

Another Round of Corporate Governance Reforms in the United Kingdom: Implications for Directors in the Financial Sector

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Abstract

Directors of listed entities in the United Kingdom are about to face greater demands from recent discussions on corporate governance reforms, in particular compliance with the obligations in section 172 of the Companies Act 2006. This article argues that leadership in a multi-stakeholder regime has become more important than ever.

Introduction

The recent collapse of Carillion has put existing corporate governance requirements under the microscope once again and called into question the rules that apply to listed entities. How could one of the UK's largest construction companies fail so dramatically? Even given regular and consistent reforms corporate collapses in the UK seemed to re-occur with shocking regularity. If there are no full-proof solutions to these problems, one thing is certain, more and more compliance obligation rests on the shoulders of company directors. This is particularly true in the financial sector where new regulatory measures have been introduced in the aftermath of the Global Financial Crisis.

This paper explores the notion of the multi-stakeholder regime and consider the implications for directors in the banking and financial sector. Recent debates and proposals to reform corporate governance are pivotal to gaining insight to the changes to come in particular those associated with stakeholder engagement. We explore the obligations towards various

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stakeholders that are implied under directors' duties and the Corporate Governance Code (CG Code). This then leads us into discussion of corporate leadership in a multi-stakeholder regime and to recommendations for directors in the financial sector of ways in which a multi-stakeholder environment might be embraced by forward looking boards who are prepared for the challenges ahead.

Recent Corporate Governance Reform Proposals

In the past few decades the UK has undergone a number of corporate governance reforms.³ Two of the most significant were the Companies Act 2006 which provided a major revision and modernization of company law, and the 1992 Cadbury Report 1992 which brought in the first CG Code. As a result directors in the UK have to comply with a number of statutory obligations (for example, sections 170 to 176) and listed entities have an additional CG Code to satisfy (the most recent revision was in 2016).⁴

In a related vein, there have been a number of Inquiries held in the aftermath of the corporate governance failures at BHS and Sports Direct in 2016.⁵ Currently, there are three significant examinations that may seek to address some of the governance issues regarding Carillion plc. These are the House of Commons' Business, Energy and Industrial Strategy (BEIS) Committee's Report on Corporate Governance; the Government's Response to the Green Paper on Corporate Governance Reform; and the Financial Reporting Council's Proposed Revisions to the UK Corporate Governance Code.

The House of Commons' Business, Energy and Industrial Strategy Committee's Report on Corporate Governance noted that the key requirements on company directors relating to corporate governance were the duties specified in the Companies Act 2006, in particular section 172.⁶ The Report stated that:⁷

³ Nicholas Bourne, *Bourne on Company Law* (7th edn, Routledge 2017) 207-219.

⁴ Alastair Hudson, *Understanding Company Law* (Taylor and Francis 2017) 172.

⁵ Business, Energy and Industrial Strategy Committee, *Corporate Governance: Third Report of Session 2019-17* (HC 70) 5 <<https://publications.parliament.uk/pa/cm201719/cmselect/cmbeis/338/338.pdf>> accessed on 28 March 2018.

⁶ *Ibid* 15.

⁷ *Ibid* 17.

We believe that more effective measures are required to ensure that directors demonstrably take seriously their duties to have regard to other stakeholders and the long-term consequences of decisions. This can best be achieved by requiring more specific and accurate reporting, supported by robust enforcement.

In addition,⁸

We recommend that the FRC amends the Code to require informative narrative reporting on the fulfilment of section 172 duties. Boards must be required to explain precisely how they have considered each of the different stakeholder interests, including employees, customers and suppliers and how this has been reflected in financial decisions. They should also explain how they have pursued the objectives of the company and had regard to the consequences of their decisions for the long term, however they choose to define this. Where there have been failures to have due regard to any one of these interests, these should be addressed directly and explained.

A similar position was taken in the Government's Response to the Green Paper on Corporate Governance Reform. The Response noted that:⁹

Section 172 of the Companies Act 2006 already requires the directors of a company to have regard to these wider interests in pursuing the success of the company, but a large number of respondents thought that this aspect of the legal framework could be made to work more effectively through improved reporting, Code changes, raising awareness and more guidance.

The Government intended to announce a number of measures, one of which is to:

(iv) Introduce secondary legislation to require all companies of significant size (private as well as public) to explain how their directors comply with the requirements of section 172 to have regard to employee and other interests;

⁸ Ibid 19.

⁹ Department for Business, Energy and Industrial Strategy, *Corporate Governance Reform: The Government Response to the Green Paper Consultation* (August 2017) 4-5
<https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/640470/corporate-governance-reform-government-response.pdf> accessed 29 March 2018.

Finally, the Financial Reporting Council's Proposed Revisions to the UK Corporate Governance Code enhance the obligations in section 172 aimed at generating and preserving value for shareholders for the long term.¹⁰ Furthermore, it noted that:¹¹

An effective board will have a clear understanding of how that value is dependent on relationships with its stakeholders and will be able to explain how these relationships help deliver the company's purpose. It understands the importance of dialogue with shareholders, workforce and wider stakeholders and is pro-active in ensuring that such dialogue takes place.

In terms of better relations with the workforce and wider stakeholders, the proposal stated that:¹²

Boards should start by identifying their different sets of stakeholders. This will include the workforce, customers, suppliers, which could be particular to the sector or location. Boards should seek input from these stakeholders to ensure they have a rounded view of how the company does business and the impact of its activities. In addition to formal and informal engagement with the workforce, possible sources of information might include:

- Contacts with key customers
- Customer complaints and satisfaction data
- Supplier feedback
- Social media
- Contacts with interest groups and the local community

[D]irectors should be accountable by explaining their decisions and how they have taken account of the interests of different stakeholders. This will include being able to explain how the benefits in terms of the long-term success of the company outweigh

¹⁰ Financial Reporting Council, *Proposed Revisions to the UK Corporate Governance Code: Appendix B – Revised Guidance on Board Effectiveness* (December 2017) 2 <<https://www.frc.org.uk/getattachment/fe7a3cc7-e076-4ee4-ad1e-5f6aa91b2159/Proposed-Revisions-to-the-UK-Corporate-Governance-Code-Appendix-B-Dec-2017.pdf>> accessed 29 March 2018.

¹¹ Ibid.

¹² Ibid 5.

any negative impacts, and any action the company plans to take to mitigate those impacts.

What is clear from the discourse of the recent corporate governance reforms is the desire to ensure directors exercise their duties in section 172 of Companies Act 2006. The proposed way of doing so is through the use of disclosure in the Annual Report. To appreciate the rationale of the proposed reforms it is crucial to examine section 172 in greater detail.

Directors' Duty to Promote the Success of the Company

Section 172 of Companies Act 2006 was a product of Company Law Review, which produced nine consultation papers and took three years to complete.¹³ One of the key debates in the codification of directors' duties was between pluralism and enlightened self-interest approach.¹⁴ According to Lady Justice Arden, the then Chair of the review, the latter meant, '[t]he company is to create value for the benefit of shareholders, but this should be done by taking a long-term view of the company where possible and thus the relationships which the company has with suppliers, employees, the community and so on have to be fostered.'¹⁵

The statutory formulation imposes legal duties onto directors to promote the success of the company. This provision is said to have deviated from a narrow view of the common law rule in *Percival v Wright* by broadening from shareholders to include other stakeholders such as, employees and creditors.¹⁶ Yet, Lady Justice Arden maintained that:¹⁷

The Company Law Review did not think changing the law was necessary to achieve that, but it thought there should be a statement in which pointed directors in favour of the long-term approach in order to give them guidance and in to help them focus on the need for foster relationships employees, customers and so on.

¹³ Justice M H Arden, 'Clause 173 [section 172]: The UK's Proposed Re-formulation of Directors' Duty of Good Faith' in R P Austin (ed), *Company Directors and Corporate Social Responsibility: UK and Australian Perspectives* (Ross Parson Centre of Commercial, Corporate and Taxation Law, 2007) 20, 21.

¹⁴ Ibid 23.

¹⁵ Ibid 23-24.

¹⁶ Bourne (n 3) 179.

¹⁷ Arden (n 13) 24.

There are a few factors when considering the interpretation of this statutory provision. The first is 'good faith'.¹⁸ In *Cobden Investments Ltd v RWM Langport Ltd*¹⁹ the court held that the duty is subjective. Keay notes that, '[n]o reasonableness test was to be applied in relation to what directors had done. Whether a director had breached his or her duty came down to a consideration of the director's state of mind and provided that directors believed in good faith that they were acting in the best interests of the company they could not be said to be in breach.'²⁰ As such, certain elements of the common rule test are preserved.

The second is the definition of 'success'.²¹ Undoubtedly, the term 'success' is not easy to pinpoint with great certainty because companies can operate with profit and occasional losses. Nevertheless, the term creates a perception or at least a concern that corporate failure could mean the interests of shareholders were not served. The impression would be that directors of failed businesses might at some stage make decisions resulting in corporate collapse. However, does it mean the statutory requirements of 'success' was contravened? The only statutory guide to 'success' is that directors must have regard to 'the likely consequences of any decision in the long term'.²² According to Hudson this, '[b]olsters the need to look to the larger context of corporate actions over time.'²³

The third concerns the 'benefit members as a whole'. The list of stakeholders and concerns would appear to be troubling at first sight because directors have to be answerable to many and even competing priorities.²⁴ Lowy argued that,²⁵

The statutory re-conceptualisation of the duty does not mean that non-shareholder constituencies rank equal to shareholders or have some independent priority in

¹⁸ Andrew Keay, 'Good faith and directors' duty to promote the success of their company' (2011) 32, *The Company Lawyer*, 138, 139.

¹⁹ [2008] EWHC 2810 (Ch)

²⁰ Andrew Keay, 'Good faith and directors' duty to promote the success of their company' (2011) 32, *The Company Lawyer*, 138, 139.

²¹ Andrew Keay, 'The Duty to Promote the Success of the Company: Is it fit for Purpose?' (2010) University of Leeds, School of Law, Centre for Business Law & Practice Working Paper, 15 <<http://ssrn.com/abstract=1662411>> assessed on 24 February 2018.

²² Hudson (n 4) 124.

²³ Ibid.

²⁴ Keay (n 23) 16.

²⁵ John Lowy, 'The Duty of Loyalty of Company Directors: Bridging the Accountability Gap Through Efficient Disclosure' (2009) 68 *The Cambridge Law Journal*, 607, 616-617.

directors' decision-making, but rather consideration of their interests should only extend to the point where this promotes the success of the company for the benefit of its members...

Therefore, it would be fair to conclude that shareholders' interests would remain paramount; the only change is the broadening of the scope of directors' considerations when decisions about the company are made. There again, whether the inclusion of wider interests of the company would in fact improve decisions made by directors, only time will tell.

It is important to note that in spite of the new statutory formulation the right of action remains the company. Even if directors breach section 172 shareholders can ratify those acts under section 239 thereby reinforcing the shareholder-centred approach of this statutory provision.

The wider Stakeholders and their Interests

Since the introduction of this new statutory provision there have been certain dicta indicating directors should take into account wider interests.²⁶ Whilst shareholders' interests remains sacred, incorporating wider interests could create more uncertainties for directors with multiple and at times competing interests to consider before reaching a decision.²⁷

Recent cases have suggested that the obligations towards creditors were incorporated into interpreting section 172. In *Secretary State for Business, Innovation and Skills v Akbar*²⁸, concerning the disqualification of directors of a family company, which at a time was on the brink of insolvency, it was held that the directors failed to act in the best interest of the company when they entered into certain transactions that led to the company's demise. In another case *Ball (Liquidator of PV Solar Solutions Ltd) v Hughes* [2017] EWHC 3228 (Ch), the directors of an insolvent company had made unjustified credit entries against their directors' loan accounts. It was held that the directors breached their fiduciary duties under section 172 to act in the best interests of the creditors because they had misapplied the company's assets for their own benefit.

²⁶ Ibid

²⁷ Bob Tricker, *Corporate Governance: Principles, Policies, and Practices* (3rd edn, Oxford University Press 2015) 72.

²⁸ [2017] EWHC 2856 (Ch)

With regards to employees, it would be incorrect to suggest that their concerns are treated as equal to shareholders.²⁹ Instead, it suggests that directors could use section 172 defensively when sued by shareholders arguing that a decision is or was made against the interests of shareholders.³⁰ In *Re Saul D Harrison & Sons plc*³¹ the directors justified the continued operation of the company to protect the interests of employees. Thus, satisfying employees' demands so as to secure their willingness to work effectively with management could be justifiable in the reading of promotion of the long-term interests of the company,³² even if there is a higher price to pay in the short term in the form of for example, wage increases and other benefits.

There are other elements directors should include in their consideration such as, the company's operational impact on the environment.³³ Some might argue that directors might prefer to minimize the financial costs with regards to environmental matters as good financial management to further the interests of shareholders. Yet when things go terribly wrong like an incident that creates an environmental disaster, without the implementation of preventive measures and the advice of technical experts regarding environmental matter, it is unlikely directors can demonstrate the requirements section 172 are met. To this end, spending more on environmental protection measures could be arguable justified or used defensively against shareholders' claims of excessiveness.

Despite the aims of the enlightened shareholders value approach embedded in section 172, directors might find the stakeholder's approach to corporate governance better satisfy the concerns of stakeholders. Clarke commented that:³⁴

The growing emphasis upon customer relations, employee relations, supplier relations and indeed the investor relations, is an indication of the way managers are grappling

²⁹ Paul Davis, *Gowers and Davies Principles of Modern Company Law* (8th edn, Sweet & Maxwell 2008) 519.

³⁰ *Ibid.*

³¹ [1995] 1 BCLC 14.

³² Davis (n 27) 509

³³ Lowy (n 22) 615.

³⁴ Thomas Clarke, 'The Stakeholder Corporation: A Business Philosophy for the Information Age' in Thomas Clarke (edn) *Theories of Corporate Governance: The Philosophical Foundations of Corporate Governance* (Routledge 2004) 189, 197.

with the need to satisfy the interests of more complex constituencies than shareholder theory would suggest. The defence of shareholder rights sits uneasily with how increasingly companies are managed.

Therefore, the overriding focus on furthering shareholders' interest vis-à-vis taking into account various stakeholders becomes less self-evident.³⁵

Another stakeholder that has not been explicitly mentioned in section 172, but of direct relevance to the financial sector in the UK is the Financial Conduct Authority (FCA). With the introduction of the Senior Managers Regime (SMR), the influence of FCA as a stakeholder in a financial services company is enormous. McCalman, Young and Chan noted that under this new regime;³⁶

[S]enior bankers must ensure they have full control over their areas of responsibility. Everything senior managers do or do not do must be defensible, with evidence to support those decisions...[I]n particular, senior bank managers have to ensure whether everything they did or did not do at work satisfies the legal test of taking reasonable steps to prevent regulatory breaches from occurring under their watch or continue to occur...[F]inally, the duty of an assigned responsible person to report to the regulators (FCA and PRA, or either) for breaches or disciplinary actions against an employee means that the banks are in effective assisting the regulators to police their staff..

In short, the FCA wields enormous power over senior management which includes directors of banks and insurance companies. SMR will shortly apply to all financial services companies in the UK. The influence the FCA holds in its disciplinary arsenal against directors are huge, including the power to vet and approve senior appointees as well as 'prohibiting individuals from carrying on regulated activities.'³⁷

³⁵ Christine Mallin, *Corporate Governance* (4th edn, Oxford University Press 2013) 20.

³⁶ James McCalman, Angus Young and Raymond Chan, 'Regulating the Culture of Banks in the UK: Strengthening Legal Accountability or Just Better Leadership?' (2017) 32 (6) *Journal of International Banking Law and Regulation*, 260, 264.

³⁷ Ibid 263; Financial Conduct Authority, 'Enforcement' <<https://www.fca.org.uk/about/enforcement>> accessed 6th April 2018.

Even though the SMR is a new measure, there were the enforcement actions against a director under Approved Persons regime (a pre-SMR requirement). In *Burns v Financial Conduct Authority*³⁸, the regulator imposed a financial penalty of £154,800 and prohibited a non-executive director from carrying on regulated activities as an authorised person under sections 66 and 56 of the Financial Services and Markets Act 2000. The Approved Person (predecessor to the SMR), is a non-executive director of two mutual societies. The regulator found she failed to disclose conflicts of interest and had used her positions to further her own commercial interests breaching the ‘fit and proper’ test for approved persons. The plaintiff initially referred the decision of the regulator to the Upper Tribunal and then later appealed to the Court of Appeal. The findings in both the Upper Tribunal and the Court of Appeal were that the plaintiff breached directors’ duties under section 175 and 177 of the Companies Act 2006.

The implications for this case is that the FCA could take action against directors for breach of their statutory duties, and those actions are powers to prohibit individuals from carrying on regulated activities in effect dismissing as well as disqualifying the director from the financial sector. FCA’s enforcements need not require litigation or prosecution, they are powers conferred under the Financial Services and Markets Act 2000 for the regulator to make an assessment because Approved Persons, and now SMR is a licensing requirement. As such, the FCA was exercising a delegated power to assess whether the licensee has breached licensing requirements. Therefore, amongst all the stakeholders of the financial services sector in the UK, the regulator FCA is one of the most influential and powerful.

Leadership under a Multi-Stakeholder Regime

From recent developments in corporate governance reform and the practicalities involved in section 172 of the Companies Act 2006, the indications are that directors in the UK, and in particular the financial sector, will be further exposed to leading and managing in a multi-stakeholder governance environment. How does this affect the notion of director behaviour

³⁸ [2017] EWCA Civ. 214.

and development? There is a distinct sense that regulating disclosure of what the Board does is not strong enough. In a 2014 special issue of the *Academy of Management Journal* devoted to rethinking governance in management research, the Editors noted that:³⁹

Recent corporate activity and views, however, have an expanded view of governance as involving stewardship and leadership, in addition to the narrower financial prudence role...[w]e refer to governance as leadership systems, managerial control protocols, property rights, decisions rights, and other practices that give organizations their authority and mandates for action.

Certainly, corporate governance is undergoing a quantum shift from box-ticking compliance to demands for a leadership imperative from Chairmen, CEOs and Boards alike which enables and empowers business performance along a number of dimensions other than profitability. Will Moynahan, Managing Partner for Board Practice at Heidrick and Struggles argued that:⁴⁰

The demand for dynamic governance is based on two realisations. First, leadership starts at the board level. Second, governance is a means of enabling and driving business performance. All things being equal, well-governed companies excel. The best companies do not wait to be governed, they shape the debate and set best practice with agile and responsive leadership that adapts quickly to the changing circumstances of business.

The Heidrick and Struggles Report, *Towards Dynamic Governance* in 2014 analysed the board composition and habits of Europe's top 400 publicly listed companies. The report identified six key characteristics that defined a new era of dynamic governance and used these to construct a board effectiveness survey, completed by 236 senior board members across Europe. The six characteristics were:⁴¹

³⁹ Laszlo Tihanyi, Scott Graffin, and Gerard George, 'Rethinking Governance in Management Research: From the Editors' (2014) 57 (6) *Academy of Management Journal*, 1535-1543.

⁴⁰ Heidrick & Struggles International, Inc. 2014, *Towards dynamic governance 2014: European corporate governance report* (London, UK) <<http://www.heidrick.com/Knowledge-Center/Publication/European-Corporate-Governance-Report-2014-Towards-Dynamic-Governance>> accessed on 11 April 2018.

⁴¹ *Ibid*, 2-15.

1. Deep Business Knowledge – the need for board members to understand the commercial DNA of the company and possess deep insights into the business. The report reveals that one in five boards in Europe still combine the role of CEO and Chairman, holding management to account becomes a challenge in such circumstances.
2. Diversity of Thought - Boards need to contain a range of members from diverse backgrounds to encapsulate stakeholder not shareholder interest. The study found that boards are becoming more international in their mix with non-national directors making up 30% of the director pool in Europe. However, female representation was poor.
3. Engaged Leadership - The best chairmen work hard on team dynamics; this requires a sophisticated understanding of people. 93% of survey respondents identified the leadership styles of the Chairman as an important contributor to board effectiveness. However, only 76% of respondents thought their own Chairman was doing a satisfactory job in this respect.
4. Strategic alignment and execution - Boards must use their knowledge and experience to help executives develop robust and sustainable strategies.
5. Capacity to adapt - Boards must do more to create the conditions within which innovation and adaptation can thrive.
6. Leadership talent - Talented people lie at the heart of dynamic governance and drive the boardroom's transformation agenda.

In the financial sector, the focus is on how Senior Managers have to deal with SMR, AND good corporate governance. This means a focus on a multiple stakeholders' model of governance. This suggests that the complexity of governance and leadership are multiplied to be accountable to various stakeholders and coming to terms with competing demands of different stakeholders. To do so, we would suggest that new reforms might trigger changing reporting processes but boards will need to provide evidence of dealing with differing

stakeholders. We would suggest that a number of simple evidence-based measures might be evident:

1. Has board composition changed in the last year?

Wider stakeholder engagement commences at the top and seeks to incorporate diversity, gender, nationalities and ethnicities. Kang et al.⁴² argue that diversity can be either visible (race, ethnicity gender, age etc) or less visible (educational, industry experience). Heterogeneity results in a broader perspective and generates differing alternatives. We would expect to see banks and financial institutions reporting a wider level of alternative recruitment portfolios at board level to move them away from the social habitus notions prevalent at organizations such as, RBS.⁴³

2. Has the nature of the buyer-supplier relationship altered?

Evidence here would be the establishment of relationships not entirely dependent on economics but enhancing wider stakeholder notions such as, sustainability, locality and support for ethnic minority businesses.

3. Do your employees and customers like you more?

We would have expectations that annual assessments of customer satisfaction would be detailed and specify 'the what' and 'the how' of stakeholder improvement.

4. Do you dare let others assess your performance beyond the annual report?

Assessments by corporate governance consultants on the performance of directors made public in annual reports or tabled at annual general meetings.

⁴² Katharine Rao, Carol Tilt, 'Board Composition and Corporate Social Responsibility: The Role of Diversity, Gender, Strategy and Decision Making', (2016) 138 (2) *Journal of Business Ethics*, 327-347.

⁴³ R. Kerr and S. Robinson, 'Leadership as an elite field: Scottish banking leaders and the crisis of 2007-2009', (2011) 7, *Leadership*, 151-173.

A truly engaging stakeholder aware board of directors would subject itself to 360-degree feedback from a number of sources and be seen to act on the results.

Conclusions and Commentary

The objectives of section 172 and recent discussions regarding reforms clearly focus on directors' engagement with stakeholders. However, even with refinements to governance codes and legal requirements strengthened to hold directors accountable in the hope of reducing the number of failures, the problem will still persist. The solution to the conundrum of corporate failure might not rest with more reform, but with enhancing leadership. To achieve accountability, leadership should be at the core, legal duties as the default rules to remedy failure and CG Codes providing and infrastructure and support.

This paper has argued that financial companies should be looking at strengthening the diversity role of their directors as well as ensuring they behave as leaders. Leadership as argued is showing the way, ensuring independence and diversity at the top and developing the skillsets of leaders towards establishing compliance cultures. We suggest boards will need to provide evidence of dealing with differing stakeholders and reporting the results of those engagement using a number of simple evidence-based measures.

However, leadership is neither a replacement nor a substitute for the laws and governance codes. They are complementary; if directors cannot reflect their stakeholders and cannot lead, they should not be appointed to leadership positions of companies. The means of bridging the gap of CG Code and the law is *Leadership in Compliance*. Compliance in a multi-stakeholder business environment requires directors to articulate their engagement and account for how decisions were made in view of interaction with various stakeholders. Stanton who research on the causes of corporate failures in the US wrote:⁴⁴

⁴⁴ Thomas Stanton, *Why Some Firms Thrive While Others Fail: Governance and Management Lessons from the Crisis* (Oxford University Press 2012) 206.

Feedback is a gift. Without soliciting and accepting feedback from knowledge able people, an executive can make serious mistakes. The point of feedback is to raise questions that prompt the gathering of more information so that major decisions, when they are made, reflect a robust understanding of the context and implications.

In sum, directors of the multi-stakeholder business environment meant that no stakeholder should be taken for granted. There is one stakeholder directors in the financial sector have to pay particular attention that is the FCA. The key is *Leadership in Compliance* where directors have to ensure regulatory accountability is achieved.