

DIRECTORS' DUTIES AND SHAREHOLDER LITIGATION IN THE WAKE OF THE FINANCIAL CRISIS

Edited by
Joan Loughrey

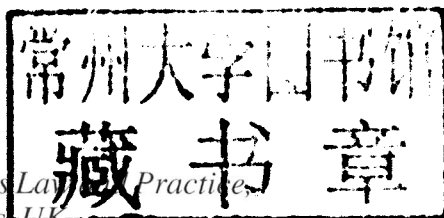
Corporations, Globalisation and the Law

Directors' Duties and Shareholder Litigation in the Wake of the Financial Crisis

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Joan Loughrey

*Director of the Centre for Business Law Practice,
School of Law, University of Leeds, UK*



CORPORATIONS, GLOBALISATION AND THE LAW

Edward Elgar

Cheltenham, UK • Northampton, MA, USA

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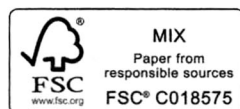
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Published by
Edward Elgar Publishing Limited
The Lypiatts
15 Lansdown Road
Cheltenham
Glos GL50 2JA
UK

Edward Elgar Publishing, Inc.
William Pratt House
9 Dewey Court
Northampton
Massachusetts 01060
USA

A catalogue record for this book
is available from the British Library

Library of Congress Control Number: 2012942514



ISBN 978 0 85793 965 4

Typeset by Columns Design XML Ltd, Reading
Printed and bound by MPG Books Group, UK

Directors' Duties and Shareholder Litigation in the Wake of the Financial Crisis

CORPORATIONS, GLOBALISATION AND THE LAW

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Edited by Joan Loughrey

Contributors

Dr Folarin Akinbami, Lecturer in Commercial Law in the School of Law, Durham University, UK.

Mr Andrew Campbell, Director, Ashridge Strategic Management, London, UK.

Mr Robin Hollington QC, New Square Chambers, London, UK.

Professor Andrew Keay, Professor of Corporate and Commercial Law, Centre for Business Law and Practice, School of Law, University of Leeds, UK and Barrister, Kings Chambers, Leeds, and 13 Old Square, London, UK.

Professor Joan Loughrey, Professor of Law, Director of the Centre for Business Law and Practice, School of Law, University of Leeds, UK.

Professor Roman Tomasic, Dean of Law, University of South Australia, Visiting Professor of Company Law, Durham University, UK.

Professor Charlotte Villiers, Professor of Company Law, School of Law, University of Bristol, UK.

Abbreviations

ACCA	Association of Chartered Certified Accountants
ASB	Accounting Standards Board
BIS	Department for Business, Innovation and Skills
CDO	collateralized debt obligations
CLRSG	Company Law Review Steering Group
CPR	Civil Procedure Rules
DTI	Department of Trade and Industry
FRC	Financial Reporting Council
FRRP	Financial Reporting Review Panel
FSA	Financial Services Authority
OFR	Operating and Financial Review
WTO	World Trade Organization

Contents

<i>List of contributors</i>	vi
<i>List of abbreviations</i>	vii
Introduction <i>Joan Loughrey</i>	1
1 The director's duty of care and skill and the financial crisis <i>Joan Loughrey</i>	12
2 The duty to promote the success of the company: is it fit for purpose in a post-financial crisis world? <i>Andrew Keay</i>	50
3 Narrative reporting and enlightened shareholder value under the Companies Act 2006 <i>Charlotte Villiers</i>	97
4 Think again: how good leaders can avoid bad decisions <i>Andrew Campbell</i>	133
5 Shareholder activism and litigation against UK banks – the limits of company law and the desperate resort to human rights claims? <i>Roman Tomasic and Folarin Akinbami</i>	143
6 Recent cases on the winding-up of hedge funds on treasure islands <i>Robin Hollington</i>	173
7 An assessment of the present state of statutory derivative proceedings <i>Andrew Keay and Joan Loughrey</i>	187
8 Directors' duties and shareholder litigation: the practical perspective <i>Joan Loughrey</i>	229
Conclusion <i>Joan Loughrey</i>	247
<i>Index</i>	257

Introduction

Joan Loughrey

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

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

¹ The House of Commons Treasury Committee, *The Run on the Rock* (HC 56–1) (January 2008) at 14.

Bingley plc, the Royal Bank of Scotland Group plc (RBS), Lloyds TSB Bank plc, and HBOS plc had been bailed out by the Government and entered full or part-public ownership.² HBOS plc was taken over by Lloyds TSB Bank plc in January 2009 while Alliance & Leicester disappeared in 2010, having been taken over by Santander plc, as were parts of Bradford and Bingley plc's business.³ The problems that were initially confined to the financial sector ultimately had an impact on the real economy, ushering in the deepest recession in the UK for 70 years. At the time of writing many of the world's economies, including the UK's, remain weak and the future is uncertain.

The question of what caused the financial crisis has been extensively discussed and no consensus has been reached other than that it was the product of the interaction of different factors. It is generally accepted that macro-economic factors such as global imbalances played a significant part.⁴ While countries such as the US, UK, Ireland and other countries had large current account deficits⁵ others such as Japan and China had accumulated large current account surpluses and developed large foreign currency reserves which they sought to invest in, inter alia, overseas securities, particularly in the US and the UK. In the US this took the form of investment in government bonds or government-guaranteed bonds and in the UK, investment in mortgage-backed securities.⁶ This resulted in large capital flows into both the UK and the US and allowed both countries to keep their interest rates at artificially low levels.⁷ The low interest rates led to the availability of easy credit, the growth of the sub-prime market in the US and, in the UK, the extension of high-risk mortgages to low-income groups. As a result there was a property and credit bubble in both countries.⁸ At the same time, the low rates of return

² BBC, 'UK banks receive £37bn bail-out' (13 October 2008).

³ See discussion in the House of Commons Treasury Committee, *Banking Crisis: Dealing with the Failure of the UK Banks*, Seventh Report of Session 2008–09 (HC 416) (21 April 2009).

⁴ FSA, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (March 2009) at 11; The House of Commons Treasury Committee, *Banking Crisis: Dealing with the Failure of the UK Banks*, Seventh Report of Session 2008–09 (HC 416) (21 April 2009) at 12–13.

⁵ FSA, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (March 2009) at 33.

⁶ Ibid at 12, 32.

⁷ Ibid at 13.

⁸ Ibid at 13, 29–30.

on government bonds led investors to seek higher returns on riskier investments and this demand was met by new financial products.⁹

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

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

⁹ Ibid at 14.

¹⁰ Though it may be that the lack of comprehension among market players of the real value of these products and the risks they presented has been over-stated. For example, the top CDO trader at Deutsche Bank is said to have referred to the assets underlying collateralized debt obligations as 'crap' and 'pigs': T. Braithwaite, F. Guerrero and J. Baer, 'Senate Report Says Goldman Misled Investors' *Financial Times*, 14 April 2011.

¹¹ FSA, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (March 2009) at 42.

¹² Ibid at 36; M. Legg and J. Harris, 'How the American Dream Became a Global Nightmare: An Analysis of the Causes of the Global Financial Crisis' (2010) 32 *University of New South Wales Law Journal* 350 at 370.

¹³ FSA, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (March 2009) at 22, 44; M. Legg and J. Harris, 'How the American Dream Became a Global Nightmare: An Analysis of the Causes of the Global Financial Crisis' (2010) 32 *University of New South Wales Law Journal* 350 at 362.

¹⁴ FSA, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (March 2009) at 16, 43.

However, the crisis has also been blamed on: financial deregulation and regulatory failure,¹⁵ in particular the failure of risk-based regulation,¹⁶ and the failure to regulate the new financial products; political pressure to engage in 'light touch regulation' so that competitiveness was not impeded;¹⁷ and gate-keeper failure, particularly that of the credit rating agencies, who awarded financial products the triple A rating that allowed public bodies to invest in them.¹⁸ The crisis has also been blamed on inadequately capitalized financial institutions that were excessively leveraged and that lacked a sufficient buffer to cope with the crisis;¹⁹ irrational exuberance in the market followed by a collapse in confidence;²⁰ a misplaced faith in the efficiency and rationality of capital markets and a mistaken belief that these would restrain excessive risk taking and winnow out harmful financial products, coupled with a presumption in favour of deregulation;²¹ and executive remuneration policies that created perverse incentives to take undue risk.²²

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

¹⁵ Ibid at 36–38, 43.

¹⁶ FSA, *The Failure of the Royal Bank of Scotland* (December 2011) at 253–294; M. Legg and J. Harris, 'How the American Dream Became a Global Nightmare: An Analysis of the Causes of the Global Financial Crisis' (2010) 32 *University of New South Wales Law Journal* 350 at 371–372.

¹⁷ FSA, *The Failure of the Royal Bank of Scotland* (December 2011) at para 672.

¹⁸ FSA, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (March 2009) at 22; M. Legg and J. Harris, 'How the American Dream Became a Global Nightmare: An Analysis of the Causes of the Global Financial Crisis' (2010) 32 *University of New South Wales Law Journal* 350 at 376–378.

¹⁹ FSA, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (March 2009) at 43; FSA, *The Failure of the Royal Bank of Scotland* (December 2011) at 64–93. Banks also had liquidity issues.

²⁰ FSA, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (March 2009) at 25.

²¹ Ibid at 39, 45, 49; R. Tomasic, 'Raising Corporate Governance Standards in Response to Corporate Rescue and Insolvency' (2009) *Corporate Rescue and Insolvency* 5.

²² FSA, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (March 2009) at 47.

²³ Ibid. See the review of the literature in H. Mehran, A. Morrison and J. Shapiro, 'Corporate Governance and the Banks: What Have We Learned from the Financial Crisis?' Federal Reserve Bank of New York Staff Report No 502 (June 2011) at http://www.newyorkfed.org/research/staff_reports/sr502.pdf (accessed 31 March 2012).

though this claim has been disputed.²⁴ The FSA, for example, concluded that there were no corporate governance failings at board level in RBS,²⁵ although closer scrutiny of its findings show that in making this assertion the FSA focused on processes and procedures, rather than the substantive effectiveness of those procedures. In fact, it found that there were questions raised over the board's effectiveness.²⁶ In any event it is not disputed that corporate governance problems were revealed by the crisis. Thus the Turner and Walker Reviews concluded that shareholders failed to act as a check on management²⁷ even when, as the FSA found in the case of the acquisition of ABN AMRO by RBS, they had significant reservations about the strategy adopted by the board,²⁸ and that boards themselves failed to identify and restrain excessive risk-taking.²⁹ Problems were also identified in relation to the performance of non-executive directors who lacked relevant industry experience,³⁰ failed to commit sufficient time to their role and failed to monitor and challenge the executive.³¹ Boards also failed to exercise adequate oversight of remuneration policies for senior employees with the result that executive remuneration, including bonuses, was linked to short-term performance.³²

²⁴ B. Cheffins, 'Did Corporate Governance "Fail" During the 2008 Stock Market Crisis? The Case of the Standard and Poor 500' (2009) 65 *Business Lawyer* 1.

²⁵ FSA, 'FSA closes supervisory investigation of RBS' (2 December 2010).

²⁶ FSA, *The Failure of the Royal Bank of Scotland* (December 2011) at paras 583–593.

²⁷ FSA, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (March 2009) at 46. See also D. Walker, *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations* (26 November 2009) at 12.

²⁸ FSA, *The Failure of the Royal Bank of Scotland* (December 2011) at 166–167. Despite a number of shareholders, particularly hedge funds, having concerns, 94.5 per cent of shareholders supported the ABN AMRO acquisition.

²⁹ FSA, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (March 2009) at 92; D. Walker, *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations* (26 November 2009) at 220, 225–226, 231.

³⁰ Although Northern Rock's board included an experienced fund manager, the former CEO of a bank and a former member of the Court of the Bank of England: F. Guerrero and P. Thal-Larsen 'Gone by the Board: Why the Directors of Big Banks Failed to Spot Credit Risks' *Financial Times*, 26 June 2008.

³¹ D. Walker, *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations* (26 November 2009) at 234.

³² *Ibid* at para 1.14. FSA, *The Failure of the Royal Bank of Scotland* (December 2011) at 225–226; T. Kirchmaier, 'Inject Governance and Not Just

In the light of these failings this book considers what lessons can be drawn from the financial crisis regarding the operation of directors' duties and shareholder litigation more generally. It might be suggested that such a project overlooks the fact that banks are quite different from other types of commercial company. The nature of their business means that they are likely to be more highly leveraged than other types of business and more vulnerable.³³ Because they play a central role in the economy, bank crises are far more significant for the real economy and for the taxpayer than other kinds of corporate collapses.³⁴ Banks and financial institutions may therefore need to be more strictly regulated and have governance arrangements that go beyond those normally required of other types of company.³⁵ Consequently, one needs to be cautious about drawing conclusions from the banks' experience during the financial crisis and attempting to apply these more widely.

Nevertheless, the financial crisis has highlighted issues that have ramifications beyond the financial sector. The Walker Review itself concluded that some of its findings and recommendations were equally applicable to other types of UK company, particularly regarding the lack of institutional shareholder engagement and the need to enhance this to facilitate greater monitoring and disciplining of management.³⁶ The UK Code of Corporate Governance was amended in the light of the Walker Review. It stipulates, *inter alia*, that all boards need to have a balance of skills, experience, independence and knowledge of the company,³⁷ that directors should have appropriate knowledge of the company and access to its staff,³⁸ that non-executive directors should constructively challenge executives,³⁹ that risk management should be addressed and boards should be responsible for determining the nature and extent of the risks

Cash: Some Thoughts on the Governance of Banks and the Likely Failure of More Banking Regulation' (27 October 2008) at 5–6 at <http://ssrn.com/abstract=130320> (accessed 16 January 2012).

³³ D. Walker, *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations* (26 November 2009) at para 1.4.

³⁴ FSA, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (March 2009) at 42.

³⁵ D. Walker, *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations* (26 November 2009) at para 1.6.

³⁶ *Ibid* at 6.

³⁷ FRC, *The UK Code of Corporate Governance* (June 2010), Principle B1.

³⁸ *Ibid*, Principle B4.

³⁹ *Ibid*, Principle A4.

that the company should undertake.⁴⁰ These responses point to concerns about the role of boards, non-executive directors and institutional shareholders that are common to both banks and other types of company.

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

⁴⁰ Ibid, Principle C2.

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

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

⁴³ 'Lloyds faces lawsuit from US investors' *The Financial Times*, 1 January 2012.

actionable breach of duty, or because the obstacles facing shareholders wishing to bring litigation were too high, or due to problems with the very concept of shareholders as effective monitors, then this has ramifications that go well beyond the financial sector. It raises far broader questions about the efficacy of the law on directors' duties and shareholder litigation as a means of holding directors to account, particularly in the context of dispersed share-ownership companies.

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

ORGANIZATION OF THE BOOK

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

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

In Chapter 2 Keay analyses the duty under the Companies Act 2006 s.172 which had been heralded as introducing a new model for corporate decision-making based on 'enlightened shareholder value', and questions whether it is fit for purpose. The financial crisis highlighted in an extreme fashion the costs to society of reckless corporate behaviour that focuses on the promotion of shareholder value in the short-term and disregards the costs of corporate behaviour to other stakeholders. Keay considers whether s.172 will be successful in discouraging short-term behaviour and in encouraging boards to take a more inclusive approach.

He also considers the prospects for successful claims for breach of the s.172 duty where boards take decisions that do not promote the success of the company.

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

While some have argued that the crisis was the product of moral failure and greed,⁴⁴ there is evidence that behavioural factors were at work in leading to the short-termist and reckless behaviour exhibited by bank boards. Thus the Walker Review claimed that

‘the principal deficiencies in [bank] boards related much more to patterns of behaviour than to organization’⁴⁵

and that behavioural changes were required from boards and senior managers.⁴⁶ Campbell’s chapter examines the kinds of cognitive failure that could cause senior managers to make bad decisions and suggests safeguards that could be put in place to reduce the impact of these sub-conscious influences on decision-making. As explained in the Conclusion his arguments give us a different way of thinking about s.172 and its potential to alter directors’ behaviour.

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

⁴⁴ A. Kling, ‘The Financial Crisis: Moral Failure or Cognitive Failure?’ (2010) 33 *Harvard Journal of Law and Policy* 507.

⁴⁵ D. Walker, *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations* (26 November 2009) at 12.

⁴⁶ *Ibid* at 9–10.