ibid
1256 Andrew Keay, ‘Comply-or-Explain in Corporate Governance Codes: In need of Greater Regulatory Oversight?’ (2014) 32 (2) Legal Studies 279.
1257 ibid
1258 ibid
1259 Anthony Hilton, ‘Grudging Acquiescence in Comply or Explain: 20th Anniversary of the UK Corporate Governance Code’ (FRC, December 2012)
<www.frc.org.uk/getattachment/06870154-78a0-44f5-a1c5-48b42f860049/FRC-Essays_comply_or-explain.pdf> accessed 11 June 2015
1260 ibid
The principle of comply-or-explain pioneered by the original Cadbury Code in 1992 has developed certain features and characteristics that distinguish it from other governance models. First, although the code insists on voluntary compliance with certain norms and practices, it is also backed by a mandatory disclosure regime as contained in the UK Listing Rules. These rules encourage all registered companies in the UK to comply with the provisions of the code covering important governance issues relating to the board of directors, non-executive directors, executive directors, reporting and controls. Presently, the code contains more than 50 provisions and gives over 110 instances of guidelines for companies. Yet such companies are not required by law to comply with these provisions, as a result, companies can ignore them provided they are able to explain the non-compliance.

Secondly, the provisions emanating from the comply-or-explain principle have now become the central features of the corporate governance system in the UK. Examples include: the separation of the roles of the chairman and the Chief Executive Officer (CEO), the appointment of a senior independent director, the nomination of remuneration committees among others. All these evolved from, and have, in fact, become entrenched in UK corporate governance thinking and practice following the advent of the comply-or-explain concept.

A third crucial feature of comply-or-explain is that the rationale is not simply about having no requirements. Rather, this approach recognises that alternative to the provision is justified so long as it achieves the goal of good governance and companies can demonstrate transparency. As the FRC notes, departures from the code provision do not constitute or

\begin{flushleft}
\footnotesize
1261 ibid
1262 Hilton (n 1259) 23.
1263 ibid
1264 Keay (n 1256) 279.
1265 Seidi et al. (n 1249) 92.
1266 ibid
1267 ibid
\end{flushleft}
presumed to be breaches because the accompanying explanation should provide some insights into the reasons and justification for the non-compliance.

Finally, the concept of comply-or-explain is not applied in isolation, but often used alongside other approaches and co-exists with codes and principles that need to be applied in all circumstances. Accordingly, UK Company law contains provisions regarding certain aspects of corporate governance. For instance, section 172 (1) of the Companies Act 2006 sets out the duties of the directors by stating ‘a director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole’. 1268

The purpose of all governance codes, whether they apply comply-or-explain principle or not, is to promote good governance. 1269 The same is true for all corporate governance legislations and regulations. It is, therefore not enough to claim that the benefits of the concept lie in its ability to promote good governance. 1270 Following this line of reasoning, it can be argued that the justification for comply-or-explain should be premised on the specific advantages it has over alternative governance models.

The strength of the UK corporate governance regime stems from its constant evolution which arguably, can be attributed to the concept of comply-or-explain. 1271 This flexibility, arguably, allows companies to choose between complying with the principles and explaining why they cannot and thus, underscores the robustness and adaptability of the model. 1272 As Seidi et al argue, the concept emphasises the possibility of deviation from what they describe as situation-specific reasons such as company size and structure. 1273 Thus, it avoids blind compliance with

1268 The Companies Act 2006, s172(1)
1269 Moore (n 1244) 89.
1270 ibid
1272 ibid
1273 Seidi et al (n 1249) 94.
the code without taking cognisance of the peculiar needs and circumstances of the company in question.\textsuperscript{1274} The merits of such a flexible approach are thought to lie in its ability to encourage companies to comply with the spirit of the code rather than the letter.\textsuperscript{1275} Indeed, the Hampel Committee which reviewed the Cadbury and Greenbury Reports, stresses that: ‘Good corporate governance is not just a matter of prescribing particular and complying with a number of hard and fast rules. There is the need for broad principles. All concerned should then apply these flexibly and with common sense to the varying circumstances of individual companies’.\textsuperscript{1276}

Advocates of comply-or-explain, opine that because companies operate in a rapidly changing environment, the model avoids ideologically fixed rules. Instead, it takes into account the concerns of other cultures, the different constituents and other choices, hence, the need for flexibility.\textsuperscript{1277} It is further argued, that the model dismisses passionate ideologies and opts for the adoption of a corporate governance regime that will shape the governance environment compatible with social values that may not necessarily fit all companies at all times.\textsuperscript{1278} In this context, it is submitted that the flexibility associated with the UK corporate governance model has driven innovation particularly, in the development of board evaluation and in the area of the separation of the position of the chairman from that of the CEO.

Moreover, the concept of comply-or-explain has been recognised as a pragmatic corporate governance tool in the UK, as obtains in the business judgement rule which states that directors cannot be held liable so long as they act in good faith without clear malfeasance.\textsuperscript{1279} Judges in the UK have affirmed this doctrine which virtually allows directors to enjoy unfettered discretion to determine the corporation’s goals. In \textit{Sheffield and South Yorkshire Permanent}

\textsuperscript{1274} Moore (n 1244) 88.
\textsuperscript{1275} Seidi \textit{et al.} (n 1249) 95.
\textsuperscript{1277} ibid
\textsuperscript{1278} ibid
\textsuperscript{1279} ibid
Building Society v. Aizlewood, the court ruled that: ‘Directors are not trustees in the ordinary sense of the word but are commercial men managing a business for the benefit of themselves and other members. Absent an abuse of discretion, their judgement will be respected by the courts’.  

Proponents insist that the flexibility it provides has brought remarkable improvement in corporate governance without the need for the often inflexible, sometimes burdensome and needless rules, laws or regulations. This flexible approach that characterises comply-or-explain, enhances business efficacy, according to its proponents.

Critics counter-argue that the doctrine gives corporate executives too much discretion, which is potentially dangerous, as almost every decision can be justified because it benefits or protects the interests of the corporation. Hence, the proposition that the comply-or-explain concept enhances business efficacy appears largely inaccurate and unpersuasive upon closer examination.

Apparently, an initiative that began as a response to corporate failures in the UK during the 1990s, has become a global phenomenon. Over 32 countries across the world have adopted the comply-or-explain concept albeit with slight variations to suit local circumstances. International organisations including the EU and the OECD have also adopted some of the principles and ideas espoused by the comply-or-explain concept. The universal appeal of the concept can be explained by the flexibility it encourages, the adaptability it provides and the innovation it promotes.

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1280 Sheffield and South Yorkshire Permanent Building Society v. Aizlewood [1890] 44 CL.D.412
1281 Moore (n 1244) 88.
1282 ibid
1284 Seidi et al. (n 1249) 96.
1285 ibid
The principle of comply-or-explain has generally received positive acclamation in the UK over the past three decades. But serious questions remain as to whether the central premise of the flexibility and the purported capacity to ensure ‘the efficient balance of flexibility and innovation has been achieved in practice’.1286 Four key weaknesses and limitations of the concept have been identified including: (a) poor explanations (b) limited shareholder engagement (c) differences of opinions between management and shareholders (d) different views as to the right approach.1287

A major weakness of the comply-or-explain concept is the inadequacy of the explanations that are often offered. Research by Seidi et al. of 257 listed companies in the UK regarding their compliance and explanations offered for the deviation only goes to confirm this position.1288 The study reveals that a significant number of the explanations analysed were either not justified1289 or were justified based on principled objection.1290 The research also found that 20 per cent of the companies studied failed to offer any explanation for their non-compliance. Even more disturbing is the revelation that the companies that did not comply but claimed to have done so ‘did not do a good job in providing explanation’.1291

The most likely reasons for these failures are twofold. First, either the shareholders did not attach much importance to the explanations or they were content with them.1292 The conclusion that can be drawn is that companies do not use comply-or-explain to fine tune1293 their governance arrangement, hence the argument that the comply-or-explain principle contributes

1287 Keay (n 1256) 282.
1288 Seidi et al (n 1249)69.
1289 Explanation for non-compliance (deviation) are simply not disclosed
1290 Objections based on inappropriate code provisions or where the provision fails to embody best practice.
1292 ibid
1293 ibid
to good and effective management of corporation seems suspect. Second, without adequate explanation in the event of non-compliance, it becomes difficult to ascertain if the deviation is justified. Against this backdrop, it is submitted that when applying the principles of comply-or-complain, it is important to emphasis the quality of the explanations provided.

Another defect of comply-or-explain is that it is overly subjective. This level of discretion enables directors to comply with what they deem appropriate and necessary and only give reasons for non-compliance. Consequently, a lot depends on the discretion of the board, which is understandable to some extent since the board requires some level of independence in the exercise of its authority. The danger, however, is that because management determines the explanation to be given, accountability is to a large extent compromised. The reason being that the adequacy, or otherwise, of an explanation is purely discretionary and highly subjective. Also, the lack of a prescriptive definition against which the code may be applied, implemented and enforced raises questions about the viability of the code to constitute an effective corporate governance mechanism.

Furthermore, the complain-or-explain principle is explicitly founded on shareholder primacy and relies on shareholders and private regulation for enforcement. The challenge, however, is that the dispersed ownership structure in the UK constitutes a major hindrance that makes it difficult for shareholders to play this enforcement role. This stems from the limited

1294 ibid
1296 Keay (1256).
1298 Keay (n 1256).
1299 ibid
1300 ibid
monitoring role of shareholders as evidenced by coordinating problems, monitoring costs and the different incentives for intervention.\textsuperscript{1302} Consequently, it is doubtful whether the capacity to ensure innovation can in reality be achieved through comply-or-explain.\textsuperscript{1303}

Moreover, because comply-or-explain is founded on the principle of shareholder primacy and private regulation of corporations,\textsuperscript{1304} it is effectively a subtle mechanism for the perpetuation of shareholder primacy. This explains why the concept is often described as the ‘hand maiden’ of light-touch regulatory approach that has been allowed to overshadow clear rules that can be enforced with no exception.\textsuperscript{1305} Obviously, a corporate governance strategy based totally on persuasion as pertains under comply-or-explain failed to work because it has been exploited by companies based on ‘economic rationality’.\textsuperscript{1306} Despite these obvious weaknesses, the UK remains wedded to the concept, as a result of which firms have been allowed to self-regulate in conformity with political preferences supported by economic theories developed in the 1960s and 1970s- notably the efficient market hypothesis.\textsuperscript{1307}

As earlier explained in this chapter, governance practices are mediated by domestic politics, economic theories and ideological leanings among other factors.\textsuperscript{1308} In that respect, it is submitted that the UK corporate governance model (comply-or-explain) emerged from specific economic beliefs, political tradition and legal and regulatory environment.\textsuperscript{1309} It is therefore, not surprising that the corporate governance reforms witnessed in the UK post the 2008 GFC are replete with evidence of how domestic political, economic and passionate ideological


\textsuperscript{1303} Moore (n 1244).

\textsuperscript{1304} ibid

\textsuperscript{1305} ibid

\textsuperscript{1306} Moore (n 1244) 94.

\textsuperscript{1307} Keay (n 1256) 86.

\textsuperscript{1308} Guillen (n 56).

\textsuperscript{1309} ibid
considerations have shaped the responses and the eventual outcomes.\textsuperscript{1310} This reflects the path-dependent nature of corporate governance models based on social power relations that are inherently shareholder-oriented.\textsuperscript{1311} The next section examines the salient policy and regulatory measures undertaken by the UK government in response to the crisis.

In responding to the GFC no single means of intervention is likely to succeed.\textsuperscript{1312} Indeed, containing a crisis of this magnitude inevitably requires an equally complex and multifaceted approach and response in view of its severity.\textsuperscript{1313} As Leaven and Valencia admit, ‘there has been very little agreement on what constitutes best practice or even good practice\textsuperscript{1314} vis-a-vis addressing the challenges posed by the crisis. Within the context of heightened uncertainty about the financial sector and the larger economy, the UK authorities were expected, and indeed required, to initiate policy responses and remedies that would be most effective.\textsuperscript{1315} In trying to find the appropriate response, the U.K government was confronted with several pertinent questions such as:

(a) How quick and aggressive should the policy actions be?

(b) How much weight should government place on macroeconomic and financial sector policies?

(c) What specific form should the responses take in view of the legal, political, economic and other constraints?

\textsuperscript{1310} ibid
\textsuperscript{1311} Fligstein and Freeland (n 59).
\textsuperscript{1312} ibid
\textsuperscript{1313} ibid
Thus, designing an efficient and effective policy response to the crisis became the preoccupation of policy makers in the UK, notably the FSA, BoE and the Treasury Department. These three bodies were established to manage, supervise and regulate economic and financial activities in the UK under a tripartite arrangement introduced through the Memorandum of Understanding (MoU) in 1997 and later revised in 2006. The individual authorities collectively contribute to the financial stability of the UK by playing their respective roles and fulfilling their responsibilities. Accordingly, the Treasury is responsible for the structure of legislation, regulation and oversight of the financial system while the BoE is charged with three crucial but closely related roles that include: (a) ensuring financial stability through its monetary policy function, (b) monitoring the payments system, and (c) providing emergency liquidity support. The role of the FSA is that of a regulator, and it does so by monitoring and supervising the financial institutions.

5.4 Policy Responses

In responding to the GFC, the UK government employed a combination of measures including both private and public, first to contain it and second to restore confidence in the market. As Singh rightly observes, ‘the ultimate goal of the wide-ranging central bank and government intervention was to address the fragility of the banking system and restore confidence in the financial market’. The measures introduced to support the Banking industry in the face of declining public and investor confidence include: Blanket Guarantees, Recapitalisation (Rescue Package), Special Liquidity Scheme (SPS), Assets Protection Scheme (APS) and the setting up

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1316 ibid
1317 ibid
1318 ibid
1319 ibid
1320 ibid
of the United Kingdom Financial Investment Limited (UKFI). These reforms went beyond the use of emergency liquidity assistance that the BoE provided to Northern Rock at the onset of the GFC.

Apart from the fiscal and financial measures, the UK authorities also embarked on some important legislative and policy initiatives aimed at tackling the loss of confidence in the financial system. These are: The Turner Review, the Walker Review and the Banking Act 2009. This section now examines each of these measures to ascertain whether and to what extent they individually or collectively address the underlying cause of the GFC.

5.4.1 Blanket Guarantees

A critical challenge that confronted the UK Authorities following the GFC, particularly after the run on Northern Rock, was how to stabilize the financial system and minimise further damage to the real economy. First, the UK authorities adopted a piecemeal approach that focused on conventional policy initiatives and ad hoc interventions including blanket guarantees. A blanket guarantee is the explicit government guarantee on all, or a substantial fraction of bank liabilities. Typically, it covers both deposits as well as non-deposit liabilities and can either be firm-specific or applied system wide. In the case of the UK, the blanket guarantee facility was extended to only specific institutions notably Northern Rock, RBS, and HBOS that were about to collapse following the GFC. Thus, the UK Authorities’ first

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1324 ibid
1325 ibid
1328 Laeven and Valencia (n 1326) 221.
1329 ibid
1330 ibid
response was to announce a blanket guarantee which would in the short-term, help contain the effects of the crisis and also prevent a further deterioration.\textsuperscript{1331} To ensure the stability of the banking sector and avoid a longer recession, a £250 billion debt guarantee scheme was introduced to support banks facing liquidity problems.\textsuperscript{1332} In addition, government also increased the threshold of deposit insurance from £ 35,000 to £50,000 as part of the measures to encourage inter-bank lending and stimulate the economy.\textsuperscript{1333}

The blanket guarantee programme has been hailed in government circles as a timely policy intervention that has provided considerable support for the UK banking industry by bringing some order and relief to the retail and wholesale banking sectors at a very critical period.\textsuperscript{1334} The benefits, according to this school of thought, lie in the impact it has on public confidence as it eliminates the incentive to withdraw deposits.\textsuperscript{1335} Indeed, a successful blanket guarantee reduces runs on banks as deposit withdrawal subsides and liquidity pressure on banks decreases.\textsuperscript{1336} In their study of bank behaviour in the EU, Gropp and Visalia conclude that blanket guarantee can in fact reduce banks’ incentive to engage in excessive risk-taking.\textsuperscript{1337} Arguably, such government guarantee, accompanied by close monitoring and supervision invariably reduces the level of excessive risk-taking behaviour associated with the pre-crisis era in the UK.\textsuperscript{1338}

It is further argued that blanket guarantee provides the trust and confidence required to avoid future runs and thus, benefits the entire economy. Evidence suggests that blanket guarantee can

\begin{footnotes}
\item \textsuperscript{1331} ibid
\item \textsuperscript{1332} ibid
\item \textsuperscript{1333} ibid
\item \textsuperscript{1334} Singh (n 1321) 906.
\item \textsuperscript{1335} ibid
\item \textsuperscript{1336} ibid
\item \textsuperscript{1337} Reint Gropp and Jukka Vesala, ‘Deposit Insurance, Moral Hazard and Market Monitoring’ (2004) 8 (4) Review of Finance 571
\end{footnotes}
be effective in slowing down the deterioration in public confidence often associated with financial crisis. This is because the introduction of that facility tends to assure depositors that government will come to the assistance of banks experiencing liquidity problems.\textsuperscript{1339} For instance, the runs on Northern Rock and the subsequent effect on the UK banking sector was due to lack of public trust and confidence in the bank to meet its financial obligations.\textsuperscript{1340} The caveat, however, is that the effectiveness of such a policy depends on the credibility of the guarantee.\textsuperscript{1341}

The perceived benefits of and justification for the blanket guarantee has not gone unchallenged. The measure has, however, been criticised in many quarters as inappropriate and inadequate policy response in view of the gravity of the GFC. According to Kane and Kliengebiel, blanket guarantees have often been unsuccessful in improving public confidence during crisis.\textsuperscript{1342} A study by Demirgüc and Detragiache confirms this proposition. From their study of 61 countries in the period spanning from 1980-1987, they conclude that contrary to popular perception, blanket guarantees actually increase risk-taking incentives and consequently compound the likelihood of further banking crisis.\textsuperscript{1343} Similarly, Duan\textit{ et al} posit that the establishment of guarantees in the UK has led to ‘bank risk-shifting behaviour’.\textsuperscript{1344} In this scenario, banks are incentivised to engage in more risky business practices as more generous blanket guarantees create bigger incentives for such banks to shift their risks to the guarantor/issuer.\textsuperscript{1345}

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From the policy perspective, it can be argued that rather than helping to address or resolve the GFC, blanket guarantees have in fact led to a substantial increase in the fiscal cost of the crisis. A greater proportion of the fiscal costs stems from the fact that the measure was introduced after liquidity support had almost reached the point of exhaustion, as a result, fiscal costs tend to be higher. Apart from the higher fiscal cost implications, blanket guarantees also create a potential moral hazard because banks that have been given such guarantees often develop a tendency where they no longer feel disciplined by depositors to avoid excessive risk-taking. Moreover, once granted this facility, it often becomes attractive for such banks to engage in risky activities. In this regard, it is submitted that rather than reducing risks, blanket guarantees rather encourage and perpetuate higher risk-taking behaviour that has the potential to trigger yet another crisis.

5.4.2 Recapitalisation

Recapitalisation is an important policy measure used in the resolution phase of a financial crisis to restore sanity in the banking industry. This became one of the major policy tools employed by governments forced to bail out financial institution so as to avoid further economic deterioration. Recapitalisation, therefore, become a strategic option adopted by the UK authorities to manage the crisis, restore the solvency of the banking system and to enable a return to profitability in the shortest possible time. In the process of recapitalising the banks, the UK authorities first made an initial capital injection of £37 Billion to ensure the stability of banks and avoid a long recession. This, was followed by a special £ 200 Billion liquidity facility, purposely to enable the banks to start

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1346 Laeven and Valencia (n 1314).
1348 ibid
1349 Edwald Engelen et al. After the Great Complacence (OUP 2011) 49.
lending again. Although, the government’s response to the crisis through the capitalisation process was considered appropriate, the participating banks were unable to take advantage of the facility.\textsuperscript{1350} In fact, the participating banks, notably, RBS, HBOS and Lloyd TSB, failed to recapitalise through the private sector due to lack of investor-confidence.\textsuperscript{1351} As a result, government was compelled to intervene by acquiring 58 per cent stake in RBS and 43 per cent in Lloyd TSB.\textsuperscript{1352}

First, the UK authorities argue that public recapitalisation of banks are designed to prevent bank failure, a breakdown of the financial system, bank runs and loss of confidence.\textsuperscript{1353} Secondly, UK authorities maintain that, but for the timely intervention through recapitalisation, economic stagnation would have continued much longer than it did during the GFC. Third, proponents contend that failure to embark on recapitalisation would have put the UK economy at a much greater risk and the associated distress. Moreover, supporters of the recapitalisation scheme maintain that such public intervention tend to align banks’ incentives in terms of risk. This is largely because such policy interventions allow government increased regulatory oversight and more stringent monitoring of the rescued banks.\textsuperscript{1354} Lastly, authorities in the UK argue that unlike in earlier crisis situations, the recapitalisation programme in the 2008 crisis have been implemented much faster than in the past.\textsuperscript{1355} Overall, the recapitalisation of UK banks during the GFC, it may be argued, has been successful in saving the banks and the economy and to a very large extent helped to avoid further job losses.\textsuperscript{1356}

\textsuperscript{1350} ibid
\textsuperscript{1351} ibid
\textsuperscript{1352} ibid
\textsuperscript{1353} Michael Brei and Blaise Gadanecz, ‘Public Recapitalization and Bank Risk: Evidence from Loan Spreads and Leverage’ (BIS Working Papers No. 383, July 2012) <\url{www.bis.org/publ/work383.pdf}> accessed 30 August 2015
\textsuperscript{1354} ibid
\textsuperscript{1355} Laeven and Valenca (n 1314).
\textsuperscript{1356} Torres (n 811) 231.
It is however, doubtful whether the stated aim of recapitalization - which is to make the system safer has been achieved. The contrary has happened as, Brei and Gadabecz reveal in their study of 40 rescued-banks and 47 non-rescued banks between 2006 and 2010. They conclude that there was ‘significantly more risk in the loan books of rescued banks than of non-rescued banks before, during and after the crisis ’. Moreover, empirical studies undertaken to investigate the link between government support in the form of recapitalisation and bank risk also point to a direct correlation. Arguably, the expectation of financial support in the event of a crisis has an adverse influence on banks’ incentive to take more risk. Often, the justification for granting this support is premised on the institution’s systemic importance or its likely adverse impact on the functioning of the system as a whole. Merton describes this concept as ‘adverse incentives’ which refers to a situation where banks are not penalised for taking increased risk but are in fact encouraged to take higher risk with the expectation of getting support in times of difficulties.

Apparently, the evidence presented by these researchers seems to undermine the effectiveness of recapitalization as a means of achieving a safe banking system. The study reveals that banks that were later rescued during the crisis took on higher risk ex-ante than non-rescued banks. Unsurprisingly, rescued banks’ lending behaviour was much riskier than non-rescued banks.

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1357 ibid
1358 Brei and Gadanez (n 1353) 11.
1361 ibid
1364 ibid
In effect, the recapitalisation programme created a situation which allowed some banks to consciously take advantage of the implicit bail-out policy of the UK government.\textsuperscript{1365}

Bank recapitalisation, as a policy intervention, whether it is system-wide or targeted, comes with an associated distortionary effect.\textsuperscript{1366} The distortion stems from the fact that it signals the authorities’ willingness to accommodate excessive risk-taking by the banks which eventually reduces the credibility of regulators in the future.\textsuperscript{1367} It not only signals the authorities’ willingness to accommodate excesses in risk-taking but that such authorities cannot realistically commit to not supporting these banks in the face of an impending failure.\textsuperscript{1368} In view of this, the recapitalisation programme adopted by the UK authorities is effectively, a form of disguised subsidy contrary to what proponents of the efficient market hypothesis have been propagating for some time now. Arguably, the overall effect of this policy intervention is largely ambiguous and highly suspicious because such a policy tends to encourage some of the very practices that triggered the GFC.

5.4.3 Assets Purchase

In the early part of 2009, the UK government became concerned that despite the introduction of blank guarantees and recapitalisation measures, the economy still looked unlikely to record any significant recovery. It became obvious that the policy measures in place were insufficient to revive the ailing UK economy.\textsuperscript{1369} Thus, the BoE and the Treasury opted for other policy

\textsuperscript{1365} ibid
\textsuperscript{1368} Hakenes and Schnabel (n 1360).
interventions leading to the introduction of the Asset Purchase Facility (APF)\textsuperscript{1370} - a new policy designed to stimulate the economy.\textsuperscript{1371}

Driving this policy was the unwillingness of investors to retain such assets because of the low interest yield they provide following the GFC.\textsuperscript{1372} This is because under the current circumstances, investors prefer to reinvest in other assets such as corporate bonds and shares.\textsuperscript{1373} As a result, a total of £375 billion was spent on the Asset Purchase Facility in three tranches.\textsuperscript{1374} The first purchase of £200 billion worth of assets took place between March and November 2009.\textsuperscript{1375} A further £75 billion in October 2011, £50 billion in July 2012 and £50 billion in February 2013 were purchased.\textsuperscript{1376} These were spread over several months and across bonds of different maturity so as to avoid any distortionary effect in the market.\textsuperscript{1377}

The aim of the Asset Purchase Facility is to inject money into the economy to boost spending, achieve the projected 2 per cent inflation target and stabilize the economy. The policy objective is the expectation that sellers of the assets, including commercial banks would be more inclined to use the cash received to create loans. At the same time, the purchase of significant amounts of traded bonds is expected to lead to a reduction in average loan costs and make it easier and cheaper for companies to access credit.\textsuperscript{1378} In that respect, the £ 375 billion allocated to the asset purchase facility represents a significant injection of liquidity designed to stimulate borrowing, increase confidence and thus generate economic activity.\textsuperscript{1379} A BoE report reveals that the first

\begin{flushleft}
\textsuperscript{1370} Colin Sherwood ‘Schemes Struggle as Bond Yield Falls’ (2013) 311 Occupational Pensions 8.
\textsuperscript{1371} ibid
\textsuperscript{1372} ibid
\textsuperscript{1373} ibid
\textsuperscript{1375} ibid
\textsuperscript{1376} ibid
\textsuperscript{1377} ibid
\end{flushleft}
£200 billion asset purchase boosted the level of economic activity from 1.5 per cent to 2 per cent,\textsuperscript{1380} which ‘suggests that in the absence of the asset purchase programme, the UK recession would have been even deeper’.\textsuperscript{1381}

A counter argument is that the Asset Purchase Programme has negatively affected savers and pensions while the benefits of the programme to the wider economy are doubtful.\textsuperscript{1382} For instance, the National Association of Pension Funds (NAPF) points out that pension funds are deeper in red than ever, following the introduction of the asset purchase programme.\textsuperscript{1383} According to the NAPF, this has forced businesses to divert resources from job creation and investment into filling the shortfalls in their pension funds.\textsuperscript{1384} NAPF insists that pension funds would prefer a stronger economy and are in principle not against the APP adding ‘we would like to see more evidence that it is working’.\textsuperscript{1385}

There are also concerns that the BoE does not seem to have an exit strategy, which has understandably, created uncertainty as to when the programme will finally come to an end.\textsuperscript{1386} The worry is that the greater the asset purchase facility becomes, the harder it will be to exit.\textsuperscript{1387} In view of the dangers associated with the APP it has been argued that the programme has not achieved much by way of addressing the causes of the GFC but merely deferring the crisis.\textsuperscript{1388} Clearly, the APP is more concerned with protecting the interest of financial institutions and their shareholders in view of its obsession with the value maximising principles underlying corporate governance in the UK.

\begin{flushright}
\textsuperscript{1380} ibid
\textsuperscript{1381} ibid
\textsuperscript{1382} ibid
\textsuperscript{1383} ibid
\textsuperscript{1384} Sherwood (n 1370).
\textsuperscript{1385} ibid
\textsuperscript{1388} ibid
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5.4.4 Nationalisation

The mortgage delinquencies\textsuperscript{1389} and the subsequent crisis that emerged in the US quickly spread to UK with Northern Rock as the first casualty.\textsuperscript{1390} Consequently, Northern Rock sought and obtained emergency financial support from the BoE.\textsuperscript{1391} This measure was however, not enough to stop the panic-stricken customers from withdrawing their savings estimated to be over £1 billion over a period of three days.\textsuperscript{1392} To stem the panic, the UK government further announced a full guarantee of depositors’ saving under a new deposit guarantee scheme which eliminated a provision whereby only 90 per cent of an amount between £2000 and £35,000 was guaranteed. The new scheme provided a 100 per cent guarantee and increased the threshold to £50,000.\textsuperscript{1393} Having exhausted all options without success, government on the advice of the FSA, nationalised Northern Rock on February 2008 and insists the bank was still solvent.\textsuperscript{1394} Justifying the government position, the Chancellor of the Exchequer explained that the bank will go into ‘a period of public ownership’\textsuperscript{1395} but ‘as a bank on commercial basis with complete autonomy for their decisions’.\textsuperscript{1396} According to the Chancellor, the government had three objectives for nationalising Northern Rock. The first, is to ensure financial stability under the prevailing circumstances where serious risk exists which could destabilise parts and possibly

\textsuperscript{1389} The situation where borrowers of home loans failed to make payments as required in the loan document. Failure to make payment on the mortgage within the stipulated time leads to foreclosure. This was what occurred in the US subprime mortgage market when defaults began to rise as people were unable to finance their mortgages due to the astronomical rise in house prices which later saw a dramatic decrease in the property prices.
\textsuperscript{1390} Goddard \textit{et al.} (n 236) 279.
\textsuperscript{1392} Sherwood (n 1370).
\textsuperscript{1393} ibid
\textsuperscript{1395} ‘Chancellor’s statement on Northern Rock,’ Northern Rock to go into Public Ownership’ \textit{The Guardian} (London, 17 February 2008) \texttt{<www.theguardian.com/business/2008/feb/17/northernrock.banking>} accessed 27 September 2015
\textsuperscript{1396} ibid
the entire banking system in the UK. Accordingly, government intervention was right and necessary in view of the urgency of the situation and the need to preserve financial stability in the face of the GFC. Second, the intervention albeit unconventional, underscores government’s attempt to safeguard depositors’ money by instituting guarantee arrangements that can also restore confidence in the banking sector. The third objective is to protect the interests of the tax payer because ‘under public ownership the government will secure the entire proceeds from the future sale of the business in return for bearing the risks in this period of market uncertainty’. A report by the House of Commons Public Accounts Committee supports this proposition. After a comprehensive analysis of the options available, the report concludes that public ownership represents the best alternative. This rather positive and optimistic portrayal of the nationalisation programme later turned out to be unfounded and to some extent misleading as the subsequent discussion demonstrates.

Following the arguments favouring nationalisation, the House of Commons proceeded to enact the Banking (Special Provisions) Act that nationalised Northern Rock on 22 February 2008. The Northern Rock Transfer Order was also made the same day and came into force that very day after it had received the Royal Assent. It is important to note that in 2010 the bank was split up into Northern Rock Plc to engage in retail banking and Northern Rock Asset Management (NRAM) to handle the bad debts.

As already indicated, one major criticism against the nationalisation was that the bank’s initial plan approved by the Treasury was over-optimistic especially on future changes in property

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1397 ibid
1398 ibid
1399 ibid
1400 ibid
1401 HCTC Report (30 March 2009)
1402 Sherwood (n 1370).
1403 In view of the urgency of the matter, the order did not conform to the 21 days, notice requirement before new instruments came force.
1404 Robert Peston, ‘Northern Rock Sold to Virgin Money’ BBC News (London, 17 November 2011)
prices.\textsuperscript{1405} This becomes more evident when compared to the publicly-available forecasts and figures at the time.\textsuperscript{1406} For instance the reported losses for the six months to the end of June was £585 Million which is £314 Million more than what has been projected and presented to the Treasury for approval.\textsuperscript{1407}

The nationalisation is further criticised because at the time of implementation, the Treasury knew very little about what it was taking on.\textsuperscript{1408} Indeed, the House of Commons Committee on Public Accounts notes that in nationalising Northern Rock, the Treasury was taking on huge risks on behalf of the taxpayer without due diligence on the quality of the bank’s loan books.\textsuperscript{1409}

The Treasury’s failure to understand the complexities of nationalisation and take the necessary action, prompted the establishment of the UK Financial Investment (UKFI).\textsuperscript{1410} This body was set up to manage taxpayer’s shares in Northern Rock and other banks that received emergency support from the Treasury. UKFI took over Northern Rock Plc in 2010 but the retail bank still made substantial losses in 2011.\textsuperscript{1411} In line with the stated policy of returning it to private ownership, Northern Rock was finally sold to Virgin Money in 2011 at the price of £931 which is £469 million less than the £1.4 billion government injected into that bank at the beginning of the crisis.\textsuperscript{1412} This figure could rise to £650 million according to the telegraph;\textsuperscript{1413} a position collaborated by both the BBC and the Guardian Newspaper.\textsuperscript{1414} It is uncertain whether the Treasury will ever fully recoup the public funds (nearly half a billion pounds) provided to

\begin{itemize}
\item \textsuperscript{1405} ibid
\item \textsuperscript{1406} Natalie Glanvill, ‘Northern Rock Bailout to Cost the UK Taxpayers Billions’ \textit{The Commentator} (London,16 2012)
\item \textsuperscript{1407} Sherwood (n 1370).
\item \textsuperscript{1408} ibid
\item \textsuperscript{1409} ibid
\item \textsuperscript{1410} Louise Armistead, ‘Northern Rock Sold to Virgin Money “at a Loss” \textit{The Telegraph} (London, 17 November 2011)
\item \textsuperscript{1411} ibid
\item \textsuperscript{1412} ibid
\item \textsuperscript{1413} ibid
\item \textsuperscript{1414} ibid
\end{itemize}
Northern Rock.\textsuperscript{1415} In this regard, it is submitted that nationalising Northern Rock was not a viable policy option but a policy failure that delivered increased public debt by making the taxpayer a compulsory shareholder in a failed bank.\textsuperscript{1416}

\textbf{5.5 Regulatory Response}

Failures in bank governance coupled with the poor management of risks as noted earlier, contributed to the severity of the financial crisis in the UK.\textsuperscript{1417} Thus, it became imperative for the UK tripartite authorities to design both macroeconomic and financial sector policy measures as well as legislative and regulatory responses to address the critical legal and regulatory defects that have been identified. Thus, in addition to the bailout and economic stimulus packages, several legislative and regulatory initiatives were undertaken in the UK following the GFC.\textsuperscript{1418}

Having examined the various macroeconomic and financial policy responses, the next section turns to the legislative and regulatory responses adopted by the UK authorities. Several legislative and regulatory measures were introduced but for the present purposes, the focus is on the Turner Review, the Walker Review and the Banking Act of 2009 in view of their relevance to the discussion.

\textbf{5.5.1 Turner Review}

The Turner Review which was set up to examine the global banking crisis published its report on March 18, 2009. According to the FSA, the aim of the review is ‘to provide a report on the origins of the financial crisis with an assessment of the regulatory deficiencies that arose and make recommendation for reform.’\textsuperscript{1419} Accordingly, the Turner Review examines the

\textsuperscript{1415} Phillip Inman, ‘Northern Rock Sale to Virgin Money Leaves Taxpayer with £400 Million Bill’ The Guardian (London, 17 November 2011)

\textsuperscript{1416} Ewald Engelen, Ishmail Erturk, Julie Froud, Sukhdev Johal, Adam Leaver, Michael Moran Adriana Nilson and Karel Williams, After the Great Complacency: Financial Crisis and the Politics of Reform (OUP 2011) 194.

\textsuperscript{1417} Kickert (n 239).

\textsuperscript{1418} Baber (n 293).

background to the GFC, the causes and more importantly the key regulatory lessons that can be drawn.1420 In analysing the causes of the crisis, the review identifies significant ‘macroeconomic imbalances over the last decade, the increased complexity in the securitised credit model, rapid expansion of credit in the USA and UK, increased leverage and an underestimation of bank and market liquidity’ as the main causes.1421

The Turner Review then makes some recommendations to serve as a blue print for future prudential regulation of banks and financial institutions.1422 The measures outlined in the recommendations seek to address the regulatory and supervisory defects that have been exposed by the GFC1423 and also ensure that the factors that triggered the current crisis are minimised if not avoided.1424 The recommendations include: the extension of coverage of bank regulation based on economic substance rather than on legal form, improved capital positioning, enhanced liquidity regulation and improved supervision of CRAs.1425 The review also recommends codes covering remuneration in order to limit incentives for excessive risk-taking and adopt a centralised clearance system for trade in collateral debt securities (CDS).1426

The crisis has necessitated a fundamental re-evaluation of the assumptions that underpin current regulatory practice.1427 The Turner Review challenges the proposition that the principle-based and self-regulatory regime is a better regulatory option. Subsequently, the Review advocates a fundamental change in global regulatory policy.1428 By focusing more on macro-economic policy, systemic risk, shadow banks and capital buffers, the recommendations herald a fundamental shift in terms of how banks and other financial institutions are regulated in the

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1420 Walker (n 1369).
1421 ibid
1422 ibid
1423 ibid
1424 ibid
1425 FSA (n 1419).
1426 ibid
1427 ibid
1428 ibid
Chapter 5

UK.\textsuperscript{1429} This becomes evident in terms of capital requirements, systemic regulation and the restructuring of the future architecture of international prudential regulatory policy.\textsuperscript{1430} In general, the recommendations reinforce the key rationale for setting up the Turner Review—which is to ensure a shift towards a more systemic approach to regulation.\textsuperscript{1431}

Although the recommendations look comprehensive and impressive, it is however, doubtful if a change in regulatory approach alone is enough to resolve the defective governance system that defines corporate purpose in terms of satisfying shareholder interest. Arguably, the Review introduces nothing substantially new but merely re-echoes many of the changes and principles already in circulation within the international community.\textsuperscript{1432} For example most of the recommendations have already been made by international organisations including the OECD and the Corporate Governance Institute (CGI).\textsuperscript{1433} Moreover, most of the shortfalls identified in the FSAs regulatory regime, particularly the principle-based philosophy of regulation remains unresolved.\textsuperscript{1434} In that respect, it is submitted that the regulatory philosophy espoused by the shareholder primacy thinking continues to shape and influence governance policies even post the GFC.

Another criticism is that the scope of the review is so wide that many of the recommendations tend to hinge on international agreement and co-operation for implementation.\textsuperscript{1435} The need for swift action in the face of seeking consensus, especially among different nations with varying interests raises questions about the feasibility of implementing the Turner recommendations.\textsuperscript{1436}

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\textsuperscript{1429} Goddard et al. (n 236) 279.
\textsuperscript{1430} ibid
\textsuperscript{1432} ibid
\textsuperscript{1433} ibid
\textsuperscript{1435} ibid
\textsuperscript{1436} ibid
This is because the international process of rule-making and subsequent implementation is notoriously slow and suffers from serious bureaucratic hurdles that are likely to frustrate immediate and effective implementation.\textsuperscript{1437} In view of these practical challenges, it is submitted that for the recommendations to have any meaning, regulators must consider substituting what Shaw describes as the ‘forensic approach’\textsuperscript{1438} for a more aggressive stance, which in this context refers to a corporate governance system that is more prescriptive, rule-based and takes a long-term approach.\textsuperscript{1439}

It worth noting that corporate governance reforms cannot just occur in a vacuum, but they are often supported and facilitated by effective and enforceable rules and regulations.\textsuperscript{1440} In that respect, the introduction of enforceable rules and regulations are necessary components of governance as they strengthen disclosure, transparency and accountability.\textsuperscript{1441} Indeed, it is the lack of strict enforceable rules and regulations, coupled with the reliance on the self-regulatory regime of comply-or-explain which provided the fertile grounds that triggered the GFC.\textsuperscript{1442}

Moreover, the Turner Review fails to address the issue of splitting banks into ‘utility’ (high street institutions) and ‘casino’ banks.\textsuperscript{1443} As noted earlier, failure to regulate these ‘casino’ banks played a critical role in the events leading to the GFC. Therefore, the decision by the Turner Review not to split the banks is a regrettable omission because such institutions eventually had to fall on taxpayer-bailouts in times of failure.\textsuperscript{1444} But supporters of the Turner Review cite the benefit of having a ‘one-stop shop’ for all forms of financing as the justification.
for taking that position. Critics including Vince Cable, Economic Spokesman for the Liberal Democrats however, sees it differently and states:

[T]he review completely fails to call for the separation of low-risk high street banking from high-risk banking. Banks should be safe places for people’s savings, not huge roulette wheels. Banks that act like gamblers in a casino, taking massive risk for big returns, cannot be allowed to come begging to the taxpayer when things go wrong in the future.1445

The Turner Review is no doubt an important milestone in the regulatory history of the UK. Although it focused primarily on the reform of banking regulation, it nonetheless has wider implications as it also examines the causes of the financial crisis and makes recommendations for consideration by the international community to avoid a recurrence of the 2008 GFC.

The Turner Review sparked a substantive discussion on many of the issues regarding regulation which effectively creates a new intellectual basis for post-crisis reform agenda and regulatory debate.1446 This is significant because prior to the Turner Review, the regulatory philosophy of the FSA was premised on the assumption that markets develop self-correcting mechanism and that market discipline is a more effective tool to ensure the strategic and financial soundness of a firm.1447 This eventually led to a regulatory and supervisory approach that focused on (a) the supervision of individual institutions rather than the system as a whole (b) gave priority to systems and processes rather than challenging business models and strategies (c) placed emphasis on the regulation of business conduct rather than prudential regulation.1448

As already mentioned, the Turner Review was established to address these critical issues, but a critical appraisal of what the Turner Review set out to do as against what it achieved tends to suggest that much remains to be done in terms of reforming how banks and other financial

1446 Walker (n 1369).
1447 ibid
1448 ibid
institutions are regulated in the UK. This is not surprising because the post-crisis reform agenda, of which the Turner Review is an important part, is still embedded in the shareholder value maximising concept that continues to define institutions and policy responses.\textsuperscript{1449} The shortcomings identified in the Turner Review prompted the establishment of the Walker Review which forms the next section of the discussion.

5.5.2 Walker Review

The decisions by boards and senior management within their corporate governance framework were key drivers of the GFC.\textsuperscript{1450} Indeed, ensuring good governance is a key element in increasing the probability that good decisions will be made whilst poor governance is a strong indicator of more problems.\textsuperscript{1451} In recognition of this, the Walker Review set out to provide a response from the corporate governance perspective to the GFC that had pushed the UK banking industry to the brink of collapse.\textsuperscript{1452} In that respect, the Walker Review remains a significant government intervention in corporate governance since the onset of the GFC.\textsuperscript{1453} Published in November 2009, the Walker Review for the first time enacted many unique corporate governance rules and principles applicable to banks and other financial institutions.\textsuperscript{1454} In total, the Review makes 39 recommendations to be implemented on a comply-or-explain basis.\textsuperscript{1455} The recommendations and the subsequent innovation it introduces falls into three categories.\textsuperscript{1456}

\begin{itemize}
\item \textsuperscript{1449} Ioannis Glinavos, \textit{Redefining the Market-State Relationship: Responses to the Financial Crisis and the Future of Regulation} (Routledge 2013) 24.
\item \textsuperscript{1450} FSA, ‘Review of Corporate Governance in UK Banks and other Financial Industry Entities: Final Recommendations’ (26 November 2009)
\item \textsuperscript{1451} ibid
\item \textsuperscript{1452} ibid
\item \textsuperscript{1453} ibid
\item \textsuperscript{1454} Andreas Kokkinis, ‘Rethinking Banking Prudential Regulation: Why Corporate Governance Rules Matter’ (2012) 7 Journal of Business Law 612.
\item \textsuperscript{1455} Walker Review (n 1450).
\item \textsuperscript{1456} Kokkinis (n 1454) 620.
\end{itemize}
First, the review recommends specific rules regarding time commitment, expertise and the induction of bank directors. The most radical step relates to the introduction of minimum time requirement for non-executive directors whereby such directors are required to invest at least 30-36 days annually in their work as members of NED. The Review further recommends that majority of NEDs, in addition to possessing the relevant experience in finance, should be required to undergo induction and regular training that are individually tailored for the performance of their duties.

The review also introduces new procedural and substantive rules relating to the remuneration for directors and senior managers. In this respect it recommends a procedure that sets out the scope and remit of the Remuneration Committee including all high-end-employees. It further recommends that in a situation where the director’s remuneration report fails to obtain 75 per cent support of votes in a resolution passed by shareholders at the (AGM), the chairman of the remuneration committee should be compelled to stand for re-election at the next general meeting. The reasoning is that such a vote indicates a failure on the part of the chairman, hence there is the need for the affected NED to seek a renewal of his/her mandate. The review also provides substantive guidance on the structure and design of executive remuneration packages including the requirement that (a) half of an officer’s performance-based remuneration should take the form of a long-term scheme (b) under which half is vested in no less than three years and the remaining half in five years.

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1457 ibid
1458 Walker Review (n 1450)
1459 ibid
1460 ibid
1461 ibid
1462 ibid
1463 Walker Review (n 1450).
1464 It should be noted that this provision has in practice been rendered redundant following the introduction of the general annual election of directors under the UK Corporate Governance Code 2010. See UK CG Code, para B.7.1
1465 Walker Review (n 1450).
Another notable innovation in the Walker Review is the emphasis it places on risk governance through the creation of a new risk committee whose functions would not just be confined to compliance risks and other risks that are marginal to the bank’s business but now includes risks intrinsic to the core activities of banks.\textsuperscript{1465} Under these arrangements, boards are required to undertake three major risks functions.\textsuperscript{1466} These include shaping the risk appetite and tolerance in a more progressive manner, focusing on the management of prudential risks especially liquidity, leverage and counter-party risk and exercising due diligence in strategic transactions during acquisitions and disposals.\textsuperscript{1467}

Admittedly, the Walker Review has been helpful in bringing about changes in how banks are governed and regulated in the UK. According to Myners, ‘the report sets a new bench mark for best practice both nationally and internationally’.\textsuperscript{1468} Similarly, the Institute of Directors (IOD) welcomes it as a positive development that will improve the effective functioning of UK corporate governance both in the financial and non-financial sectors.\textsuperscript{1469}

But are these changes capable of resolving the fundamental misalignment of corporate governance and banking regulation that triggered the financial crisis? Arguably, the changes in the Walker Review are by no means the appropriate response to GFC mainly because of the failure to tame the problem (shareholder primacy) that underscores the GFC.\textsuperscript{1470} The following reasons explain and justify this proposition.

First, the recommendations are rather limited in terms of effecting any meaningful changes in the governance of banks. This is because it fails to propose a new theoretical framework that


\textsuperscript{1466} Kokkinis (n 1454) 621.

\textsuperscript{1467} Walker Review (n 1450).

\textsuperscript{1468} Paul Myners ‘Banking Crisis: Reforming Corporate Governance’ A Paper Presented at the Association of Pension Funds Investment Conference, London 21 April 2009

\textsuperscript{1469} IoDs Submission to the Walker Review (2009)

provides a basis for ‘a fundamental re-evaluation’\textsuperscript{1471} of how banks are directed and controlled.\textsuperscript{1472} Essentially, the recommendations still remain embedded within the traditional agency cost paradigm that has characterised corporate governance practice and thinking since the Cadbury Report.\textsuperscript{1473} In this respect, it is submitted that the Walker Review introduces nothing new or dramatic but rather it ‘preserves the shareholder primacy and the resulting objective of profit maximisation at the heart of bank’s corporate governance model’.\textsuperscript{1474}

Moreover, the Walker Review goes to reaffirm the shareholder oriented corporate governance model already embedded in (s172) of the Companies Act 2006\textsuperscript{1475} which provides clear guidance as to whose interest directors are expected to promote and serve. According to this provision ‘A Director of a company must… promote the success of the company for the benefits of its members as a whole’.\textsuperscript{1476} A critical analysis of this provision reveals that promoting shareholder-interest remains the paramount object and purpose.\textsuperscript{1477} This statutory provision creates a situation which cannot easily be altered by soft-law, hence any changes in that regard and particularly, in respect of banks, must necessarily be done through statutory amendments.\textsuperscript{1478}

It is further argued that, the recommendations are ‘soft law’ in nature and compliance is voluntary and discretionary. By their construction, these recommendations raise questions about their effectiveness since their application is purely voluntary in accordance with the comply-or-explain principle. This often, leads to a box-ticking exercise where corporate

\textsuperscript{1471} Kokkinis (n 1454) 622.
\textsuperscript{1472} Cadbury Report (n 1220)3.
\textsuperscript{1473} Kokkinis (n 1454) 620.
\textsuperscript{1474} ibid
\textsuperscript{1475} The Companies Act 2006 s172
\textsuperscript{1476} The Companies Act 2006 s172 (1)
\textsuperscript{1477} The Companies Act 2006 s172 (2)
\textsuperscript{1478} Kokkinis (n 1454).
executives tend to abide by procedures (the letter) but do not comply with the spirit. In view of this shortcoming, the effectiveness of the Walker recommendations in addressing the causes of the financial crisis remains insignificant if not questionable.

Another criticism is that the recommendation on the regulation of executive remuneration does not seem robust enough. This is because the nature and structure of performance-based remuneration encourages perverse and excessive risk-taking by managers as manifested in management practices prior to the GFC. Arguably, performance-based remuneration has been the main source through which profit maximisation continues to influence managerial behaviour and consequently threatens the entire financial system not just the banking sector. Moreover, the provision requiring with-holding a quarter of executive remuneration for three years and the rest for another five years do not go far enough since periods of economic booms often last longer. Consequently, the perverse incentives which the recommendations seek to avoid will continue to persist. In the face of such obvious defects, it is submitted that the recommendations of the Walker Review are not just insufficient but inappropriate to deal with the corporate governance weaknesses and regulatory failures that characterised bank governance and regulation in the UK before and during the GFC.

The overriding message from these reviews and reports is the urgent need for a more holistic regulatory approach to the banking industry and the entire financial system. Clearly, bank failures, and the GFC in general have strengthened the case for a rethinking of bank corporate governance.

1480 Moore (n 1246) 279.
1481 ibid
1482 ibid
1483 Kokkinis (n 1454) 622.
1484 ibid
governance. This forms an integral part of a broader restructuring of the corporate governance model underpinned by a managerial norm shaped and determined by shareholder primacy.\textsuperscript{1486}

The reality, however, remains that apart from a few cosmetic changes; most of the reforms in the reports and reviews seek to maintain the status quo as they demonstrate no appetite or desire to introduce any radical changes that question the pre-eminence of the shareholder primacy theory.

Moreover, there is now a widespread recognition that ‘soft laws’ (codes and principles) alone are not enough to deal with the crisis in the banking sector.\textsuperscript{1487} Obviously, the severity of the crisis in the banking industry calls for a more rule-based approach to regulation as opposed to the current principle-based regime. In response to this new reality, the UK authorities introduced several legislations to address the issues raised. One of such legislative initiatives is the Banking Act of 2009 which forms the next section of this chapter.

\textbf{5.6 Legislative Response}

\textbf{5.6.1 The Banking Act 2009 (Banking Act)}

Following the collapse of Lehman Brothers in the US and the failure of Northern Rock in the UK, governments, central banks and regulatory authorities were compelled to re-evaluate the regulation of banks.\textsuperscript{1488} After the run on Northern Rock, it became obvious that the existing regulatory regime in the UK was inadequate to deal with banks in distress or on the brink of collapse.\textsuperscript{1489} The failure of Northern Rock underscores the inadequacies in the current regime which undoubtedly, needs urgent reform.\textsuperscript{1490} The problem with the current regulatory regime is

\begin{flushright}
\textsuperscript{1486} ibid
\textsuperscript{1487} ibid
\textsuperscript{1488} Deborah Zandstra and Tim Bennett, ‘Stabilisation Takes Two: The UK Bail-in Provisions Restructuring.’ (2014) 4 CRI 137.
\textsuperscript{1489} Singh (1321).
\end{flushright}
that it places a moratorium on depositor’s rights to access their funds for a considerable period.\textsuperscript{1491} Obviously, such delays are bound to cause considerable unease among depositors and panic in the market as happened in the case of Northern Rock.\textsuperscript{1492}

The fact that the FSA was unable to intervene and take control of Northern Rock from the shareholders when it was still solvent, provides further justification for a new regulatory regime.\textsuperscript{1493} Arguably, the failure of Northern Rock exposes the lack of an effective legal regime to deal with failing banks.\textsuperscript{1494} An earlier intervention, it may be argued, could have minimised the magnitude of the losses incurred by the public when the bank was finally nationalised.\textsuperscript{1495}

Also, the current legislations, particularly, the Enterprise Act 2002\textsuperscript{1496} and the Insolvency Act 1986\textsuperscript{1497} seek to protect creditors’ interest and rescue the company as a going concern, but did not apply to building societies.\textsuperscript{1498} This is a vital omission because building societies including Bradford & Bingley were among the worst affected entities during the GFC.\textsuperscript{1499} In the face of these developments, it became obvious that a new legal regime was required to address these pertinent issues.

After a series of consultations, and guided by the experience from the Northern Rock collapse, the Banking Act of 2009 was passed in February 2009.\textsuperscript{1500} The Act for the first time creates a more comprehensive statutory regime which provides the BoE, the FSA and the Treasury with early and timely intervention powers.\textsuperscript{1501} These early intervention powers are contained in seven main provisions dealing with insolvency procedure, bank administration procedure

\begin{footnotesize}
\textsuperscript{1491} Singh (n 1321).
\textsuperscript{1492} ibid
\textsuperscript{1493} ibid
\textsuperscript{1494} Avgouleas (n 1490).
\textsuperscript{1495} ibid
\textsuperscript{1496} The Enterprise Act 2002
\textsuperscript{1497} The Insolvency Act 1986
\textsuperscript{1498} The Insolvency Act 1986, s 249(e)
\textsuperscript{1499} Singh (n 1321).
\textsuperscript{1500} Avgouleas (n 1490).
\textsuperscript{1501} The Banking Act 2009
\end{footnotesize}
(partial transfer of assets) financial service compensation scheme, strengthening the powers of the tripartite authorities to respond to problems arising from the inter-bank payment scheme.

Other equally important provisions cover the governance of central banks, the establishment of stability committee and the modification of financial assistance to building societies. Arguably, the Banking Act constitutes the most radical reform of banking regulation\textsuperscript{1502} in the UK since the enactment of the FSMA 2000.\textsuperscript{1503} Indeed, early intervention in failing banks is a regulatory and supervisory imperative because ‘a key component of maintaining financial stability is to intervene in banks in distress before they fail’.\textsuperscript{1504} In effect, such early intervention mechanism has become crucial to minimise the harmful disruption to the economy.

The reforms introduced by the Act have five main objectives including: (a) strengthening the stability and resilience of the UK financial system, (b) reducing the likelihood of individual banks facing difficulties (c) ensuring effective protection of depositors in the event of a bank failure and (d) strengthening the Bank of England and (e) ensuring effective coordinated actions by authorities, both in the UK and internationally.\textsuperscript{1505} To achieve these objectives, the Act introduces the Special Resolution Regime comprising three stabilisation options (private sector takeover, the setting up of a bridge bank, temporary nationalisation). These pre-insolvency arrangements introduced by the new regime are meant to provide financial stability by intervening in distressed banks before they fail.\textsuperscript{1506} These arrangements form the next section of the discussion.

\textsuperscript{1502} Avgouleas (n 1490).
\textsuperscript{1503} Financial Services and Markets Act 2000
\textsuperscript{1504} Singh (n 1321).
\textsuperscript{1506} ibid
5.6.1.1 *Special Resolution Regime (SRR)*

The SRR under the Banking Act empowers the Treasury, BoE and the FSA to make use of one of the stabilisation powers or alternatively initiate bank insolvency or a bank administration in the ‘situation where all or part of the business of a bank has encountered or is likely to encounter, financial difficulties’.\(^{1507}\) This provision raises two important issues. First, the definition of a bank as a deposit-taking institution incorporated and regulated by FSA is problematic because it fails to include investment banks.\(^{1508}\) This failure to recognise the role of investment banks in the crisis is a significant omission by the SRR. Moreover, the definition of financial difficulties seems rather too broad and thus, allows the tripartite authorities too much discretion which can be subject to abuse.\(^{1509}\) In practice, the decision to deploy any of the tools provided under the SRR can only become effective after intense consultation between the Treasury, BoE and the FAS. Apart from reasons of accountability, the purpose is to further ensure that each institution fulfils its responsibility in accordance with its mandate and expertise.\(^{1510}\)

The Banking Act makes provision for three stabilisation options under the SRR, namely private sector purchase, bridge bank and temporary public ownership. But before triggering any of these options, the Act requires that certain conditions are fulfilled.

5.6.1.2 *The exercise of stabilisation powers*

As already indicated, the use of the stabilisation powers depends on the fulfilment of certain conditions. Section 7 of the Act provides that two general conditions must be met before the stabilisation powers can be exercised.\(^{1511}\) But before deploying any of the stabilisation tools,

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\(^{1507}\) The Banking Act 2009, s 1(1)

\(^{1508}\) The Banking Act 2009, s 2(1)

\(^{1509}\) Singh (n 1321).


\(^{1511}\) The Banking Act 2009, s 7
the FSA must satisfy itself that without financial support from the Treasury or BoE, the affected bank would be unable to survive.1512

Generally, two conditions must be met before the process can be triggered. The first general condition is that the bank is failing or likely to fail or has failed to satisfy the threshold conditions as contained in section 41(1) of the Financial Services and Markets Act.1513 A failing bank as defined in the Act refers to a bank that has failed or is failing to meet its threshold conditions and in the circumstance is ‘not reasonable likely to turn its fortunes around so that it meets its threshold conditions’.1514 The terms ‘fail’ and ‘failing’ have been broadly defined in section 7(2) to mean ‘fault or短coming’ ‘a weakness’ ‘in default’ ‘unsucessful’ or ‘become insufficient’.1515 The broad definition coupled with the normative interpretation of a ‘failed or failing’ bank underscores what Singh refers to as ‘the wide spectrum of problems and financial difficulties a bank could experience between solvency and insolvency’.1516 The problem with such a wide interpretation is that it becomes difficult for a bank to predict how it will be judge/assessed by the FSA in the circumstances. Secondly, considering the timing and other relevant factors, it is unlikely that action will be taken by the FSA in respect of satisfying the threshold conditions as provided for in the FSMA without the exercise of the stabilisation powers.1517

In addition to the general conditions already mentioned, the act requires the FSA to consult with the BoE and the Treasury before deciding whether the threshold conditions have been met or not1518 It is only then that the BoE or Treasury may proceed to make use of the stabilisation powers. The exercise of these stabilisation powers as Mayes and Wood explain is to be done

1512 The Banking Act 2009, s 7(5)
1513 Financial Services and Markets Act 2000, s 41(1)
1514 The Banking Act 2009, s 7(3)
1515 The Banking Act 2009, s 7(2)
1516 Singh (n 1321).
1517 ibid
1518 ibid
within certain defined legal limitations. Indeed, section 76 of the Act restrains the BoE from exercising its stabilisation powers where such action is likely to contravene UK’s international obligations. On the other hand, the Treasury under the Act can request the BoE to take specific action to comply with the UK’s international obligations.

5.6.1.3 Procedure for exercising the stabilisation options

The Banking Act prescribes three stabilisation options taking into consideration which of these tools can best help achieve the optimal results while ensuring that they remain compatible with their legal obligations. Consequently, the Act provides that these options ‘may only be exercised in respect of UK incorporated deposit-taking institutions’. It should be added that this also applies to building societies and credit unions subject to the necessary modifications.

Before exercising any of the above options, the BoE and the Treasury must ensure that the public interest test and considerations have been fulfilled. The three crucial factors that should inform the exercise these options are; information regarding the state of the balance sheet, the operational details of the bank concerned and the known interest of third parties. Furthermore, the Act sets out the procedures for triggering the use of the stabilisation options and assigns to each member of the tripartite authority specific responsibilities at every stage of the process. Accordingly, the FSA is charged with the responsibility of initiating the special resolution regime. The caveat, however, is that the FSA must first, satisfy itself that the bank

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1520 The Banking Act 2009, s 76 (3)
1521 The Banking Act 2009, s 77(1)
1522 Singh (n 1323).
1523 The Banking Act 2009, s 2
1524 The Banking Act 2009, s 89
1525 The Banking Act 2009, s 89
1526 The Banking Act 2009, s 89
1527 The Banking Act 2009, s 7(9)
is, or is likely to fail to meet the ‘threshold’ conditions and that the bank is not capable of taking steps to rectify the situation. When this general condition is fulfilled, the BoE in consultation with the FSA and the Treasury then decide whether a private sector purchase, a bridge bank or public ownership (nationalisation) would be the most appropriate course of action. The BoE may only exercise these powers where it is deemed necessary to protect the stability of the UK financial system, protect public interest, promote public confidence in the system or protect depositors. The decision regarding public ownership and the use of public funds to support a failing institution fall under the Treasury. The Treasury exercises these powers with the consent of the BoE where it can be demonstrated that these mechanisms are necessary for the protection of public interest. It is important to note that these options can be used singly or in combination, but it requires consensus building and agreement between the Tripartite Authority- BoE, FSA and the Treasury. Having examined the procedure for triggering the resolution regime, the next section turns to the various options prescribed by the Banking Act 2009.

5.7 Stabilisation options

5.7.1 Private Sector Purchase

Section 11 of the Banking Act 2009 establishes the private sector purchase as the first stabilisation option under which all, or part of the business of the bank is sold to another party usually a commercial purchaser. The BoE orchestrates and executes the process using two

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1528 Threshold conditions include adequacy of resources and the fitness of the bank’s management
1529 The Banking Act 2009, s 8(2)
1530 Bewick (n 1510).
1531 The Banking Act 2009, s 11
instruments namely share transfers\textsuperscript{1532} or property transfer instruments.\textsuperscript{1533} The sale of parts of Dunfermline Building Society to Nationwide was executed under the private purchase option following the conclusion by the FSA that Dunfermline was unlikely to meet the threshold conditions as the company could no longer continue as a going concern.\textsuperscript{1534} Once the share transfer has been made, the BoE is required to notify the other relevant authorities, the bank concerned and other interested parties.\textsuperscript{1535}

The share transfer instruments under the Act enables the BoE and the Treasury to exercise very wide-ranging powers including the removal of a director of a specified bank, variation of service contract, termination of service contract of a director of specified bank and the power to appoint a director of a specified bank under sections 82 and 83.\textsuperscript{1536} These provisions attracted stiff opposition from the banking industry for being too draconian, intrusive, and in violation of privately negotiated contracts.\textsuperscript{1537}

The BoE and the Treasury justify these provisions on two grounds. First, the authorities argue that there is a need to make a ‘clean break’ from the previous regime that failed the shareholders and creditors of the bank.\textsuperscript{1538} The second justification is the punitive purpose that will be served by that action as the public will want to see some sort of punishment imposed on such directors.\textsuperscript{1539} With respect to the transfer of share or property to a private sector purchaser, the

\textsuperscript{1532} Share Transfer Instrument is a mechanism which provides for securities issued by a specified bank to be transferred and makes provision for the purposes of, or in connection with the transfer of securities issued by a specified bank
\textsuperscript{1533} Property Transfer Instrument is an instrument which provides for property, rights or liabilities of specified bank to be transferred and makes other provision for the purposes of, or in connection with the transfer of property rights or liabilities of a specified bank
\textsuperscript{1534} Bewick (n 1510).
\textsuperscript{1535} ibid
\textsuperscript{1536} Banking Act 2009, s 82, 83
\textsuperscript{1537} Bewick (n 1510).
\textsuperscript{1538} ibid
\textsuperscript{1539} ibid
Act requires the Treasury to make a compensation scheme order\textsuperscript{1540} to carter for the interest of third parties and the payment of such compensation is to be determined by an independent valuer. The private sector purchase solution is considered by UK authorities as the option of first resort hence it is important that the acquiring bank is solvent. Thus, ‘the bank taking over the failed bank must itself be in a sufficiently good position to be able to acquire the failed institution’.\textsuperscript{1541}

\textbf{5.7.2 Bridge Bank}

The second resolution mechanism under the Banking Act 2009 is the bridge bank option. The bridge bank option is a temporary solution allowing the authorities enough time to orchestrate a buyer for the bank in distress.\textsuperscript{1542} Furthermore, it allows prospective buyers ample time to undertake the necessary due diligence. Under this option the BoE issues one or more property transfer instruments including property, rights and liabilities acquired or arising before, between and after the date of transfer.\textsuperscript{1543} These also include property outside the UK as well as rights and liabilities under the law of a country or territory outside the UK. To give meaning and effect to the bridge bank share transfer instrument, section 30 (2) provides for two options.\textsuperscript{1544} The property, rights and liabilities of the bridge bank can either be transferred to a company wholly owned by the BoE or a company wholly owned by the Treasury.\textsuperscript{1545} In effect, the bridge bank is not an institution simply designed for the purposes of holding bad assets, but it should be managed as a going concern.\textsuperscript{1546}

\textsuperscript{1540} A compensation scheme order is an order (a) establishing a scheme for determining whether transferors should be paid compensation, or providing for transferors to be paid compensation and (b) establishing a scheme for paying compensation

\textsuperscript{1541} Singh (n 1321).

\textsuperscript{1542} ibid

\textsuperscript{1543} The Banking Act 2009, s 30 (1)

\textsuperscript{1544} The Banking Act 2009, s 30(2)

\textsuperscript{1545} The Banking Act 2009, s 30(3)

As mentioned earlier, a bridge bank is a short-term measure that seeks to address an immediate need and therefore exists until a permanent solution is found by way of a private sector purchaser. It should however, be noted that in a situation where it is not feasible for part or all of a bridge bank’s business to be transferred to the private purchaser, the bridge bank will either be wound up or taken into temporary public ownership. This should only be done after giving due consideration to the objectives of the SRR and the interests of creditors. Some commentators suggest that creditor interest consideration is what informed the decision to transfer part of Dunfermline business relating to social housing to a bridge bank called DBS Ltd.

The bridge bank option, is arguably, as a major innovation that has helped in dealing with failing banks either through private sector purchase or public ownership. Commenting on the advantages of the Bridge bank option, LaBrosse argues that ‘notwithstanding its limited use, it certainly provides the authorities with another option for dealing with banks in distress’.

The bridge bank option has, however, been criticised for lack of clarity in terms of the private sector transfer or transfer to public ownership. This lack shortcoming poses some difficulties for the BoE with respect to competition and management. For instance, how does the management of the bridge bank distinguish between being competitive to preserve the value of its franchise while at the same time ensuring that it is not granted a competitive advantage against other banks? The governance of the bridge banks also throws up some dilemmas regarding whom the directors are answerable to. Is it the BoE or the company? As in any other company, the duty presumably would be owed to the company as a whole as stipulated

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1547 ibid
1548 ibid
1549 Singh (n 1321).
1550 LaBrosse (n 1546).
1551 ibid
1552 Singh (n 1321).
1553 Avgouleas (n 1490).
in section 172 of the Companies Act 2006.\textsuperscript{1554} The difficulty, however, is how to fulfil the legislative requirement under the Companies Act while at the same time meeting the objectives and conditions attached to the bridge bank.\textsuperscript{1555} To overcome such a dilemma, it is submitted that the company would have to be guided by the reasons for its existence – that is to provide a temporary respite to resolve the challenges of the business for which it has assumed responsibility.\textsuperscript{1556}

5.7.3 Temporary Public ownership

Temporary Public ownership is the third resolution technique applied when all other options have failed. It is considered the last resort under sections 13 and 82\textsuperscript{1557} of the Act which mandates the Treasury to transfer the failing bank into temporary public ownership or temporary nationalisation.\textsuperscript{1558} To achieve that purpose, the Treasury may make an order transferring the failing bank to a nominee of the Treasury or a company wholly owned by the Treasury.\textsuperscript{1559} In that case, the Treasury assumes ownership of the bank on behalf of the state as happened in 2008 when Northern Rock and parts of Bradford & Bingley were nationalised.\textsuperscript{1560} After it was taken into temporary public ownership, Northern Rock was restructured into two separate entities namely; Northern Rock Plc and Northern Rock Asset Management.\textsuperscript{1561} The NRAM was later handed over to UK Asset Resolution Company, a holding company wholly owned by the Treasury.

Proponents of nationalisation argue that because the state had a vested interest in these institutions, it becomes imperative for the state to intervene by nationalising them to prevent

\textsuperscript{1554} The Companies Act 2006
\textsuperscript{1555} Avgouleas (n 1490).
\textsuperscript{1556} Singh (n 1321).
\textsuperscript{1557} The Banking Act 2009, s 82
\textsuperscript{1558} The Banking Act 2009, s 13 (1)
\textsuperscript{1559} The Banking Act 2009, s 13 (2)
\textsuperscript{1560} Singh (n 1321).
\textsuperscript{1561} Press Release, ‘The Creation and Sale of Northern Rock’ (National Audit Office, 18 May 2012)
complete failure.\textsuperscript{1562} It has been argued, that amidst the serious liquidity problems confronting the bank, state intervention was necessary and reasonable.\textsuperscript{1563} Indeed, nationalisation allowed banking services to continue by ensuring that customers had access to their bank accounts. From this perspective, it is submitted that no other response was likely to have been significantly better than nationalisation.\textsuperscript{1564}

The caveat, however, is that nationalisation is only possible after one of the two conditions have been fulfilled. First, the Treasury must establish that the exercise of the stabilisation power is necessary to resolve or reduce a serious threat to financial stability in the UK.\textsuperscript{1565} Second, it must demonstrate that the exercise of that power is necessary for the protection of ‘the public interest’ where the Treasury has provided financial assistance to the troubled bank.\textsuperscript{1566} In such circumstance, the Act requires prior consultation between the tripartite authorities before the Treasury can decide if the conditions provided for in section 9(4) have been met.\textsuperscript{1567} Thus, the procedure under the Banking Act requires consensus between the different constituents of the tripartite authority.\textsuperscript{1568} To assist in the decisions and interpretation of these provisions a code of practice has been drawn up by the Treasury under section 5 of the Act.\textsuperscript{1569} The purpose is to provide general guidelines regarding the management of banks taken into temporary public ownership.\textsuperscript{1570} In a situation where all the stabilisation options have failed, the Act provides for bank insolvency procedure (BIP) and bank administration procedure (BAP).

\textsuperscript{1562} ibid
\textsuperscript{1563} ibid
\textsuperscript{1564} ibid
\textsuperscript{1565} The Banking Act 2009, s 13 (3)
\textsuperscript{1566} ibid
\textsuperscript{1567} The Banking Act 2009, s 9 (4)
\textsuperscript{1568} Bewick (n 1510).
\textsuperscript{1569} The Banking Act 2009, s 5 (12)
\textsuperscript{1570} Richard Heis, ‘Banking Act 2009 and Bank Failing’ (2014) 7 CRI 147.
5.8 Critique of the Special Resolution Regime

At the heart of the Special Resolution Regime (SRR) is the desire to engineer a policy shift such that a more permanent and comprehensive bank resolution tools are made available to regulators. The need for a SRR for banks became more evident following the collapse of Northern Rock.\textsuperscript{1571} Consequently, these tools are designed purposely to avoid the fate that befell Northern Rock and to ensure that creditors bear the burden of bank failures not the tax payer.\textsuperscript{1572} Nonetheless, it can be argued that the resolution tools introduced by the Banking Act 20009 in their present form are not only insufficient but seem to be the wrong response to the GFC for the following reasons.

First, the prescribed solutions tend to be more suited to the resolution of smaller domestic institutions but inadequate for dealing with failures in large multinational financial institutions.\textsuperscript{1573} For instance, it is extremely difficult to transfer complex individual functions of a bank to a private sector purchaser or a bridge bank.\textsuperscript{1574} These problems become compounded when the transfer is to be completed within a short time frame and between different jurisdictions\textsuperscript{1575} Furthermore, the stabilisation option makes it possible for liabilities to be transferred or left with the insolvent banks thereby defeating the very purpose of the resolution tool. Viewed from this perspective, it is submitted that in the present situation, the Act fails to provide any effective mechanism for imposing losses on creditors or equitizing existing creditor claims.\textsuperscript{1576}

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\textsuperscript{1572} Zandstra and Bennet (1488).
\textsuperscript{1573} ibid
\textsuperscript{1574} Avgouleas (n 1490).
\textsuperscript{1575} ibid
\textsuperscript{1576} ibid
\end{flushright}
Also, the SRR raises serious governance issues regarding the sweeping powers it grants the BoE and Treasury. The concerns are mainly about the provisions contained in section 77 of the Act which grants the Treasury unrestrained powers to amend the law for purposes of exercising the SRR powers.\textsuperscript{1577} This includes; the power to change any legislation, provision or contract in relation to the exercise of power under the Banking Act.\textsuperscript{1578} As Walker explains, this provision enables the tripartite authority to circumvent the oversight role of parliament.\textsuperscript{1579} For instance, although the actions of the tripartite authority can in theory be subjected to parliamentary scrutiny, the fact still remains that any act done preceding parliamentary approval will always stand. As a result, the right of parliament to perform an oversight role through parliamentary scrutiny and approval have been circumvented. The Treasury however, sees this anomaly differently and argues that ‘in the absence of such powers there are real and significant risks that the authorities may be unable to fully effect a transfer’.\textsuperscript{1580} This, could arguably, have serious adverse implications for the public interest, financial stability and the protection of depositors’ funds.\textsuperscript{1581}

Moreover, the Banking Act allows the tripartite authority to set aside contracts, interfere with legal and commercial relationships between the residual bank and the commercial purchaser or bridge bank.\textsuperscript{1582} The exercise of this unrestrained power against a UK subsidiary of a foreign bank could have the undesirable consequences of harming relations between the UK and the home country of the affected bank.\textsuperscript{1583}

\textsuperscript{1577} The Banking Act 2009, s 77
\textsuperscript{1578} The Banking Act 2009, s 77
\textsuperscript{1579} Walker (n 1369)
\textsuperscript{1580} Select Committee on Delegated Powers and Regulatory Reform ‘First Report, Banking Bill’ (No. 2 H.L 18 December 2008)
\textsuperscript{1581} ibid
\textsuperscript{1582} The Banking Act 2009, s 72
\textsuperscript{1583} Select Committee (n 1589).
Chapter 5

The unrestrained powers of the authorities have also raised concerns about the lack of accountability. This is particularly important when the BoE makes transfer orders in the context of a bridge bank option. Arguably, it is a form of temporary public ownership, but such transfer orders remain outside parliamentary scrutiny, hence parliament is unable to hold the authorities accountable for their actions. In this respect it is contended that the arrangement represents what Engelen et al. consider ‘a critical institutional move in sheltering the operations of the publicly owned institutions from democratic control’.\textsuperscript{1584} The removal of political control over these institutions is a significant policy and regulatory failure because it is the taxpayer who will be called upon to bail out these institutions in times of failure.\textsuperscript{1585}

Also, the tripartite arrangements introduced by the Act have been heavily criticised for lack of clear leadership structure and information flow.\textsuperscript{1586} Even though there have been some attempts to define the role, function and responsibilities of each authority, the turf war that has characterised the UK regulatory landscape continues to undermine the effective performance and collaboration between the various agencies. The situation is further compounded by the overlapping nature of these functions and the ineffective information flow; all of which militate against the effective implementation of the SRR.

\textbf{5.9 Conclusion}

Following the GFC of 2007/2008 governments and central banks across the globe were compelled to initiate policy responses to contain the ongoing crisis and possibly prevent a recurrence. In the UK, the government’s initial response was to provide bailouts and fiscal stimulus packages which enabled it to acquire stakes in Northern Rock, RBS, HBOS and Lloyd TSB.\textsuperscript{1587}

\footnotesize{\textsuperscript{1584} Engelen et al. (n 1226) 22.  \\
\textsuperscript{1585} ibid  \\
\textsuperscript{1586} ibid  \\
\textsuperscript{1587} ibid}
As the crisis developed, it became evident that the government lacked effective legislative and regulatory tools to deal with these systemically important financial institutions.\textsuperscript{1588} Subsequently, government introduced many regulatory and legislative reforms aimed at instituting a robust regulatory framework that will help correct the legislative deficiencies exposed by the GFC.\textsuperscript{1589}

This chapter started by providing an overview of the evolution of the corporate governance system in the UK which is founded on comply-or-explain principle. The comply-or-explain principle is often credited with not just the flexibility it provides but that it also avoids ideologically fixed rules and burdensome laws and regulations.\textsuperscript{1590} Its main weakness however, is the inadequacy of the explanations often provided and that such explanations are in most cases, very subjective. In effect, a lot depends on the discretion of the companies concerned; a situation which often compromises accountability.

Admittedly, these wide discretionary powers which are underpinned by the philosophy of self-regulation and the failure to hold companies accountable were significant contributory factors to the GFC. Consequently, it is submitted that notwithstanding the regulatory and legislative reforms, corporate governance thinking and practice in the UK post the 2008 GFC has not changed. Instead, it has remained embedded in the complain-or-explain principle despite the weaknesses and shortcomings identified in that model. In fact, the status quo remains as the previous discussion demonstrates.

In addition to the governance reforms, the UK authorities also introduced significant private and public measures including: recapitalisation, blanket guarantees, asset purchase and

\begin{footnotes}
\begin{enumerate}
\item[1589] ibid
\item[1590] ibid
\end{enumerate}
\end{footnotes}
nationalisation. These were meant to allay market fears about the stability of individual financial institutions and the soundness of the entire financial system.\footnote{Singh (n 1321).}

Admittedly, the bailout and rescue package have largely helped in minimising the extent and severity of the crisis, but they do not constitute the appropriate long-term solution to the GFC. Clearly, the initial decision to bailout institutions was an ad-hoc measure which changed from ‘nationalisation by default to nationalisation by choice’.\footnote{Hall (n 1374).} It is equally remarkable that this happened within a period of just eight months in UK, the heart of capitalism where the narrative for the past three decades has been an unquestioned belief in the ability of the markets to self-correct. Against this backdrop, it becomes difficult to understand and even questionable, how the market failed to provide the self-regulatory and efficiency mechanisms when it mattered most.\footnote{ibid} While acknowledging that systemic problems like the banking crisis demand comprehensive solutions, the scale of the socialisation of the banking sector by the UK authorities came as a surprise when viewed against the alleged superiority of free market system as espoused by the shareholder primacy theory.

By these arrangements, the UK taxpayer became ‘a reluctant shareholder’\footnote{Fried and Shilon (n 975).} in failed banks which must be first managed, and thereafter sold off in a way that maximises shareholder value.\footnote{ibid} Against this backdrop the conclusion can be drawn that the bailouts, particularly nationalisation, has either by design or accident, allowed the doctrine of shareholder primacy to remain supreme ‘without recognising that shareholder primacy is what got us into this mess’.\footnote{Engelen \textit{et al.} (n 1226) 194.} It effectively, discredits the pre-crisis claim that markets in general and financial markets in particular were uniquely designed and equipped to manage and minimise risks.\footnote{ibid}
Moreover, in responding to the GFC, the UK authorities failed to realise that the deficiencies in banks prior to the crisis were more due to inappropriate patterns of herd behaviour underpinned by the desire to maximise profit for the shareholder.\footnote{ibid} In that respect, the bailout and stimulus packages seemed at best inadequate and at worst misguided in the sense that these solutions are not based on a full explanation as to the causes of the GFC.

Obviously, the policy responses were not limited to bailouts and rescue packages to contain the crisis.\footnote{Jacine Alt Sahalia \textit{et al.} ‘Market Response to Policy Initiatives during the Global Financial Crisis’ (2012) 87 Journal of International Economics 162, 165.} They have also entailed a series of regulatory and legislative measures following which many laws, rules and guideline were enacted. Although several legislative and regulatory initiatives were introduced, the discussion in this chapter focused on the Turner Review, the Walker Review and the Banking Act 2009.

The Turner Review examines the Global banking crisis and makes recommendations to correct the regulatory shortcomings that led to the financial crisis. In that respect the Review provides a blue print for future prudential regulation of banks and other financial institutions by addressing the defects in the regulations and supervision that have been exposed by the GFC. Unsurprisingly, the FSA hails the Turner Review as heralding a fundamental shift from a light-touch and principled-based approach to a more intensive rule-based regulatory regime.\footnote{FSA (n 5) 5.}

Critics however, argue that the Turner Review provides only a partial and rather hasty understanding of the causes of the crisis. Consequently, the recommendations fail to recognise, let alone necessitate a fundamental re-evaluation of the assumptions that underlie current regulatory practice; especially the theory that markets function in a rational and efficient manner. Arguably, because the causes of the crisis have been misdiagnosed, the solutions that have been suggested by way of recommendations turned out to be inappropriate. It is, thus,
submitted that the Turner Review does not represent any radical changes to the existing regulatory style but rather works within the established FSA approach that is characterised by the light-touch and self-regulatory regime in which the efficient market hypothesis reigns supreme.\textsuperscript{1601}

As part of the effort to address the governance issues raised by the GFC, the UK government set up the Walker Review to examine corporate governance in the banking industry and make the necessary recommendations.\textsuperscript{1602} It was premised on the idea that there was a need for a rethinking of corporate governance in banks as part of a broader restructuring process in response to the crisis.\textsuperscript{1603} The Review identifies five key areas that require immediate and radical reforms. These areas are: The Combined Code (comply-or-explain) approach, patterns of board behaviour, low level engagement in terms of supervision and monitoring, poor risk management as evidenced by high risk appetite and tolerance.\textsuperscript{1604} In the end, the Review makes 39 recommendations ranging from board composition, functions, time commitment, risk management, remuneration policies like claw-back clauses and the regulation of CRAs.\textsuperscript{1605} The Review, is therefore, represents the most significant government-sponsored review of UK corporate governance in recent times.\textsuperscript{1606} According to Walker, the review provides a response from the corporate governance perspective in respect of the factors that pushed the financial sector to the brink of collapse.\textsuperscript{1607}

Apparently, the Walker Review may seem comprehensive and impressive but the question that remains is whether these changes are capable of resolving the fundamental misalignment of

\begin{flushleft}
\textsuperscript{1601} Stout (n 29).
\textsuperscript{1602} Walker Review (n 1450) 4.
\textsuperscript{1603} Walker (n 1369).
\textsuperscript{1605} Walker Review (n 1450).
\textsuperscript{1606} Walker (n 1369).
\textsuperscript{1607} ibid
\end{flushleft}
corporate governance and banking regulation. First, it is submitted that the Review seems to be offering more of the same thing because it specifically approves and reaffirms the comply-or-explain approach to corporate governance. Further, the Review ignores the fact that the internal governance of banks is a crucial factor of financial stability, a cause of bank failures and by extension a source of systemic risk. Although the recommendations seek to alleviate some of these tensions, the faithful adherence to the orthodox shareholder-centric corporate governance model remains intact and untouched. In that respect it is fair to state that the Walker Review does not address the root cause of the GFC despite its good intentions.

A further attempt to stabilise the economy in the wake of the crisis came with the enactment of the Banking Act. The purpose of the Act as already noted is to establish a permanent and more coherent resolution regime for failing banks. But it became obvious that the Special Provisions Act 2008 was incomplete and did not constitute a permanent measure as it was intended to elapse after one year. Hence, the Banking Act which became effective from February 2009 creates for the first time, the Special Resolution Regime and puts it on a more permanent basis. The SRR comprises a stabilisation procedure, bank administration procedure (BAP) and bank insolvency procedure (BIP). The responsibility of exercising the stabilisation powers is shared between the FSA, BoE and the Treasury. By this arrangement, the FSA decides whether a particular bank has fulfilled the general conditions to bring the SRR into effect while the BoE implements the SRR except in cases of temporary public ownership

1608 Drew (n 1485).
1609 Walker (n 1369).
1610 ibid
1611 Drew (n 1485).
1612 Yeoh (n 1322).
1613 ibid
1614 The Special Provisions Act 2008
1615 ibid
1616 The Banking Act 2009, s 7
1617 Yeoh (n 1322).
where the Treasury takes charge. In deciding whether to use the resolution powers, the tripartite authority takes into account the need to stabilise the UK’s financial system, protect public funds and avoid interfering with property rights.

Admittedly, the Banking Act is a significant legislative initiative that seeks to resolve some of the issues confronting the banking system in the UK. Arguably, the SRR has broadened and strengthened the range of tools available to resolve the problems of failing banks in an orderly manner. This is achieved by deploying the stabilisation options such as private sector purchase, bridge bank or temporary public ownership. Indeed, the SRR marks a major policy shift because this new regime ensures that banks, creditors and shareholders bear the burden of bank failure and not the taxpayer.

Furthermore, the Act strengthens the powers of the tripartite authority by giving it the mandate to respond promptly to the inter-bank payment scheme to prevent harmful disruption to entire industry. Other provisions cover the governance of financial institutions and the modification of assistance to be given to building societies. These new range of powers which the Act confers on the authorities are deemed necessary to deal with the problems of failing banks, restore confidence and mitigate the effects of the GFC. From this perspective, it can be argued that the Banking Act provides an appropriate and reasoned response to the shortcomings that emerged in the banking sector during the GFC.

There are, however, concerns over some aspects of the Act and its effectiveness as a regulatory tool capable of responding to the GFC. First, the tripartite authority has been criticised for

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1618 The Banking Act 2009, s 12(5)
1619 The Banking Act 2009, s 12(7)
1620 McCormick (1224).
1621 The Banking Act 2009, s 12(8)
1622 Walker (n 1369).
1623 ibid
1624 Singh (n 1321).
1625 ibid
lack of clear leadership structure with the attendant overlapping of functions and responsibilities.\textsuperscript{1626} Such overlaps often lead to conflicts between these authorities and thus, create problems for both regulators and regulated entities.\textsuperscript{1627}

In evaluating the UK government responses to crisis, this chapter analysed the various policy options ranging from bailouts and rescue packages to regulatory and legislative initiatives. It became evident that these measures alone did not provide answers to the causes of the GFC. For example, bank bailouts per se are an inadequate response to the crisis because bailouts are simply ad-hoc measures that can only mitigate but do not address the fundamental cause of the crisis. Indeed, the problems that beset the financial system which eventually caused the financial crisis cannot be resolved without a radical change in the defective business model which emphasises the managerial norm of shareholder value maximisation and short-term profits.\textsuperscript{1628} Thus, the defects and deficiencies that led to the crisis were the result of inappropriate patterns of governance and a misguided business model underpinned by a desire to maximise profits for shareholders in the short-term.

As the above discussion makes clear, the policy responses by the UK authorities did not lead to any fundamental change in the basic regulatory, legislative and governance philosophy.\textsuperscript{1629} Indeed, most of the responses and their underlying philosophies rest upon a distorted conception of the role and purpose of the corporation in society. This distorted conceptualisation defines corporate purpose in terms of profit maximisation, shareholder-empowerment and the protection of shareholder interest as the sole and legitimate purpose of the corporation.\textsuperscript{1630}

\textsuperscript{1626} ibid
\textsuperscript{1627} Georgosouli (n 1434)561.
\textsuperscript{1628} McCormick (n 1224).
\textsuperscript{1629} MacNeil (n 1248).
\textsuperscript{1630} Black (n 848).
Clearly if you define your mission as to maximise profit at the expense of all others, all others will treat you as a problem as was the case prior to the GFC.

Despite the widespread recognition that shareholder primacy is indeed, the problem, the prescriptive agenda at the heart of this governance model remains central to the corporate governance discourse and the policy response following the GFC.\(^\text{1631}\) This is evidenced in the Turner Review and the Walker Review both of which contain provisions advocating an increased shareholder-role in the appointment, remuneration and audit committees of company boards.

Also the post-crisis responses in the UK still maintain the distinctive light-touch and principle-based approach to regulation.\(^\text{1632}\) This approach, as mentioned earlier, emphasises self-regulation and supervisory engagement instead of being an enforcement-led regulatory regime with a more robust approach to serve as a credible deterrent.\(^\text{1633}\) Against this backdrop, it is submitted that the policy responses and interventions in the UK only provide immediate and temporary relief to the GFC but leave intact the problem of how to deal with the issue of shareholder primacy. Apparently, the reforms do not constitute a radical departure from past governance and regulatory practices. Instead, they reinforce existing corporate governance model characterised by self-regulation, comply-or-explain and adherence to the shareholder primacy theory and its propositions; profit maximisation, short-termism and market fundamentalism.\(^\text{1634}\) Understandably, the process of corporate governance cannot be isolated from the contextual issues that have shaped it. In the UK context, the corporate governance framework is based on social power relations that are inherently capitalist and champions the market as the most effective means of regulating corporate behaviour.\(^\text{1635}\) Consequently, the

\(^{1631}\) Horn (n 161).
\(^{1632}\) ibid
\(^{1633}\) ibid
\(^{1634}\) Stout (n 29).
\(^{1635}\) Horn (n 161).
idea that financial markets should be kept from political control to enable shareholders to reap maximum profit dominated market actors and politicians alike.

Arguably, the reform initiatives post the GFC, fail to address the underlying issues that have shaped the current corporate governance regime. Rather, they are more about tweaking the existing system than changing it in any significant manner. In that respect, it is fair to conclude that these reforms are simply addressing the symptoms and not the causes of the GFC.  

The next chapter undertakes a comparative study of the responses in the US and the UK with the view to exploring what accounts for such differences and similarities. More importantly, it interrogates why authorities in both jurisdictions failed/ refused to recognise that at the heart of the financial crisis lies the shareholder primacy theory and short-termism. In that respect, any response short of addressing the issue of shareholder primacy and the short-termist approach corporate governance is, at best, an exercise in futility.

1636 Seabrooke and Tsingou (n 329) 320.
CHAPTER 6

A COMPARISON BETWEEN THE US AND UK RESPONSES

6.1 Introduction

As explained in the previous chapters, both the US and the UK embarked on several institutional and regulatory changes in response to the GFC.\(^{1637}\) These institutional changes and policy responses, arguably, underscore the weaknesses of the current corporate governance system and more importantly, provide an opportunity and an impetus for major reforms.\(^{1638}\)

Accordingly, this chapter makes a comparative analysis of the responses in the two jurisdictions by reviewing the institutional, legal and regulatory changes that occurred on both sides of the Atlantic following the GFC.\(^{1639}\) Consequently, this section explores the differences and similarities with respect to the rescue packages (recapitalisation, bank guarantees, assets purchase and nationalisation) and other measures that sought to slow down the crisis and eventually prevent the threat of a deeper recession.

The second section compares some of the legal and regulatory initiatives undertaken in the US and the UK since the advent of the GFC. Important legislations particularly, the Wall Street Reform and Consumer Protection Act\(^ {1640}\) and the UKs Banking Act 2009\(^ {1641}\) will be examined. Obviously, context is very critical to an understanding of why governments in the US and UK responded the way they did. Therefore, in explaining the differences, the institutional arrangements including the particular structural characteristics of the economy, the legal system, political considerations and ideological inclinations are vital to the discourse because


\(^{1639}\) ibid

\(^{1640}\) EESA 2008

\(^{1641}\) The Banking Act 2009
these factors eventually shape the policy responses and outcomes.\textsuperscript{1642} Section four concludes that while there are obvious similarities and major differences in terms of the responses, one thing that remains unchanged is the continuous attachment to the shareholder-oriented governance model.

### 6.2 Initial Responses

In responding to the financial crisis, governments in the US and UK first employed similar ad-hoc measures to arrest the economic decline and reduce the systemic dangers that have been presented. Bailouts of various forms, including huge injection of central bank liquidity, recapitalisation, bank guarantees, direct asset purchase solutions and nationalisation were introduced.

#### 6.2.1 Stabilisation

Following the panic that ensued after the failure of Lehman Brothers in October 2008, the US government came under immense pressure to initiate measures to stabilize the economy.\textsuperscript{1643} In response, the US authorities injected $700 million into purchasing troubled assets to stabilise the financial system and minimise the systemic dangers posed by the GFC.\textsuperscript{1644} Similarly, the BOE and the FSA sought to slow the impact of the crisis by injecting £500 billion into the UK economy. Following from this, the country’s eight largest banks- Abbey, Barclays, HBOS, Lloyds TSB, Nationwide Building Society, RBS, Standard Chartered and several building societies were saved from collapse by this initiative.\textsuperscript{1645}

\textsuperscript{1642} Thomas Clarke, \textit{Theories of Corporate Governance} (Routledge 2004) 19.
\textsuperscript{1643} Hoshi and Kashyap (n 879).
\textsuperscript{1644} ibid
\textsuperscript{1645} Mark Kleinman, ‘Financial Crisis: UK Government Unveils Bailouts for UK Banks’ \textit{The Telegraph} (London, 8 October 2008)
The approaches of the US and UK authorities in respect of the initial responses seemed to converge, as their toolkit was largely similar.\textsuperscript{1646} Initially, there were no significant legislative initiatives; instead the existing tools were used to combat the problem as and when it appears. But the process in the UK was much slower and took longer than in the US. This can be explained by the UK’s membership of the European Union.\textsuperscript{1647} Under EU regulations, financial support for banks and other financial institutions require prior approval of the European Commission so as to avoid breaching EU competition and state aid rules.\textsuperscript{1648} Obviously, in such circumstances, implementing effective remedies are bound to take longer in the UK. Even though the US system has its own complexities, the UK faced more constraints in implementing financial reforms than the US.

6.2.2 Bailouts

Following the outbreak of the crisis, the US Congress proposed the purchase of troubled assets to stabilise the financial system and the entire economy. As a result, TARP which became the centre piece of the Emergency Economic Stabilisation Act 2008 was enacted.\textsuperscript{1649} But a few weeks after the passing of this legislation, attention quickly shifted to recapitalising banks through the purchase of preferred stock. Subsequently, the US authorities unveiled the capital purchase programme (CPP) within TARP. Under the CAP, a total of $200 billion was earmarked for recapitalisation of which $145 billion was allocated to nine major American banks.\textsuperscript{1650} The caveat, however, was that these beneficiary financial institutions were subjected to strict stress test and given target capital levels to attain.\textsuperscript{1651} Some of the banks that received

\textsuperscript{1647} ibid
\textsuperscript{1648} ibid
\textsuperscript{1649} ibid
\textsuperscript{1650} ibid
\textsuperscript{1651} ibid
capital assistance were allowed to repay while others either resold assets or issued equity.\textsuperscript{1652} This strict stress test approach which compelled financial institutions to repay the capital received from the public purse is noticeably absent in the UK.\textsuperscript{1653}

In addition to recapitalising banks, the US authorities provided the troubled-auto industry with $55 billion to enable this critical industry to stay afloat.\textsuperscript{1654} Consequently, government took direct control of the management of these companies by appointing the ‘auto czar’ to supervise the management.\textsuperscript{1655} In all 591 institutions/companies benefited directly from this facility.

Just like the US, the authorities in the UK recapitalised financial institutions to the tune of £578 billion as part of a programme which included £250 billion to guarantee debt and other securities that banks were unable to sell.\textsuperscript{1656} The introduction of the government debt guarantees had the immediate effect on inter-bank risks premium and facilitated lending between banks. Unlike in the US, recapitalisation programme in the UK had to be approved by the EU to minimise the negative effects of spill-over on financial competition within the Union.\textsuperscript{1657} Also EU guidelines exclude insolvent financial institutions from the recapitalisation and credit guarantee programmes. This explains why the UK government nationalised Northern Rock instead of recapitalising it.\textsuperscript{1658} The UK programme also differed from what pertained in the US where the initial bailout had a specific time frame lasting till 2009. In the case of the UK, the programme was meant to be a short-term measure that must be reviewed, approved and extended on regular basis by the European Commission. Consequently, the programme was

\begin{footnotesize}
\begin{itemize}
\item[\textsuperscript{1652}] ibid
\item[\textsuperscript{1653}] Hoshi and Kashyap (n 879).
\item[\textsuperscript{1654}] ibid
\item[\textsuperscript{1655}] ibid
\item[\textsuperscript{1656}] James Kirkup, ‘Banks Bailout: Taxpayers May Take Shares in Barclays and HSBC’. \textit{The Telegraph} (London, 18 January 2010)
\item[\textsuperscript{1657}] ibid
\item[\textsuperscript{1658}] ibid
\end{itemize}
\end{footnotesize}
first approved on October 13, 2008, extended on December 2008 and April 15, 2009 respectively.

Furthermore, the American rescue plan was primarily devoted to purchasing mortgage-backed securities but failed to address the fundamental solvency problems facing the banking sector.\footnote{ibid} In effect, the US approach can be considered short-termist because it was mainly aimed at tackling the immediate funding shortfall.\footnote{ibid} The UK package on the other hand, invested in banks through the purchase of shares as well as guaranteeing bank debts. Against this background, it can be argued that the rescue plan in the UK adopted a dual approach by addressing both the solvency and funding challenges facing the banks.\footnote{ibid}

It should be noted, however, that this taxpayer-funded rescue plan comes with very stringent conditions under which these rescued-banks were required to abide by many restrictions. First, they were barred from paying dividends to ordinary shareholders until the preference share (government shares) have been fully redeemed.\footnote{ibid} Second, the government restricted the payment of bonuses and executive remunerations. Thirdly, banks were required to continue lending to small businesses and homeowners at competitive prices; preferably at the pre-crisis levels.\footnote{ibid} Finally, government acquired a say in the appointment of new board members by being the largest shareholder in these banks. Contrary to the situation in the US where similar restrictions met very little resistance, the restrictions in the UK faced serious opposition from different quarters.\footnote{ibid} While investors pondered the likely impact of these restrictions, the share prices of the three affected banks fell further largely due to the restrictions on the payments of

\footnote{ibid}{ibid}\footnote{ibid}{ibid}\footnote{ibid}{ibid}\footnote{ibid}{ibid}
dividends. The drop in the share price of RBS was 8 per cent, 14 per cent for Lloyds TSB and 27 per cent for HBOS.\footnote{ibid}

The UK and the US also differ in their approach to the implementation of the recapitalisation programmes. In the US the government adopted a uniform and more authoritative approach towards the beneficiary banks. As a result, recapitalised-banks were compelled to supplement their eroded capital systems by issuing new equity.\footnote{Ghosh and Mohamed (n 840).} But in the UK, the authorities were not only flexible but also bought a combination of ordinary shares and preference shares in affected banks. More importantly, the amount and proportion of the stakes acquired in the affected banks was negotiated with the individual bank. Thus, the extent to which different banks participated varied according to their needs. Indeed, this flexible approach enabled HSBC, Barclays, Abbey, Nationwide, Standard Chartered and Clydesdale to opt out of the recapitalisation programme leaving RBS Lloyds TSB as the only major recipients.\footnote{Hall (n 1374).}

Obviously, these procedural disparities underscore the differences in the corporate governance systems in the two jurisdictions. The American corporate governance system emerged from a specific legal tradition prone to limiting the activities of banks. Consequently, its approach is rule-based and inherently prescriptive. By contrast, the UK corporate governance system is principle-based which allows for flexibility and consensus. It can be argued, therefore, that these differences in approach account for how each of the two countries responded to the crisis in the banking industry.

\footnote{ibid}
\footnote{Ghosh and Mohamed (n 840).}
\footnote{Hall (n 1374).}
6.2.3 Stimulus Plans

It became obvious that the bailout packages in the US and the UK were necessary but not sufficient to ensure economic recovery.\textsuperscript{1668} Instead, the crisis demanded more proactive policies by way of economic stimulus package. In response, the US government adopted the stimulus package under ARRA of 2009 while the UK authorities introduced a similar programme to stimulate the sluggish economy. In terms of size, the US government passed a far larger fiscal stimulus plan by providing $787 billion for the package representing 5.5 per cent of GDP.\textsuperscript{1669} This, is in sharp contrast to the £25 billion ($37.5 billion)\textsuperscript{1670} allocated to the stimulus plan in the UK; a figure which fails into insignificance when compared to the founding the US government committed into its stimulus package. This disparity can be explained by the fact that the UK has been constrained in its ability to devote more resources to the stimulus plan due to the significant burden that bank bail-outs have put on public finance.\textsuperscript{1671} A report by the OECD confirms that bank bail-outs in the UK increased the budget deficit by £175 billion representing 12.4 per cent of GDP in 2009/2010.\textsuperscript{1672} In that respect, it becomes obvious that the UK was confronted with greater fiscal strains than the US in view of the higher UK budget deficit as a proportion of its GDP.\textsuperscript{1673} Against the backdrop of increasing budget deficit, it was not surprising that the size of the package adopted in the UK was very modest as compared to that of the US.\textsuperscript{1674}

The size of the packages adopted in the two jurisdictions is only one consideration. Further differences exist between the policies pursued in the two countries in terms of time distribution


\textsuperscript{1669}Ghosh and Mohamed (n 840)134.

\textsuperscript{1670}Ashbee (n 1668) 7.

\textsuperscript{1671}ibid


\textsuperscript{1673}ibid

\textsuperscript{1674}Ashbee (n 1668)3.
and the programmes to be funded. US policy makers took a long-term view of the stimulus plan and based their projections on a longer time frame. Hence, more than a third of the entire stimulus spending was allocated to 2010.\textsuperscript{1675} Moreover, well over 40 per cent of the total stimulus funding went into expenditure projects in line with a deliberate policy choice that sought to focus on infrastructure projects, educational expansion and innovation to boost American competitiveness.\textsuperscript{1676}

In contrast, UK authorities pursued a short-term approach and concentrated almost all the projected stimulus funding on 2009.\textsuperscript{1677} As a result, subsequent years, especially 2010 witnessed prolonged period of fiscal tightening and retrenchment to recoup earlier spending. This was made clear during the 2009/2010 pre-budget report which sought to reduce borrowing to 3.2 per cent of GDP. A further policy difference relates to the target areas of the stimulus plans. Whereas the US allocated over 40 per cent of the total stimulus money to expenditure projects, the UK devoted almost all the stimulus funding to tax concessions which benefited mainly large corporations.\textsuperscript{1678}

Obviously, questions have been raised as to (a) why the US adopted far larger fiscal stimulus than the UK (b) why the UK committed itself to fiscal retrenchment in 2010 whereas the US allocated the largest share of stimulus funding to that year and (c) why did the UK reject spending on infrastructure projects while they constituted a sizeable proportion of the US total expenditure on the stimulus.?

Answers to these questions require careful consideration of the political preferences of the political actors. First, there was an assumption that the left-leaning labour government of Prime Minister Gordon Brown would focus on capital expenditure projects to stimulate economic

\textsuperscript{1675} ibid
\textsuperscript{1676} ibid
\textsuperscript{1677} Glinavos (n 1449)163.
\textsuperscript{1678} ibid
growth in line with its core ideological beliefs. But this expectation turned to be unfounded and failed to materialise due largely, to New Labour’s reluctance to align itself with a specific economic theory. This makes it rather difficult to determine the reasoning that goes into shaping its policies. 1679

Also, significant disagreements were said to have existed between the Prime Minister and the Chancellor of the Exchequer, Alistair Darling as to the nature, scope and extent of the stimulus plan. Whereas the Prime Minister is said to have advocated for large scale stimulus package, the Chancellor successfully sought and obtained a stimulus package that was limited in terms of scope and resource commitment. 1680

Similarly, political developments in the US influenced the adoption of the stimulus package on such a large scale due to political instincts and personality factors. Arguably, the election of Barack Obama as President in the November polls inevitably led to shift and indeed, reordering of policy priorities. 1681 This dramatic policy shift culminated in the enactment of ARRA of 2009 which provided the legal basis for the $787 billion stimulus package.

Admittedly, personality-based explanations have their limits and hence, not sufficient to explain the process of policy decisions. Other factors such as the thinking of political actors played a vital role in shaping the formulation and eventual implementation of the stimulus packages in both jurisdictions. In the US, Federal Reserve Chairman, Ben Bernanke openly backed the use of the stimulus policies as part of an economic programme that sought to mitigate the effects of the crisis and re-invigorate the larger economy. 1682 The US government also received the backing of another important institutional actor- the US Chamber of Commerce which argued

1680 Ashbee (n 1668) 5.
1681 Ashbee (n 1668) 7.
that the 2008 stimulus would ‘spur business investment, consumer spending, increase productivity and lead to economic recovery in the US’.\textsuperscript{1683}

Interestingly, whilst the stimulus package in the US received the full backing of two important institutional players, the situation in the UK was the reverse. The Governor of the BoE, Mervin King opposed further stimulus plan when he warned publicly against an expanded fiscal stimulus in the face of greater strains and budget deficits in the UK.\textsuperscript{1684} The BoE governor told the House of Commons Treasury Committee that ‘given how big those deficits are, I think it would be sensible to be cautious about going further in using discretionary measures to expand the size of those deficits’.\textsuperscript{1685}

Furthermore, the Bank’s reluctance to endorse expansionary policies (stimulus) had the support of some powerful voices within the Treasury as well as the Confederation of British Industries (CBI). The CBI was far less sanguine about the calls for fiscal expansion through stimulus. In a statement prior to the pre-budget statement, the CBI called for a fiscal boost to address the challenges facing the UK economy. The fiscal boost advocated by the CBI was, however, confined to tax cuts for companies, incentives to small and medium-sized enterprises and a time-limited stimulus. Nonetheless, the CBI was not oblivious to the huge deficit and national debt. It notes that; ‘given the poor state of public finances, fiscal stimulus package will need to go hand in hand with credible framework for getting back on track.’\textsuperscript{1686} According to the CBI, such an approach would ‘prevent future generations being burdened with huge levels of debt’.\textsuperscript{1687}

\textsuperscript{1683} US Chamber of Commerce, Press Release (Washington, 18 Sept 2008)
\textsuperscript{1684} Ashbee (n 1668) 6.
\textsuperscript{1687} ibid
As the above discussion shows, political exigencies and debt levels only provide part of the answers to the differences and similarities in respect of the stimulus package. Institutional arrangements, economic actors, were to a very large extent, critical in moulding the stimulus strategies adopted by the UK and US and the subsequent regulations that emerged after the GFC.

6.3 Regulatory Response

The shortcomings of the pre-crisis regulatory regime compelled regulators in both countries to introduce many regulatory reforms. In view of the multiplicity of the regulatory initiatives, it would be impossible to compare and discuss all the reform measures. Consequently, the comparison of the regulatory responses focuses on two key areas namely: bank resolution and credit rating agencies (CRAs)

6.3.1 Credit Rating Agencies (CRAs)

Credit Rating Agencies are key governance entities in both the domestic and international regulatory architecture. These institutions are perceived as having contributed significantly to the GFC and thus, triggered regulatory changes in both the UK and the US. For these reasons, governments in these two jurisdictions introduced more stringent regulatory regimes to control the activities of CRAs. Effectively, the broad policy objectives of the regulatory reforms in terms of credit rating agencies in the UK are very much like those in the US.

First, there is the recognition in both jurisdictions that CRAs played a critical role in triggering the GFC. There was a general consensus in the UK and US that the conduct and practices of CRAs created three major and inter-related problems namely; (a) the risk of overreliance on

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1688 Lannoo (n 1637).
1689 Aline Darbellay, Regulating Credit Rating Agencies (Edward Elgar 2013) 54.
1690 ibid
1691 ibid
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credit rating by financial market participants (b) the high degree of concentration in the rating market (c) a defective business model (issuer-pay model) and (d) the absence of civil liability of credit rating agencies vis-à-vis investors. Arguably, these conduct and practices stifled competition in the industry and placed an inherent conflict of interest at the heart of the business model which was central to the financial crisis.

Second, in response to the GFC both the UK and the US adopted legislations designed to regulate the governance and operations of CRAs. In the US the authorities passed the Dodd-Frank Act 2010, which provides for the regulation of CRAs. Similarly, in the UK, CRAs have been subjected to a new regulatory regime governed by EU Regulation 1060/2009 (CRA) as amended by Regulation 513/2011.

Generally, the regulations in the UK and US are aimed at achieving greater transparency, improving the accuracy and integrity of the rating process and by extension ensuring stability in the global financial markets. Arguably, while there is no consensus on a single set of reforms, the objectives are similar in that they are aimed primarily at introducing direct government oversight to replace the self-regulatory regime that existed before the GFC. Admittedly, the UK and the US share certain common principles like transparency, organisational requirements concerning conflict of interests and good corporate governance. Moreover, the legislations in both jurisdictions tend to have similar aims. A closer examination,
however, reveals that the means of achieving the set objectives differ significantly between the two countries. An exploration of these differences follows in next section of the discussion.

As earlier indicated, CRAs in the US are regulated by the Dodd-Frank Act of 2010.\textsuperscript{1700} It was an attempt to redress the pertinent issues highlighted by the governance and regulatory failure of CRAs. The Act provides for ‘improvements to the regulation of credit rating agencies’,\textsuperscript{1701} and thus, establishes an entirely new framework to govern and regulate CRAs.\textsuperscript{1702} Section 931\textsuperscript{1703} spells out the aims of the Act which include: reducing the reliance on credit ratings, enhancing competition and supporting due diligence and accuracy in the rating process.\textsuperscript{1704} It is important to point out that Dodd-Frank only provides the broad legal framework and allows the SEC to give ultimate effect to the provisions.\textsuperscript{1705} Thus, the SEC through the office of rating agencies is required to write rules and conduct further studies for future legislations as the need arises.\textsuperscript{1706} Consequently, the regulatory intervention in respect of CRAs in the US will be undertaken through ad-hoc intervention as opposed to what pertains in the UK where CRAs are regulated by well-defined and legally binding EU Regulations.

Unlike in the US, CRAs in the UK are not regulated by domestic law but by EU regulations in view of the country’s membership of the European Union.\textsuperscript{1707} EU Regulation 1060/2009 (CRA)\textsuperscript{1708} as amended by EU Regulation 513/2011\textsuperscript{1709} is the main legal instrument governing the regulation of CRAs in the UK. In 2011 regulation 513/2011 amended regulation 1060/2009 and transferred the responsibility of regulating CRAs from national authorities to a new

\begin{flushright}
\textsuperscript{1700} Dodd-Frank Act 2010
\textsuperscript{1701} Dodd-Frank Act 2010, s 931
\textsuperscript{1702} Coors (n 1699)28.
\textsuperscript{1703} Dodd-Frank Act 2010, s 931
\textsuperscript{1704} Coors (n 1699) 29.
\textsuperscript{1705} ibid
\textsuperscript{1706} ibid
\textsuperscript{1707} ibid
\textsuperscript{1708} EU Regulation 1060/2009
\textsuperscript{1709} EU Regulation 513/2011
\end{flushright}
European agency- the European Securities and Markets Agency (ESMA). In so doing, the new regulation revoked any domestic laws that are inconsistent with the new regulation or no longer required.

Functionally, regulation 513/2011 vests the ESMA with information gathering powers as well as the enforcement of sanctions and penalties. In addition, the ESMA is entrusted with the exclusive supervisory powers of registering CRAs in the EU. This also includes the European subsidiaries of well-known CRAs such as Fitch, Moody’s and Standard & Poor’s. The changes introduced by the new regulation mean that CRAs in the UK (EU) would operate in a much simpler regulatory environment than their American counterparts.

Moreover, users of CRA services will enjoy better protection as result of a centralised EU supervisory regime. This is in sharp contrast to the American system where several agencies are involved in administering rules, establishing guidelines, ensuring enforcement and reviewing existing regulations. Apart from the SEC, several other agencies at both the Federal and State levels are engaged in one way or the other in the regulation of CRAs. Given the complexity of this relationship and the turf war that it breeds, the need for a simpler and more transparent system becomes inevitable.

Civil liability of CRAs vis-à-vis investors is another area where considerable differences exist between the UK and US. Previously, CRAs have successfully argued that ratings are opinions and not recommendation to purchase, sell or hold any security. In the US for example, the assertion was that the status of CRAs was the same as financial Journalists and therefore enjoys

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1710 McVea (n 1694).
1711 ibid
1712 ibid
1713 ibid
1714 Katz et al. (n 1698)
1715 ibid
1716 ibid
the same protection under the First Amendment which guarantees freedom of expression.\textsuperscript{1717} This together with rule 436(g) Act 1933\textsuperscript{1718} and section 10(b) of the Securities and Exchange Act 1934\textsuperscript{1719} have shielded CRAs from investor litigation (civil liability) and until recently, prevented direct regulation of their operations.\textsuperscript{1720} Under section 10(b) of the Securities and Exchange Act 1934, the standard of plea was very high and the plaintiff had to plead with ‘particularity of facts giving rise to a strong inference that the CRA misrepresented or omitted to disclose material information with scienter.’\textsuperscript{1721} Scienter is here defined as a ‘mental state embracing intent to deceive, manipulate or defraud’.\textsuperscript{1722}

The enactment of section 933(b) of Dodd-Frank lessened the pleading requirement in private actions against CRAs.\textsuperscript{1723} The changes introduced by section 933 (b) only require the plaintiff to establish particular facts giving rise to a strong inference that a CRA knowingly, or recklessly failed to (a) conduct a reasonable investigation of the rated security in respect of the factual elements relied upon by its methodologies for evaluating the credit risk or (b) obtain reasonable verification that such an investigation was undertaken by an independent source.\textsuperscript{1724} By lessening the pleading requirements, the Dodd-Frank Act makes it possible for CRAs to be held liable for their faulty judgements and ratings. Arguably, the threat of civil liability will ultimately strengthen due diligence, improve internal controls and enhance good corporate governance. Incidentally, the pleading requirements in the UK regarding civil liability of CRAs

\begin{footnotes}
\footnote{1718}{Securities Act 1933, r 436(g) stipulates that credit ratings from NRSROs assigned to public offering were not considered as expert or central part the registration statement. CRAs could thus, not be held liable if the registration contained an incorrect rating.}
\footnote{1719}{Securities and Exchange Act 1934, s 10(b)}
\footnote{1720}{World Bank (n 1714).}
\footnote{1721}{Securities and Exchange Act 1934, s 10(b)}
\footnote{1722}{Securities and Exchange Act 1943, s 5 (a)}
\footnote{1723}{Dodd-Frank Act 2010, s 933 (b)}
\footnote{1724}{Dodd-Frank Act 2010, s 933 (c)}
\end{footnotes}
has become more onerous and demanding as compared to the US due to the influence of EU law.

CRAs in the UK are regulated by Regulation 1060/2009 as amended by Regulation 513/2011. Article 35 (a) is very relevant as it deals with the liability of CRAs in the EU. Due to its membership of the EU and in keeping with section 2 (2) of the European Communities Act 1972, the Treasury Department enacted the Credit Rating Agencies (Civil Liability) Regulations 2013 to give meaning and effect to Regulations 1060/2009 and 513/2011.

In terms of incurring liability, the regulation is very explicit as to when and under what circumstances a CRA will incur liability for its ratings. Under Article 35(a) CRAs can only be held liable when they commit intentionally, and with gross negligence any of the infringements listed in Annex 111 to the Regulation. The infringements include: (a) failure to disclose conflict of interest (b) failure to adopt measures to ensure ratings are based on thorough analysis (c) issue credit ratings that do not comply with published methodologies (d) failure to notify ESMA of intended material changes to existing rating methodologies.

Of critical importance is the provision that CRAs will not incur liability for simple negligence or merely because they have issued an incorrect rating and that the infringement must have (had) an impact on the rating. The regulation further requires the plaintiff (investor) to establish that he reasonably relied on the rating agency on two conditions. First, that the reliance was in accordance with Article 5(a) (1) of the regulation and second, he exercised due care in respect of the decision to invest, hold on or divest from a financial instrument covered by the

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1725 European Communities Act 1972, s 2 (2). This Act empowers a designated Minister or Department to make regulation for implementing any community obligation, or enabling such obligation to be implemented.
1726 The Credit Rating Agencies (Civil Liability) Regulation 1637/2013
1727 The Credit Rating Agencies (Civil Liability) Regulation 1637/2013
1729 Bruyne (n 1692) 88.
1730 EU Regulation 513/2011 s 5(a) (1)
rating.\textsuperscript{1731} It is only when these conditions have been fulfilled that an investor may then claim compensation from the CRAs for the losses suffered\textsuperscript{1732}. From the above discussion, it becomes obvious that a higher standard of proof is required to bring civil liability claims against CRAs in the UK than their US counterparts. It can be argued that failure to reduce the pleading requirements in the UK/EU is not just a missed opportunity to sanitise the CRA industry, but it also sends the wrong signal to CRAs that the likelihood of being held liable for their actions is either minimal or non-existent.

The role of CRAs in the GFC has never been in doubt in the two jurisdictions. But the regulatory approach remains an area of fundamental divergence between the two economic blocks. Further, the two positions differ as the U.K (EU) approach relies on strict surveillance of the methodology of the rating regime. In this respect, Article 11(a) of Regulation 513/2011 requires registered CRAs to furnish ESMA with rating information such as rating outlook of the rated instrument, the type of rating action, date and time of publication.\textsuperscript{1733} In addition to the above, Article 14(3)\textsuperscript{1734} of the Regulation requires CRAs to notify the ESMA of its rating methodologies, key rating assumptions and any intended changes to the rating methodologies. Arguably, the above prescriptions together with the emphasis on detailed registration requirements tend to preserve the status quo by raising the barrier to entry. This, in effect has the unintended consequence of stifling competition and turning the credit rating industry into an oligopoly.\textsuperscript{1735}

In contrast, the Dodd-Frank\textsuperscript{1736} provisions render the SEC impotent regarding the basis of the ratings, their underlying assumptions, procedures and methodologies. Although the Act

\begin{itemize}
\item \textsuperscript{1731} ibid
\item \textsuperscript{1732} ibid
\item \textsuperscript{1733} EC Regulation 513/2011 art.11(a)
\item \textsuperscript{1734} EC Regulation 513/2011 art.14(3)
\item \textsuperscript{1735} Wold Bank (n 1714) 6.
\item \textsuperscript{1736} Dodd-Frank Act 2010
\end{itemize}
empowers the SEC to conduct on-sight inspection of CRAs and to take disciplinary action, it nonetheless prohibits the SEC from interfering in the rating procedure and methodology used. Consequently, the regulatory approach in the US relies on the CRAs themselves to self-regulate on the basis that such an approach is a better regulatory option as compared to the strictly rule-based regulation. Authorities in the US justify this approach by arguing that the introduction of competition in the rating industry would compel CRAs to improve their methodologies and ratings. Following from this, the SEC granted NRSRO status to eleven (11) CRAs since 2008 to increase the number of such agencies so as to reduce the current dependence on a few-select CRAs.

Realising that external ratings alone are not enough, the US government introduced the use of internal credit ratings that allow large financial institutions to carry out their own risk assessment. According to US authorities, this practice encourages competition which they contend, remains the best regulatory mechanism to improve transparency, accuracy and integrity of the rating process. In effect, the regulation of CRAs in the US involves minimal, informal public oversight that relies on market acceptance rather than regulatory standards. Hence, whereas UK authorities seek to promote accountability and transparency in the rating industry through effective supervision and a clear-cut regulatory regime, the authorities in the US prefer market discipline through transparency and competition.

6.3.2 Bank Resolution Regimes

The need for early intervention remains one of the most contested issues regarding the reform of financial regulation following the GFC. Authorities in the US and UK recognised that the

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1737 ibid
1738 Lannoo (n1638) 4.
1739 ibid
1740 ibid
1741 ibid
1742 Singh (1321).
present insolvency regimes are inadequate to deal with banks in distress particularly, after the failure of Lehman Brothers and Northern Rock.\textsuperscript{1743} Therefore, the policy rationale is the realisation that a key component of maintaining financial stability is through early intervention in distressed banks before they fail.\textsuperscript{1744} This is because formal structured intervention mechanism avoids the risk of the authorities hesitating when the need arises to make decisions about banks in financial difficulties.\textsuperscript{1745}

Consequently, the issue of early intervention became an integral part of the regulatory responses adopted in the two jurisdictions although the history of such interventions differs remarkably. While the UK was exploring the need for early intervention, the focus of the US was on the nature of the intervention. As opposed to the UK where such intervention is quite novel, early intervention has been part of the US system since 1991 under the Federal Deposit Insurance Corporation Improvement Act 1991 (FDICA).\textsuperscript{1746} The FDICA empowers regulators to take ‘prompt and corrective action’\textsuperscript{1747} to rectify the problem of insufficient capital before it reaches the point of insolvency. The restructuring of the regulatory discretion through the principle of prompt corrective action seeks to limit regulatory forbearance and allows a significant level of discretion deemed necessary to mitigate bank risk.\textsuperscript{1748} It is worth noting that prior to enactment of the Dodd-Frank Act, insolvent deposit-taking institutions and bank resolution mechanisms

\begin{footnotesize}
\textsuperscript{1743} ibid  \\
\textsuperscript{1744} ibid  \\
\textsuperscript{1745} Geoffrey Davis and Marc Dobler, ‘Bank Resolution and Safeguarding the Creditors Left Behind’ (2011) 3 Bank of England Quarterly Bulletining 52.  \\
\textsuperscript{1746} The Federal Deposit Insurance Corporation Improvement Act 1991 s.1831.0  \\
\textsuperscript{1748} ibid
\end{footnotesize}
were dealt with under the Federal Deposit Insurance Corporation Act (FDICA). In fact, Dodd-Frank only came to strengthen the scope and application of this existing legislation.

As compared to the US, the situation in the UK was very different. Prior to the SRR under the Banking Act 2009, insolvent banks in the UK were subject only to the normal corporate insolvency law. Insolvency is here defined as the inability to pay debts as they mature, or as obligations become payable. The insolvency process, particularly in respect of banks deemed systemically important has the potential to generate wider costs or negative externalities for society far beyond the losses to the bank’s own creditors. The principal problem with the existing insolvency regime relates to its negative impact on depositors’ right to access funds during that period, creating delays which eventually cause further panic in the financial sector. Moreover, the existing insolvency regime did not apply to building societies like Bradford and Bingley although these entities experienced massive problems before and during the GFC. These problems, coupled with the failure by the FSA to take control of Northern Rock while it was still solvent, and ensure a quick and efficient payment of depositors, made the introduction of the new legislation necessary.

Also, the political climate in the UK post the Northern Rock failure changed dramatically and the move towards a SRR was initiated following these developments. Therefore, as compared to the US, the SRR in the UK is considered a new mechanism as the country had no pre-existing resolution or special insolvency regime. Against this backdrop, it is submitted that SRR in the

1750 ibid
1751 Davis and Dobler (n 1745) 54.
1752 ibid
US and the UK evolved along different paths although the circumstances necessitating their introduction seem similar.\textsuperscript{1753}

6.4 Funding

Another area where the US and UK differ is in terms of how to fund the SRR. The US legislation expressly prohibits the use of public funds to support distressed financial institutions. It therefore, established the resolution fund to be financed by the systemically-important financial institutions themselves.\textsuperscript{1754} This is to ensure that the financial institutions rather than the public bear the cost of the resolution mechanism.\textsuperscript{1755} Furthermore, compelling financial institutions to pay for the resolution process makes them interested parties in the design of such a mechanism, and has the potential to reduce the moral hazard problems associated with bailouts.\textsuperscript{1756} An added advantage is that making the institutions responsible for the process generates cross-monitoring which in turn provides the incentive to encourage each other and avoid unnecessary risk-taking.\textsuperscript{1757}

This approach is, however, fraught with two obvious problems. First, it relies on financial institutions to fund the resolution process. In the event of these institutions being unable to provide the needed funding would mean the end of the entire project. The second problem is how to determine the appropriate focus of the measures introduced under the new SRR in view of the difficulty in identifying a ‘systemically important’ institution. Although various

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\textsuperscript{1753} Davis and Dobler (n 1745) 56.
\textsuperscript{1756} ibid
\textsuperscript{1757} ibid
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definitions have been provided, the Financial Stability Oversight Council (FSOC), the body charged with overseeing the resolution mechanism is yet to provide a clear-cut definition.

On the other hand, the UK adopts a different approach in respect of funding the SRR. This process, be it partial transfer, bridge bank or nationalisation does not provide for the establishment of a fund to pay for the cost of the resolution. In fact, the Banking Act stipulates the use of public funds to support troubled banks and financial institutions with the approval of parliament. The Treasury is however, empowered to pledge public funds without parliamentary approval if it is determined that the need is ‘too urgent to permit arrangements to be made for the provision of money by parliament’.\textsuperscript{1758} The reliance on the Treasury for funding and the FSCS to cover the depositor guarantee were evident in the case of RBS and Lloyds-HBOS.\textsuperscript{1759} Arguably, such government discretionary support through the Treasury, invariably gives an implicit guarantee to financial institutions limited only by the nation’s own balance sheets.\textsuperscript{1760} Indeed, far from limiting insurance to only depositors, the regime actually insures all creditors fully at the expense of the taxpayer.\textsuperscript{1761} Obviously, such implicit taxpayer-funded insurance tends to provide incentives to some of the systemically-important institutions to engage in excessive risk-taking as witnessed prior to the GFC. From this perspective, it is submitted that some of the very governance and regulatory practices that triggered the financial crisis have resurfaced under the UK special resolution regime.

6.5 Transparency

In terms of transparency, the two approaches differ with respect to the decision-making process with the UK approach being the very opaque and grants the Treasury Secretary more

\begin{notes}
\item[1758] The Banking Act 2009, s 228-231
\item[1759] Davis and Dobler (n 1745) 56.
\end{notes}
discretionary powers. This is made possible by the adoption of a code of practice, ostensibly to clarify the provisions of the Act under the pretext that ‘the concepts at issue are too complex to be reduced to hard-edged statutory definition’. Consequently, the code spells out the responsibilities of each authority but fails to explain how these bodies should work together to design a solution to define a failing bank. For example, the BoE in consultation with the FSA decide on the viability of the first two options, namely private sector transfer and bridge bank. The Treasury only plays a role when the preferred option is nationalisation, when the use of public funds and the need to protect public interest becomes imperative.

The overlapping responsibilities and lack of clarity is further compounded by the separation of the FSA into two regulatory entities. The inclusion of two additional regulatory bodied makes an already complex process more complicated and renders it rather opaque. Apparently, this opaqueness is a direct result of the less prescriptive character of the Act following the adoption of the code of practice.

In another breadth, the less prescriptive approach or principle-based model seem advantageous because it allows banks enough time to deal with the issues confronting them. An example is the decision by the FSA to allow the Icelandic bank Kaupthing adequate time to resolve its liquidity problems before triggering the powers of administration.

The resolution regime in the US tends to be more explicit, rule-based and allows no room for ambiguity by strictly adhering to the provisions contained in the FDICA 1991 and the Dodd-Frank Act. In keeping with this prescriptive approach, legislations in the US empower regulators to insist on strict compliance and allow minimum discretion to limit regulatory forbearance.

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1763 R v (on the application of Kaupthing) HM Treasury [2009] EWHC 2542 (Admin) [16]- [28]
1764 Singh (n 1321) 15.
This prescriptive approach enables the regulators to embark on specific actions if it is
determined that the capital position of a financial institution is deteriorating. The specific
actions include requesting the firm to (a) submit a plan explaining how it intends to recapitalise
(b) capital restructuring plan and (c) impose restriction on bonuses by requesting directors to
agree with the regulations on the payment of bonuses, commissions, severance and
remunerations.1765 Arguably, this prescriptive and rule-based approach in the US is possibly
appropriate and more efficient given the large number of bank failures and closures experienced
during the GFC.1766

Indeed, early intervention policy on its own is not an antidote to bank failures and the
subsequent GFC that followed. The success, to a very large extent, depends on the experience
and judgement of the regulators making the right choices as acknowledged by the FSA in
respect of the Northern Rock failure.

Similarly, although the prompt corrective action (PCA) mechanism has been in existence in the
US since 1991, that alone could not prevent bank failures in that jurisdiction. This seems to
suggest that the concept of early intervention regime as a means of resolving bank failures has
been oversold and that a re-examination of the governance model of banks is what is required
to avoid banks falling into crisis. Above all, the weaknesses identified in both jurisdictions
relate not to whether the intervention is rule-based as in the US or principle-based as obtains in
the UK. Indeed, they can be explained by the fact that both the US and UK adhere to a
governance model founded on the principle of shareholder primacy which advocates private
regulation, market fundamentalism and profit maximisation for short-term purposes.

1765 Dodd-Frank Act 2010, s 183 (4)
1766 Singh (n 1321) 18.
6.6 Analysis

As earlier discussed, corporate governance tends to operate within the parameters set out by national laws, regulations, economic goals and expectations of the dominant interest group. Therefore, to understand the approaches to the reforms, it is necessary to look beyond the labels and to consider the current context underlying the approaches to corporate governance. Admittedly, the US and UK may differ in their responses to the crisis but a careful analysis of observed patterns indicates the same kind of reform arguments are dominant in both countries. These relational similarities identified in the two jurisdictions can be explained by how problems and solutions are defined and how risk is perceived. In line with this hypothesis, it is not surprising that the two jurisdictions advance similar arguments that use the crisis to push a reform agenda that reflects not just their definition of the problem and solution but also tends to enhance the shareholder primacy theory.

Indeed, the GFC affected the UK and the US differently in many respects, but the subsequent reforms in both countries look similar mainly because large UK financial institutions adopted essentially the same business model as those operating in the US. The ‘originate to distribute’ business model replaced the ‘originate to hold’ model that has been in operation until recent times. The ‘originate to distribute’ is a process that allows financial institutions to expand their lending seemingly without violating the underlying capital requirements set by the regulators. The model generated instruments such as collateralised debt obligation (CDO) mortgage-backed securities (MBS) and credit default swaps (CDS). In fact, the use of these instruments to exploit the weaknesses of the regulatory system was common in US and UK. The over-reliance on this inappropriate business model eventually led to the failure of the

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regulatory structures on both sides to enforce the capital requirements that would have otherwise mitigated the impact of the GFC. Consequently, it can be argued that the adoption of similar business models in these jurisdictions shaped the policy response and reforms initiatives. Generally, however, the reforms in both jurisdictions do not constitute a radical departure from past practice, building instead on the existing business model that sparked the GFC.

Another factor that explains the similarity in response is how authorities in both countries perceive and define the causes of the financial crisis. Authorities in the US and UK identify the causes as an agency problem that can be resolved by aligning the interest of managers with that of shareholders. As a result, it became imperative for policy makers in the two countries to design post-crisis responses that are essentially similar in content. The solutions contained in these reforms have internal as well as external elements. The internal elements focus on strengthening the internal governance of corporations through the appointment of non-executive directors (NED) to monitor management. The reforms in the two jurisdictions also mandate management to fulfil higher reporting and disclosure requirements to ensure transparency and accountability. Much as these measures may seem to improve corporate governance, they are in fact empowering devices that tend to strengthen the position of shareholders at the expense of other corporate constituents.

Externally, both Dodd-Frank and the Banking Act contain provisions that seek to regulate the conduct of financial and non-financial institutions. Subsequently, the two legislations provide for bank resolution regimes that ensure the early rescue of banks in financial distress or allow for the orderly liquidation of such banks.

1771 Purmanandam (n 1769).
1772 Sahalia et al. (n 1599).
In addition to the above, the deregulatory experiences of the two countries find expression in their policy responses to GFC. Since the early 1980s, the neoliberal administrations in the US and UK embraced the rhetoric of deregulation ostensibly to address economic failures.\textsuperscript{1773} This was based on the assumption that neoliberal economies produced the best possible outcomes in terms of efficiency; hence, it was essential to decentralise and assign the regulatory functions to private regulatory bodies.\textsuperscript{1774} This approach emphasises private ordering as the best means of promoting economic efficiency and allowed firms/corporations to regulate themselves in conformity with political preferences supported by economic theories developed in the 1960s and 1970s: notably the efficient market hypothesis.\textsuperscript{1775} In both the US and UK, this ‘light touch’ regulation was marked by very limited role for government and the dismantling of control, monitoring and surveillance in the name of deregulation. At the same time, the approach relied heavily on private market operators to determine the form and content of regulation. Clearly, it was a strategy based totally on persuasion, shaped by entrenched political and economic interests and mediated by ideological considerations.\textsuperscript{1776} Against this background, it can be argued that the subsequent reform agenda adopted post the GFC has largely been shaped by these developments. Moreover, there is now a growing recognition that, this passive approach to financial regulation is no longer sustainable. As a result, regulatory intervention has become inevitable because the GFC has challenged established understanding and expectations that had dominated the era of ‘light-touch’ regulation of the early 1990s in the US and UK.\textsuperscript{1777} Notwithstanding the factors already mentioned, the adoption of Anglo-American corporate governance paradigm with its underlying assumptions provides the most cogent reasons for the similar responses in the US and UK. The Anglo-American corporate governance model as

\textsuperscript{1773} Lorraine Talbot, *Progressive Corporate Governance for the 21\textsuperscript{st} Century* (Routledge 2013) 145.
\textsuperscript{1774} ibid
\textsuperscript{1775} Engelen et al. (n 1226) 54.
\textsuperscript{1776} Lodge and Wegrich (n 1767).
\textsuperscript{1777} Engelen et al. (n 1226) 160.
explained earlier is characterised by the shareholder primacy, unquestioned belief in the efficiency of the markets, short-termism, dispersed ownership and unitary board of directors with a chairman separate from the CEO.

Following the adoption of this shareholder-oriented model, an array of economic and legal institutions emerged to serve the purpose of orienting corporate managers towards increasing share price and ultimately creating shareholder value.\textsuperscript{1778} As Davis explains, the outcome of this development is that the managerial market, boards of directors and the take-over markets all compelled corporate managers to focus on their companies’ share price as the sole and legitimate purpose of the firm. This was further reinforced by the practice of tying executive compensation to share price through devices such as stock options.\textsuperscript{1779}

Furthermore, the external managerial markets saw a dramatic increase as companies sought to recruit outside CEOs rather than from within their own organisations.\textsuperscript{1780} Accordingly, managers seeking to attract outside investments often include a number of safeguards to demonstrate their commitment to the protection of shareholder value.\textsuperscript{1781} On the other hand, those who fail to show sufficient devotion to shareholders are likely to be subjected to take-over moves and eventually suffer by way of higher cost of capital.\textsuperscript{1782} Indeed, by the 1990s, few executives both in the US and the UK had any doubts that their companies exist to create shareholder value as evidenced in the mission statements of several international brands including Coca Cola.\textsuperscript{1783} The mission statement of Coca Cola states that the company exists to create value for its share owners on a long-term basis by building a business that enhances the Coca Cola trade mark.

\textsuperscript{1778} Gerald Davis, \textit{Managed by the Market: How Finance Re-Shape America} (OUP 2009) 83.
\textsuperscript{1779} ibid
\textsuperscript{1780} ibid
\textsuperscript{1781} ibid
\textsuperscript{1783} ibid
In the US the idea that corporations exist to serve shareholder interest attained pre-eminence at the time of President Ronald Reagan. The corporate governance framework during this era has been shaped by what Davis refers to as ‘Reaganomics’.\footnote{Davis (n 1778) 85.} It is a version of market fundamentalism that has been influenced by neo-classical economic thinking in which management is driven and determined by the free market ideology.\footnote{Simon Caulkin ‘Corporate Apocalypse’ \textit{Management Today} (London, 1 January 2009) <www.managementtoday.co.uk/corporate-apocalypse/article/870435> accessed 20 July 2016} Indeed, faced with formidable competition from Japan and the newly-emerging economies of Asia, the over-bloated Anglo-American conglomerates were compelled to adopt a governance model that allows them to remain competitive.\footnote{Davis (n 1768) 89.} Consequently, managers resorted to down-sizing, less investment in research and development and relocating to countries with lower labour costs all in an attempt to maximise shareholder value.\footnote{ibid} Through the invisible hand of the market, corporations in America have come to be structured to serve shareholder interest as advocated by the Reagan administration which provided an impetus to the free market economic theory.\footnote{ibid} In this context, it may be argued that the corporation has, more or less become an institutional reflection of the principles of laissez-faire capitalism driven by a neo-liberal agenda.\footnote{ibid}

As the GFC demonstrates, the notion that the free market economic system produces better outcomes and thus, be kept from political control and left to market actors has proven be flawed in many respects. Indeed, the last two decades have witnessed several corporate failures including the Enron fraud, the WorldCom scandal in the 2000s and the costly taxpayer-bailouts of financial firms in 2008. Apparently, the markets did not function and government
intervention with public money became the only viable alternative. Thus, the excessive faith placed in the market as a self-correcting mechanism and fear of government intervention in the economy have all turned out to be misplaced. Arguably, ‘the markets may fear big government, but governments are now beginning to fear big markets’. The reason, as the GFC illustrates, is that financial markets pose a greater risk to the economy, the state and taxpayers than the state can ever pose to the markets. Indeed, the fundamental problem is that markets, left unto themselves have the tendency to distort the economy by the creation of excessive public debts as happened in the recent crisis. Across the advanced economies, the overall bailout constitutes about 3 per cent of GDP, the full cost of the crisis is estimated to be much bigger while public debt has increased by 34 per cent. Moreover, living standards have fallen 10 per cent below pre-crisis levels.

A similar neo-liberal economic model was adopted by the Thatcher government in the UK since 1979 under the guise of privatisation. Privatisation under the Thatcher-led conservative government was part of a neo-liberal agenda that sought to roll back the public sector by selling parts of the nationalised industries, opening them up to greater competition and contracting out public services to the private sector. It is estimated that over fifty companies including: British Gas, British Telecom, Water and Electricity were privatised under the pretext that state-run companies were not only badly managed but also stifled competition. Hence, privatisation was seen as fundamental to improving UK’s competitive edge and overall economic performance.

Apparently, the rational for privatisation was not clearly spelt out by its proponents except to state that it is intended to ensure a property-owing democracy in which individuals at all levels would own a stake in the economic success of the UK. The ex-post justification for the privatisation suggests however, that the overriding motivation for the programme was more ideological than economic.\footnote{1798} This explains why the privatisation programme has often been dismissed as 'a product more of political opportunism than an economic theory'.\footnote{1799} In fact, the neo-liberal agenda as evidenced by privatisation fails to deal with the discontents and contradictions so ubiquitous in the market-based economy.\footnote{1800} First, the philosophical foundation of privatisation rests upon a rather distorted and incomplete conceptualisation of the purpose of the corporation in society and the ability of the market to act as a self-correcting mechanism.\footnote{1801} Second, it can be argued that privatisation programme is also flawed for its reliance on profit-oriented corporations to perform what is effectively a public function in the form of regulation.\footnote{1802} Obviously, such profit maximising entities are bound to put their private corporate interest above and beyond the wider public interest. It is, therefore, no coincidence that the GFC of 2008 was preceded by management practices that portrayed profit maximisation for the benefit of shareholders as the sole and legitimate goal of the corporation. Thus, a corporate governance model founded on shareholder primacy, the efficient market hypothesis, short-termism and private regulation emerged in response to political preferences and economic theories of this era.\footnote{1803} Since then, corporate governance in the UK has been subjected to the rather rigid template of shareholder primacy, the flawed concept of market efficiency and the unquestioned adherence to the comply-or-explain principle.\footnote{1804}
It is important to remember that the age of deregulation was also an age of privatisation during which authorities in the US and the UK gave meaning and effect to market fundamentalism. In so doing, both the US and UK adopted the neo-liberal doctrine of the self-correcting market mechanism on the assumption that unfettered free markets provide optimal outcomes when they are not distorted by government intervention. Authorities in the two countries justify this doctrine by arguing that it was conducive to stability and wealth creation. This ideology, with its emphasis on shareholder primacy, however, proved to be a source of financial instability and the cause of the GFC.

Moreover, the same logic that drove the neo-liberal agenda in the early 1980s - the willingness to allow ideology and political preferences to blind governments to the risks posed by unregulated markets continues to shape the responses to the crisis. While there are obviously some differences in the two countries, major similarities exist in terms of the philosophies underlying the interventions; the challenges posed by the crisis and perhaps more importantly the adherence to the Anglo-American model of corporate governance. It is therefore, submitted that these factors, to an appreciable extent account for the similar but flawed responses adopted by the US and the UK to the GFC.

6.7 Conclusion

A comparison of the post crisis responses in the US and UK reveal several differences as well as major similarities which eventually shaped the nature and content of the legislative and regulatory responses. Policy responses in the US and UK post the GFC mainly consists of three types of interventions: bank bailouts, stimulus package and regulation of financial institutions. As part of the initial response, some financial institutions considered ‘too-big-to-fail’ were taken into public ownership through bailouts and subsequent nationalisation in

1805 Engelen et al. (n 1226) 163.
1806 De Vogli (n 333).
both jurisdictions.\textsuperscript{1807} This became evident when Treasury Departments were obliged to replace the limited depositors guarantee with state guarantees by using public money to guarantee all depositors in failing banks such as Northern Rock, RBS and TSB Lloyds. A similar response occurred in the US where financial institutions including Bear Seams, AIG were nationalised and mortgage-providing firms like Fannie Mae and Freddie Mac taken into public ownership.\textsuperscript{1808} This huge extension of public ownership and the extensive underwriting of the financial industry represents the single most important policy intervention, and arguably, a dramatic policy reversal that questions the long-established assumptions about the efficient market hypothesis.\textsuperscript{1809} These developments, led to the ‘ politicization’ of the markets whereby politicians on both side have become actively engaged in the management of the financial system. For instance, the nationalisation programme and the stimulus package signalled a dramatic shift as well as an increase involvement of the political class in financial matters. This new-found role effectively empowered Treasury officials to become involved in the detailed management of troubled financial institutions, determined which banks needed to be rescued; taking into consideration factors such as size, interconnectivity and relevance to the economy. In addition to the initial bailout and stimulus packages, authorities in both countries recognised the need for a more stringent approach to financial regulation. It became apparent and indeed, evidence abounds to suggest that the current model of banking regulation and resolution have failed and need substantial reforms.\textsuperscript{1810} Consequently, governments in the US and UK tightened the legal and regulatory controls by enacting major legislations namely the Dodd-Frank Act 2010 and the Banking Act 2009 respectively.

\textsuperscript{1807} Engelen et al. (n 1226) 62.
\textsuperscript{1808} Davis (n 1778) 89.
\textsuperscript{1809} Engelen et al. (1226) 65.
\textsuperscript{1810} Hill and Painter (n 1800) 72.
On the face of it, these legislations seem forward looking as they tend to tilt towards the more stringent and prescriptive regulatory approach embedded in the American regulatory culture.\textsuperscript{1811} In that context, they appear to be the most appropriate response to the regulatory failures and corporate governance deficiencies exposed by the GFC.

The purported ‘success’ of these legislations however, obscure the reality that several aspects of the regulatory approach have not changed. Some provisions of these legislations, in fact, tend to defend the free market ideology and uphold a corporate governance system ‘whose substance is the promotion of shareholder value’\textsuperscript{1812} as evidenced by the increasing economic power of institutional shareholders. Unsurprisingly, institutional shareholders have assumed more power and have become an integral part of the governance process post these reforms.\textsuperscript{1813} This echoes the view that although, some of the regulatory issues have been addressed and corporate governance improved, the fundamental mode of conceptualising the corporation as profit-oriented vehicle purposely established to satisfy shareholder interest remains untouched.\textsuperscript{1814} On the basis of the above analysis, it is submitted that with the exception of some minor differences, the response of the US and UK governments to the GFC are fundamentally similar.

The sources of these similarities are complex and deeply rooted in several factors including: the unquestioned belief in the Anglo-American corporate governance model with its emphasis on shareholder primacy, efficient market hypothesis, deregulation and financial innovation which in turn, reflects the neo-liberal agenda. Driven by the neo-liberal agenda, corporations shifted from ‘originate to hold’ to ‘originate to distribute’ business model with its attendant risky business practices under the guise of financial innovation. Apparently, this business model

\begin{itemize}
  \item [\textsuperscript{1812}] Engelen \textit{et al.} (n 1226) 164.
  \item [\textsuperscript{1813}] Peter Burnham, ‘Class, Capital and Crisis: A Return to Fundamentals’ (2010) 8 (1) Political Studies Review 27.
\end{itemize}
which became the hallmark of the global financial system transformed banking institutions into ‘uncrushi-putious gambling houses’.\textsuperscript{1815} The proliferation of these risky financial products in the form of credit default swaps, collateralised debt obligations and mortgage-backed securities dominated the financial systems of these jurisdictions.\textsuperscript{1816}

Perhaps, more crucial is the strict adherence to the rhetoric of the shareholder primacy as underpinned by the Anglo-American school of corporate governance. This model is characterised by flexibility, deregulation, excessive faith in the market and the presumption that the model represents the future of capitalism itself.\textsuperscript{1817} The emergence and the eventual predominance of the shareholder-oriented model in the US and UK is closely linked with the neo-liberal agenda that began in the early 1960s and later pursued by the Reagan and Thatcher regimes.\textsuperscript{1818} Decades of market-based economic policies in the name of privatisation and deregulation allowed firms to regulate themselves in conformity with political preferences that consider the corporation a vehicle for capital accumulation with the state acting as a facilitator.\textsuperscript{1819} It should be stressed that the process by which the state plays this facilitator role is inherently political which reaffirms the path-dependent nature of corporate governance models.\textsuperscript{1820}

Indeed, the reasons for the similarities in the post-crisis reform agenda in the US and UK run deeper and derive from a shared belief in the free market economy, a reliance on the shareholder primacy as the ideal model of governance to which all other states must aspire.\textsuperscript{1821} The combination of these factors resulted in the unique similarities of the responses in the two

\textsuperscript{1815} Hill and Painter (n 1800)73.
\textsuperscript{1816} De Vogli (n 333) 2.
\textsuperscript{1817} Engelen et al. (n 1226)168.
\textsuperscript{1818} ibid
\textsuperscript{1819} Hupkes (n 1790) 86.
\textsuperscript{1820} Fligstein and Freeland (n 59).
\textsuperscript{1821} Douglas M. Branson, ‘The Very Uncertain Prospect of “Global” Convergence in Corporate Governance’ in Thomas Clarke (ed), Theories of Corporate Governance (Routledge 2004) 272.
jurisdictions. The central message, therefore, is that despite some differences, the response to the crisis in the US and UK are very similar both in approach and outcomes. These outcomes as earlier discussed, point to an abysmal failure to address the problem of shareholder primacy and short-termism, although the underlying assumptions have been forcefully taken apart.\footnote{Stout (n 29) 74.}
CHAPTER 7

CONCLUSIONS AND RECOMMENDATIONS

7.1 Introduction

What started as a subprime mortgage problem in the US quickly turned into a global financial crisis with far-reaching social, economic and political ramifications. In response, governments across the world including the US and UK introduced several legislative, regulatory and governance reforms. The thesis set out to explore whether the corporate governance reforms introduced in the US and UK post the financial crisis address the underlying causes or merely treating the symptoms. The study argues that because the causes of the crisis have largely been misunderstood and misdiagnosed, the subsequent responses have tended to address the symptoms and not the underlying causes. Against this back drop, this concluding chapter discusses the nature and outcomes of the response, the conclusions that can be drawn, makes some recommendations to minimise the effects of future crisis and suggests areas for further research.

7.2 Analysis

Following the crisis, the debate about the causes began in earnest with various schools of thoughts adopting different positions. While some attribute the crisis to corporate governance failures, others argue the crisis was not in any way related to corporate governance. Yet a third school of thought insists the crisis stems from ineffective implementation of existing corporate governance rules, codes and principles.

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1823 William Sun, Jim Stewart and David Pollard (eds.) Corporate Governance and the Global Financial Crisis: International Perspectives (CUP 2011) 2.
1824 ibid
1825 ibid
The findings of this study, however, run counter to all these propositions. At best corporate governance failures, as has been forcefully argued, merely acted as triggers and cannot be blamed for causing the crisis. The underlying cause of the crisis as this study argues, is the mistaken idea that the sole and legitimate purpose of the corporation is to maximise shareholder value in the shortest time possible. This single-dimensional conception of shareholder primacy proved unrealistic and dysfunctional as evidenced by the massive corporate frauds at Enron, WorldCom, Pamalat in the early part of 2000 and the subsequent taxpayer-funded bailouts of some of the largest financial institutions in 2008.

The philosophical foundation of shareholder primacy rests on the mistaken claims that (a) shareholders ‘own’ the corporation, (b) shareholders are the residual claimants of the profits and (c) they are principals who hire and control the directors and executives to act as their agents. Contrary to this narrative, a critical examination of shareholder primacy reveals that the ideological legitimation underlying the shareholder primacy—namely the prudential claim, the moral claim and the functional claim—have all been debunked and rejected.

First, shareholders as the study shows, only own shares in the company which should not be confused with the ownership of the company itself. Their rights vis-a-vis the company are restricted and limited to non-binding votes that can be ignored by management under the business judgement rule. The actual exercise of power and control over the corporation remains the prerogative of management and not shareholders. It is therefore, misleading to

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1826 Stout (n 29) 86.
1827 ibid
1828 Cheng and Warfield (n 398) 24.
1829 Thomas Clarke, ‘Corporate Governance Causes of the Global Financial Crisis’ in William Sun, Jim Stewart and David Pollard (eds), Corporate Governance and the Global Financial Crisis: International Perspectives (CUP 2011) 172.
1830 ibid
1831 Stout (n 29) 56.
1832 ibid
characterise shareholders as owners based on assumptions that are inherently inaccurate and unsustain-
able.

Also, the perceived superiority of the shareholder value maximisation approach cannot be substantiated. So far, no persuasive empirical evidence exists to suggest that corporations run along the shareholder-oriented approach are more efficient or perform better than those that are not. 1833 Indeed, if shareholder value thinking was good for shareholders as is being claim, then governance structures and business practices would have greatly improved investor returns over the past two decades. 1834 A closer look at this proposition reveals however, that the exact opposite has happened. The shareholder primacy approach with its emphasis on share price and the use of stock-based compensation schemes became more of a problem due to its short-term approach to the governance of corporations. 1835

As explained earlier, the shareholder primacy theory is an artificial construct that produced not just poor shareholder value, but it also destroyed shareholder value before and during the GFC. 1836 Thus, this thesis takes the position that the cause of the recent GFC can be traced not to flawed individuals or flawed regulations but to a flawed idea which advocates that corporations are only managed well when they maximise share price to satisfy shareholder interests and demands. 1837 Apparently, the emergence of the shareholder primacy thinking as the dominant governance theory under the Anglo-American corporate governance cannot be viewed in isolation. Rather, it is part of a broader discourse about the corporate purpose dating back to the Berle-Dodd debate and thus, reflects the different perceptions of the role and purpose of the corporation in society. 1838 Despite the initial reservations and objections, Berle

1833 Bakan (n 343) 64.
1834 ibid
1835 ibid
1836 Stout (n 29) 84.
1837 ibid
1838 Horn (n 161) 33.
had, by the close of the debate, finally conceded that the corporation is a public institution whose purpose is to serve the larger societal interests.  

That notwithstanding, the perception that corporation exists solely to maximise shareholder returns continues to hold sway on corporate governance thinking and practice. This has been made possible by academics who provided the intellectual justification and policy entrepreneurs who successfully pushed through significant corporate governance regulations designed to make managers more focused on promoting shareholder interest. 

The shareholder value thinking was further entrenched by international organisations particularly the IMF, World Bank and the OECD. These institutions often advocate, and sometimes, mandate corporate governance practices and structures conducive to shareholder interest. It is important to stress that, although, the OECD may lack the coercive powers of the IMF and World Bank, it nonetheless plays a crucial role in defining what constitutes good corporate governance and also legitimises this social construct through the appearance of consensus building. These institutions often, equate good corporate governance with the Anglo-American model which emphasises market efficiency, deregulation whereby the corporation is primarily an instrument for achieving the goal of maximising shareholder value. 

As the study shows, shareholder value maximisation is not a ‘natural’ by-product of market forces, rather it is attributable to the strong bargaining power of interests groups able to preserve a legal and institutional regime conducive to their financial interest. Indeed, the choice of corporate governance practice in any country expresses the interaction of economic preferences

1840 Talbot (n 1773) 43.
1841 Soederberg (n 296) 142.
1842 ibid
1843 ibid
1844 Horn (n 161) 36.
and social power relations.\textsuperscript{1845} It signifies a power struggle that is fuelled by the different perception and understanding of the nature and purpose of the corporation in society. Consequently the adoption of a corporate governance model founded on shareholder primacy reflects political and economic preferences that are inherently neo-liberal.\textsuperscript{1846} This echoes the earlier definition of corporate governance as the practices that define and reflect the power relations within the company and the way, and for which purpose it is run.\textsuperscript{1847} Thus, the emergence of the shareholder primacy as the dominant governance theory in the US and UK reflects a neoliberal agenda constructed by social forces embedded within the political struggle. Admittedly, some aspects of the reforms have been very positive in terms of improving governance practices, ensuring transparency and accountability. Nonetheless, the overall reform measures did not represent a significant departure from past practices, building instead on the existing shareholder-oriented corporate governance model that triggered the GFC.\textsuperscript{1848} Unsurprisingly, the responses in both the US and UK reinforce the shareholder primacy proposition by focusing mainly on measures that seek to improve the existing governance regime without changing the fundamentals. As a result, the reforms tend to focus on restructuring the composition and functions of boards of directors, advocate shareholder empowerment and align the interest of management with that of shareholders.\textsuperscript{1849} Apparently, the introduction of stricter rules on disclosure, executive compensation, risk management and regulation of CRAs are all geared towards maintaining the status quo and protecting shareholder interest.

From this perspective, it stands to reason that these measures alone are acutely inadequate as they fail to address the issue of shareholder primacy thinking, short-termism and the larger

\textsuperscript{1845} ibid
\textsuperscript{1846} Fligstein and Freeland (n 59).
\textsuperscript{1848} Bakan (n 343) 67.
\textsuperscript{1849} Clerc (n 109) 93.
question of what constitutes the corporate purpose and whose interest the corporation exists to serve.\textsuperscript{1850} The remedies contained in the reforms have failed to recognise and resolve these three fundamental issues, but chose to focus on the symptoms rather than the underlying cause of the crisis. Consequently, it is submitted that, the corporate governance reforms in the US and UK following the GFC do not by any means constitute a radical departure from the shareholder-oriented corporate governance model. If anything, they are, but a modest refinement of the prevailing governance theory that has created the worst global financial crisis since the Great Depression.\textsuperscript{1851} The defects of these reforms become evident in the continuing recurrence of corporate failures since 2009 which suggests that the world is not yet ready to avert the next crisis.\textsuperscript{1852} Apparently, corporations, particularly financial institutions, seem determined to return to business as usual, perhaps, with a few cosmetic changes, but no fundamental reform in way they perceive and define the corporate purpose and the governance practices they adopt.

### 7.3 Recommendations

In view of the defects identified in the shareholder primacy model, the study suggests an alternative model of corporate governance with different underlying assumptions in which the interest of the larger society and long-term relationship define the purpose of the corporation.

#### 7.3.1 Reconceptualise and Redefine Corporate Purpose

A fundamental reform of the present dysfunctional system starts with a reconceptualization and redefinition of the nature, purpose and role of the corporation in society. This necessarily requires radical changes in how business and economics are taught in law schools, business schools and economics departments. This is because the emphasis schools and training institutions put on certain values or approaches will reverberate for decades as happened with

\begin{footnotesize}
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\item[Bakan (n 343) 66.]
\item[Ibid.]
\item[Ibid.]
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the shareholder primacy theory.\textsuperscript{1853} The values espoused in these institutions will determine how business leaders and lawyers behave, professional association standards are set, and policies are adopted.\textsuperscript{1854}

In this regard, there is an urgent need for a new approach that will emphasise an alternative model, which in theory and practice recognises that the purpose of the corporation is to advance the interest of society. This is achieved by finding the right balance between the competing claims of various groups and assigning to each group its due share. Under this inclusive model, corporations are obliged to be responsible to the interest of society and not merely accountable to shareholders.

What is being proposed here is the concept of common good so that corporate executives have a single target, but one that includes all corporate constituents not just shareholders.\textsuperscript{1855} The proposed model draws on the African philosophical concept of \textit{Ubuntu} which denotes coexistence, consensus and consultation.\textsuperscript{1856} The common good in the context of \textit{Ubuntu} is defined as ‘the sum of the interests of the several members who compose the community’.\textsuperscript{1857} This concept emphasises the collective interest where the success of one person depends to a very large extent on the success of all others- the community.\textsuperscript{1858} Its main attributes includes; community, consensus, interdependence, solidarity and long-term relationship. Consequently, this approach renders the exclusive focus on shareholder primacy almost impossible and unattractive because all aspects of governance practices, goals and objectives are geared towards realising these values for the common good on long-term basis.\textsuperscript{1859} It is, therefore,
critical that these values permeate all aspects of governance and be demonstrated in actions and decisions of the corporate entity.

Obviously, the concept of *Ubuntu* is not static but capable of evolving and adapting to the changing social conditions, which makes it applicable to relationships other than those of the traditional setting in which it was developed.\(^{1860}\) In this respect, it may be argued that this non-western concept and cultural experience can contribute to the corporate governance discourse. As Justice Makoro rightly notes ‘the strength of Ubuntu lies in its potential as a tool for aligning the interests of the entire community’.\(^{1861}\) Justice Sachs echoes this in *Port Elizabeth Municipality v Various Occupiers* when he states that Ubuntu is part of the cultural heritage in an evolving society that stresses the need for interdependence, respect and concern for others.\(^{1862}\) Similarly, in *The City of Johannesburg v Rand Properties Ltd*, the South African Constitutional Court held that the essence of Ubuntu is ‘the capacity to express compassion, reciprocity, harmony and humanity in the interest of building, maintaining and strengthening the community; it speaks to our humanity and responsibility to each other’.\(^{1863}\) Clearly, these rulings remind the entities involved that the interest of other members of the community cannot be ignored but should be factored into the decision making process, governance and business practices.

It is worth noting that the *Ubuntu* concept differs from the stakeholder approach in that the stakeholder theory focuses on how individuals with conflicting group interest can live in relationship with the same organisation. The *Ubuntu* idea on the other hand, stresses the common good where managers have single target that is inclusive of all constituents of the


\(^{1861}\) Justice Makoro, *S v Makwanyane* 1995 (3) SA 391 CC


\(^{1863}\) Ruling of the South African Constitutional Court in *The City of Johannesburg v Rand Properties Ltd* 2007 (1) S.A 75 (W)
corporation not only shareholders.\textsuperscript{1864} Arguably, the proposed model will help prevent the excesses, greed and persistent corporate failures associated with shareholder primacy because it is underpinned by the values of interdependence and responsibility towards the community and not just markets and individuals.\textsuperscript{1865}

7.3.2 Formalise Worker Participation

As part of the consensus building agenda envisaged under the new governance model, this study advocates for the inclusion of workers representatives on the board of directors like the co-determination model found in Germany, Sweden, Denmark and Norway.\textsuperscript{1866} Arguably, worker-participation engenders high level of stability and trust between the interest of capital and labour thereby creating the basis for more consensual industrial relations framework.\textsuperscript{1867} Moreover, the knowledge workers bring to board level deliberations make both sides more realistic in their expectations concerning critical issues affecting the firm. In practice, collective participation through information, consultation and co-decision-making ensures that the interest and voice of labour are not ignored but considered in strategic matters such as mergers, acquisitions, layouts or relocation. It has been argued that the resilience of the German economy for the past three decades is partly attributed to the efficiency of this model as it takes a long-term approach to governance practices and decision-making.\textsuperscript{1868}

The inclusion of workers on the board of directors recently received a boost from the British Prime Minister Theresa May, who expressed discontent with the current model of corporate governance in the UK. The Prime Minister argues that the practice of drawing the supposedly independent non-executive directors (NED) often from the same narrow social and professional

\textsuperscript{1864} ibid
\textsuperscript{1865} ibid
\textsuperscript{1866} Carsten Jungmann, ‘The Effectiveness of Corporate Governance in One-Tier and Two-Tier Board Systems: Evidence from the UK and Germany’ (2006) 3 (4) ECFR 426.
\textsuperscript{1867} ibid
\textsuperscript{1868} ibid
background just as the executives is counter-productive. According to her, this practice invariably renders the system ineffective as it limits the scrutiny they are expected to provide.\footnote{Jack Torrance, ‘Theresa May Reveals Radical Plans to Shake Up Britain’s Boardrooms’ \textit{Management Today} (London, 11 July 2016)} Her suggestion that workers and consumers be given a role in the governance of corporations is very significant because it indicates a tacit admission at the highest level of government that the current corporate governance model in the UK is defective and needs a radical overhaul.

\subsection*{7.3.3 Covenant Governance}

The study further recommends the introduction of strict personal liability into the governance of major corporations particularly the banking industry under the principle of ‘covenant banking’.\footnote{Hill and Painter (n 1800) 146.} This is to ensure that executives are held contractually liable from their personal assets for portions of the losses of the companies (banks).\footnote{Anat Admati and Martin Hellwig, \textit{The Bankers’ New Clothes: What’s Wrong with Banking and What to Do about It} (Princeton University Press 2013)} Arguably, such a regime will compel senior officials to provide personal guarantees against losses enforceable under the law of contract with strict liability, where proof of fault is not required.\footnote{ibid}

This has become more compelling when viewed against the backdrop of the defects identified in the current bank regulatory regime, especially under the Banking Act 2009 and Dodd-Frank Act 2010.\footnote{ibid} Like previous legislations, neither the Bank Act 2009 nor Dodd-Frank is deterrent enough to avert the excessive risk-taking that characterised management practices just before the crisis. This may well be because those ultimately responsible for the reckless risk-taking behaviour did so with money that is not their own but belongs to someone else.\footnote{ibid} The cure, therefore, is to introduce personal liability, first, to serve as a deterrent and avoid the kinds of
behaviour that triggered the 2007/2008 GFC and second, to ensure that bankers do not take refuge in the entity shield to avoid personal liability.\textsuperscript{1875}

Moreover, this new model will serve as a constant reminder to corporate executives, particularly bankers be guided by the long-term interest of the corporation and pay heed to the broader social consequences of their actions. Viewed from this perspective, the strict liability regime must not only stress the responsibilities of company executives but also society’s way of making people take responsibility for their actions.\textsuperscript{1876}

\textbf{7.3.4 Adopt Stringent, Rule-Based Regulatory Regime}

To forge a new corporate governance model, the current light-touch regulatory approach must give way to a more stringent regime.\textsuperscript{1877} Evidently, the passive approach to regulation is no longer sustainable and government intervention has thus, become inevitable against the backdrop of the recent GFC.\textsuperscript{1878} Moreover, government intervention with taxpayer-funded bailouts reflects an explicit rejection of the private ordering of the markets and the philosophy that champions the efficient market hypothesis and deregulation.\textsuperscript{1879} Clearly, in circumstances where the markets have failed and government intervention becomes inevitable, a more stringent regulatory system remains the most realistic strategy to avert excessive risk, corporate abuse and possible crisis.

The central argument, first, is that because corporations have amassed so much power and influence over society, it is critical that their activities are regulated by the state. Indeed, corporate power has become very ubiquitous and the influence of the corporation so pervasive

\textsuperscript{1875} ibid
\textsuperscript{1876} Hill and Painter (n 1800) 191.
\textsuperscript{1877} Robert Cobbaut and Jacques Lenoble (eds), Corporate Governance: An Institutionalist Approach (Kluwer Law International 2003)
\textsuperscript{1878} Drew (n 1485).
\textsuperscript{1879} ibid
that without regulation, these corporations would pursue their own interest regardless of the often-harmful consequences to others.

Secondly, the huge social and financial cost arising from the corporate failures following the GFC which compelled governments to intervene with bailouts, strengthens the arguments in favour of a stringent regulatory regime. The fact that society had to bear the cost of the crisis in terms of job losses, home repossessions and taxpayer-funded bailouts, makes it imperative for society to demand that a new regulatory regime is devised to compel corporations to serve, promote and be accountable to the broad domains of society. Given the severity of the GFC, the size of the bailout/stimulus packages and the burden imposed on society, it is not unreasonable to demand a robust financial regulatory regime for taxpayers.\(^{1880}\) Finally, the corporation, as a creature of the state has always been regulated in one way or the other. Thus, the question is not whether the state should regulate or not but how and in whose interest, it does so.\(^{1881}\) Despite the ferocity of the deregulatory movement in the last three decades, a case can be made that there was still some form of regulation; except that the regime was not sufficiently stringent enough. This is not surprising because it was an approach designed purposely to satisfy shareholder demands and expectations. Against this backdrop, it is submitted that a more stringent regulatory system will help minimise some of the consequences of imprudent behaviour arising from the light-touch regulatory regime of the last three decades. It is also instructive to note that whatever one thinks of governments, they remain, to a very large extent, publicly accountable institutions that constraint the tyrannical and unaccountable power of corporations through regulation.\(^{1882}\) Consequently, effective government regulation and enforceable laws therefore must be at the heart of the new corporate governance model to curtail the abuse of corporate power.

\(^{1880}\) Drew (n 1485).
\(^{1881}\) Bakan (n 343) 89.
\(^{1882}\) ibid
7.4 Implications

The study has significant theoretical and practical policy implications in terms of the definition and conceptualisation of the corporate purpose. First, it addresses the key philosophical question surrounding an important corporate governance issue dating back to the Berle-Dodd debate. In so doing, the study provides useful insights regarding the nature and purpose of the corporation and moves beyond the constraints of traditional mode of thinking that perceives shareholder value maximisation as the sole and legitimate purpose of the corporation.

Secondly, the study explores new directions regarding the underlying cause of the GFC and consequently, provides a clearer understanding of not just how but why the 20007/2008 GFC occurred. From this perspective, the crucial implication of the study is the extent to which it renders obsolete the mistaken assumptions of the shareholder primacy and how the concept has been rendered untenable in the face of the evidence provided and arguments advanced in this study.

7.5 Contribution

An original contribution of this research is that it provokes a reconceptualization of the corporate purpose and the possible emergence of a new governance model that defines the corporate purpose in terms of its ability to meet the competing demands of the different corporate constituents. This new model should also focus on taking a long-term view of corporate governance instead of the short-term approach. Thus, the research provides important insights and answers an important question that has confronted corporate governance practitioners, researchers and students for the past three decades.

Moreover, the reconceptualised governance model suggested in this study is intended to encourage policy makers and business managers to adopt policies and business practices to ensure that the corporation is run in the best interest of all stakeholders for the benefit of the entire society.
Chapter 7

7.6 Avenue for Future Research

The study undoubtedly provides critical insights on what is, arguably, the most important issues pertaining to the corporate governance discourse and its theoretical and policy implications. A crucial omission however, is the failure to address the international dimension of the crisis but only focused on the US and the UK. Obviously, the increasing interconnectedness of financial institutions, a surge in cross-border lending and the threat of domino effect made the GFC more acute and globally synchronised. From this perspective, the shortcoming identified in this study provides an opportunity to conduct further research into the international dimension of the GFC and the policy responses that followed.

7.7 Concluding Remarks

The GFC of 2007/2008 and the debate surrounding its causes raised questions about the presumed superiority of the shareholder primacy theory that has characterised corporate governance in the US and UK. As this study reveals, it is time to discard the tyranny of shareholder thinking because its philosophical legitimation is based on mistaken assumptions and assertions.

In a determined pursuit to maximise shareholder value, corporations adopted executive compensation schemes based on share price, cut back on research and development as well as employee benefits just to meet estimates for quarterly earnings. Moreover, regulatory changes in the early 1990s marked an important turning point that brought the US and UK closer to the shareholder–oriented model of governance. But the main driving force, and perhaps, the most important factor is the unquestioned belief and wholesale acceptance of the shareholder primacy by the business world.

It is however, refreshing to note that the shareholder dogma is witnessing a decline as various scholars and critics have begun questioning its theoretical and philosophical foundations and
gradually leading to the emergence of new concepts and paradigms. This new thinking on shareholder value as the research demonstrates, also goes to resolve the age-old debate on the purpose of the corporation. The corporate purpose, this research argues, should entail ‘balancing a variety of claims by various groups in the community and assigning to each a portion of the income stream since public policy rather than private cupidity’. Indeed, it is the failure to get the balance right that has led to the GFC. The study submits that any post-crisis corporate governance reform, whether legislative or regulatory that does not lead to a reconceptualization of the corporate purpose will remain an exercise in futility.

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