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Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment

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Abstract

Shares in publicly-quoted UK companies are, similarly to those in their US counterparts, dispersed amongst many holders. The central problem of corporate governance for UK listed firms is therefore rendering managers accountable to shareholders. This paper investigates the way in which the mechanisms used to control these managerial agency problems are enforced. It provides a roadmap of the enforcement strategies employed, and a first approximation of their empirical significance. The results suggest three stylised facts about the UK corporate governance system. First, shareholder lawsuits are conspicuous by their absence. Formal private enforcement plays little or no role in controlling managers. Secondly, and contrary to leading accounts in the economic literature, it is public, rather than private, enforcement which dominates in relation to listed companies. However, the lion's share of the interventions by the relevant agencies—the Takeover Panel, the Financial Reporting Review Panel, and the Financial Services Authority—is of an informal character, not resulting in any legal action. Suasion, rather than sanction, is the order of the day. Thirdly, a simple divide between public and private enforcement fails fully to take account of the role played by institutional investors in the UK, who have engaged systematically in informal private enforcement activity. Strong informal private enforcement has historically therefore been the flipside, in the UK, of weak formal private enforcement.

Keywords: Corporate law, public enforcement, private enforcement, UK corporate governance, derivative action, institutional investors.

JEL Classifications: G38, K22, K41, M48

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I. INTRODUCTION

A great deal of attention in the past decade and a half has been devoted to the comparison of corporate governance regimes in countries around the world, and to the role, if any, played by law in facilitating deep and liquid securities markets. However, in both the analytic and empirical scholarship, the focus has mainly been on the role played by the substantive law. This, however, risks overlooking the divide, as Roscoe Pound memorably put it, between 'law in books' and 'law in action'.[1] The way in which rules are enforced will clearly affect agents' incentives to comply. The effectiveness of a regulatory regime, therefore, is a function of both substantive rules and enforcement mechanisms.

Recent scholarship has begun to address enforcement-related issues. Thus the authors of well-known cross-country empirical studies of 'law and finance' have included enforcement-related variables in their analyses.[2] Some have concluded that private enforcement in corporate and securities law—that is, civil litigation—is correlated both with deep and liquid securities markets and with dispersed stock ownership. Other work, however, questions whether the measures of 'enforcement' employed in these analyses are meaningful.[3]

The UK, as one of the countries in the world with the greatest degree of dispersion in stock ownership of listed corporations, is therefore an interesting case for analysis.[4] Shares in publicly-quoted UK companies are, similarly to those in their US counterparts, dispersed amongst many holders.[5] The central problem of corporate

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[1] R Pound, 'Law in Books and Law in Action' 44 *American Law Review* 12 (1910).

[2] S Djankov, R La Porta, F Lopes-de-Silanes, and A Shleifer, 'The Law and Economics of Self-Dealing', NBER Working Paper 11883 (2005) (henceforth 'Self-Dealing'); R La Porta, F Lopes-de-Silanes, and A Shleifer, 'What Works in Securities Laws?', (2006) 61 *Journal of Finance* 1 (henceforth 'What Works?').

[3] JC Coffee, Jr, 'Law and the Market: The Impact of Enforcement', (2007) 156 *University of Pennsylvania Law Review* 229; HE Jackson and MJ Roe, 'Public Enforcement of Securities Laws: Preliminary Evidence', forthcoming (2008) 87 *Journal of Financial Economics*.

[4] Indeed, it is singled out by La Porta *et al* ('Self-Dealing', *supra* n 2, 12-16) as an exemplar of the 'common law' approach.

[5] See R La Porta, F Lopez-de-Silanes, and A Shleifer, 'Corporate Ownership Around the World', (1999) 54 *Journal of Finance* 471, 492; M Becht and C Mayer, 'Introduction', in F Barca and M Becht (eds.), *The Control of Corporate Europe* (Oxford: OUP, 2001), 19-30; M Faccio and LHP Lang, 'The Ultimate Ownership of Western European Corporations', (2002) 65 *Journal of Financial Economics*

governance for UK quoted firms is therefore rendering managers accountable to shareholders.[6] In contrast, for the UK's private companies, the central governance problems concern how to minimise the costs of conflicts of interest between majority and minority shareholders, and between shareholders and creditors.[7]

This paper investigates the strategies employed for enforcing constraints on managerial agency costs in UK listed firms. It provides a roadmap of the enforcement mechanisms used, and a first approximation of their empirical significance. In so doing, two distinctions are drawn. First, in keeping with much of the existing literature, the relative contributions of public and private enforcers are compared. The resulting picture is that, contrary to leading accounts in the economic literature,[8] it is public rather than private legal enforcement which dominates in the UK. Indeed, to a degree that may be startling to observers whose experience of 'common law' enforcement is based on the US,[9] shareholder lawsuits are conspicuous by their absence in the UK. In contrast, the most empirically significant enforcement agencies in relation to corporate governance are the Takeover Panel, the Financial Reporting Review Panel, and the Financial Services Authority.

A simple divide between public and private enforcement fails, however, to take account of the role played by the strong community of institutional investors in the UK. To put this in context, we distinguish between *formal* and *informal* enforcement. Institutional investors, who hold the majority of the shares in UK listed companies, have engaged systematically in the production of rules and norms that facilitate low-cost informal interventions in response to managerial failure. Moreover, an examination of the history shows that the currently significant public enforcement agencies in the UK owe their origins to private informal enforcement. Strong informal

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365, 379-380; CG Holderness, 'The Myth of Diffuse Ownership in the United States', forthcoming (2008) 21 *Review of Financial Studies* (online advance access doi:10.1093/rfs/hhm069), 19.

[6] See R Kraakman *et al*, *The Anatomy of Corporate Law* (Oxford: OUP, 2004), 21-22.

[7] See PL Davies, *Introduction to Company Law* (Oxford: Clarendon Press, 2002), 215-17.

[8] La Porta *et al*, 'What Works?', *supra* n 2.

[9] For details of private enforcement activity in the US, see RB Thompson and RS Thomas, 'The Public and Private Faces of Derivative Lawsuits', (2004) 57 *Vanderbilt Law Review* 1747; J Armour, B Black, BR Cheffins, and RC Nolan, 'Private Enforcement of Corporate Law: An Empirical Comparison of the US and UK', working paper presented at ALEA Conference (2008).

private enforcement has historically therefore been the flipside, in the UK, of weak formal private enforcement.

The rest of the paper proceeds as follows. Part II outlines a taxonomy of enforcement strategies, with a view to developing a 'roadmap' of their deployment in the UK. Parts III-V then seek to give an approximate 'snapshot' of the current empirical significance of these strategies in the UK, focusing respectively on formal enforcement, public enforcement (formal and informal), and informal private enforcement. Part VI then conducts a historical enquiry with a view to articulating how the UK's system came to have its current features. Part VII concludes with a summary of implications.

II. ANALYSING AND MEASURING ENFORCEMENT STRATEGIES

1. A taxonomy of enforcement strategies in corporate law

It is helpful to start with a conception of 'enforcement'. If we restrict the scope of the enquiry to 'legal' enforcement, then we have in mind some form of court proceeding. Within this, a distinction can be drawn between 'public' and 'private' enforcement, according to whether the party initiating the action is a state official or a private party. This distinction may matter economically because of differing incentives.[10] A public enforcer is usually paid a salary regardless of outcomes, whereas private enforcers are primarily motivated by the prospect of payments contingent upon success in litigation. We might therefore expect private enforcement to be more sensitive to changes in the costs of enforcement, and where these costs are low, to be more intensive than public enforcement. Moreover, public enforcement agencies are relatively centralised and subject to political control, whereas private claimants are not. Whilst this makes public enforcement easier to coordinate, detractors argue that these features also make public enforcers relatively easy to bribe.[11]

So far, we have a two-way taxonomy of legal enforcement, divided into public and private. Yet it seems artificial to restrict the scope of the enquiry to court proceedings. There are many other techniques that we may refer to as 'informal' enforcement, which secure compliance without recourse to legal proceedings. This

[10] See La Porta et al, 'What Works?', *supra* n 2; Jackson and Roe, *supra* n 3.

[11] See, e.g., JR Hay and A Shleifer, 'Private Enforcement of Public Laws: A Theory of Legal Reform', 88 *American Economic Review* 398.

gives a second dimension to the taxonomy, yielding a four-way categorisation, represented in Figure 1.

Figure 1: A simple taxonomy of enforcement strategies

	Public	Private
Formal		
Informal		

Informal *public* enforcement consists of interventions by public bodies that do not involve judicial or quasi-judicial proceedings. A public agency which relies largely on informal enforcement is able to economise on the considerable costs of legal proceedings. This permits more money in a fixed budget to be allocated to the detection of misconduct, as opposed to prosecuting those who have already been detected.[12] If informal sanctions are effective, such an approach may secure better levels of compliance than reliance on formal sanctions.

A common mode of informal enforcement is through the imposition of 'reputational' sanctions—for example, publishing a public statement that a firm has failed to meet a required standard, or—more strongly—exhorting other firms to avoid doing business with the wrongdoer. In environments characterised by repeated interactions between parties, the value of future business opportunities mean that a reputation for not behaving opportunistically is important. Whilst reputational sanctions can be generated by disgruntled trading partners complaining about an actor's behaviour, they tend to work much more effectively in the presence of an objective and expert agency which investigates conduct and publicises results.[13] Consistently with this, empirical studies from other jurisdictions report that public censure by a regulatory authority has a negative impact on the censured party's stock price, even where no legal sanctions are imposed.[14]

[12] P Fenn and C Veljanovski, 'A Positive Theory of Regulatory Enforcement' (1988) 98 *Economic Journal* 1055.

[13] See, e.g., RC Picker, 'Simple Games in a Complex World: A Generative Approach to the Adoption of Norms' (1997) 64 U Chic LR 1225, 1239-40, 1286; J McMillan and C Woodruff, 'Private Order Under Dysfunctional Public Order' (2000) 98 Mich LR 2421, 2426-30.

[14] BL Liebman and CJ Milhaupt, 'Reputational Sanctions in China's Securities Market' forthcoming (2008) 108 Colum LR. Moreover, where sanctions are imposed for matters implying a breach of trust—fraud, for example—the drop in stock price frequently exceeds the expected value of the sanction, implying that the firm's reputation has been harmed by the signal of its propensity for

Alternatively, the regulator might simply have a private conversation with a regulated firm, warning them of a failure in conduct and requesting that it be put right. Sanctions are simply threatened, rather than applied immediately. Such a threat will induce the firm to remedy a default, provided that this costs less than the harm which would be caused by sanctions. The threatened sanctions could include anything from legal proceedings to public censure alone. The agency can retain the option of using public censure as a sanction by not revealing the identity of the transgressing firm at the outset.

Turning to informal private enforcement, we have in mind here action taken by parties who contract with firms—their investors, customers, and suppliers.[15] Such parties can sanction a firm by reducing their willingness to contract with it—in the case of investors, refusing to buy shares, or selling those they already have. This will affect a firm's share price. As an alternative to refusing to deal with a firm altogether, private parties may be able to exercise contractual entitlements that have the effect of sanctioning individuals whose conduct has failed to comply with desired standards of conduct. The most obvious in the corporate context is the removal of managers from office following a shareholder vote. These two modes—famously dubbed 'exit' and 'voice' by Hirschman[16]—can also work together, as in the context of a hostile takeover: a large number of investors sell their shares, dissatisfied with managers' performance, depressing the share price and making management vulnerable to displacement by a takeover.

When we focus on private enforcers, the choice between formal or informal mechanisms may make a difference, depending on the relative expertise of courts

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opportunism: see CR Alexander, 'On the Nature of the Reputational Penalty for Corporate Crime: Evidence' (1999) 42 J L & Econ 489; JM Karpoff, DS Lee, and GS Martin, 'The Cost to Firms of Cooking the Books' forthcoming (2008) 43 *Journal of Financial and Quantitative Analysis*.

[15] In relation to private parties, the distinction between formal and informal enforcement to some degree tracks the distinction drawn in the social norms literature between 'third party' and 'second party' enforcement: third parties being external to the interaction regulated by the conduct (courts and arbitrators), and second parties being themselves participants (visiting reputational sanctions): See RC Ellickson, *Order Without Law: How Neighbours Settle Disputes* (Cambridge, MA: Harvard University Press, 1991), 126-32.

[16] AO Hirschman, *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States* (Cambridge, MA: Harvard University Press, 1970).

versus investors and other institutional features of the two mechanisms. In particular, the rules of civil procedure matter a great deal to the efficacy of formal private enforcement, whereas the identity of major investors makes a big difference to the success of informal private enforcement.

Expanding the frame of reference to include informal enforcement leads us into another analytic issue: whether 'enforcement' should be understood as relating solely to *rules*, or to encompass the enforcement of *conduct*. A rule-based account of enforcement posits a rule or code, breaches of which form the subject of enforcement activity. However, if we are willing to include 'informal' enforcement, then the actions or inactions that attract an 'enforcement' intervention may not always be so clear as to have crystallised in a rule or code. If both agent and principal 'know the score', they need not state the details of desired conduct in advance, and can obviate the *ex post* costs of articulating and verifying the desired conduct to a court. What is being enforced is not so much a rule as compliance with desired standards of conduct.

It may well be argued that a more appropriate term for such a mechanism is 'governance', rather than 'enforcement'.[17] Governance connotes the exercise of investors' entitlements regarding control of the firm. In modern theories of the firm, such entitlements—ultimately based on the power to control the firm's physical assets—take on particular significance where the costs of enforcing desired standards of conduct through the courts are high.[18] Rather than take a misbehaving manager to court, investors simply exercise their entitlements to remove the manager from control of the firm. Yet this type of action depends, for efficacy, on an underlying threat of *court* enforcement: if necessary, specific relief to protect investors' governance

[17] See, e.g., OE Williamson, *The Mechanisms of Governance* (New York: Oxford University Press, 1996), 145-170. See also R Kraakman et al, *supra* n 6, 23 (distinguishing between 'regulatory' and 'governance' strategies for mitigation of agency costs). Another categorisation that might usefully be employed distinguishes based on the time of the intervention—that is, between '*ex post*' and '*ex ante*'. (see La Porta et al, 'Self-Dealing', *supra* n , 2, 8-9; Coffee, *supra* n 3, 229). *Ex post* enforcement—as with a court case—imposes a sanction after a particular action has (not) been taken, with the goal of deterring (motivating) agents at the outset. *Ex ante* enforcement, on the other hand, is concerned either with precautionary rules, or with the application of standard-based constraints on actions before they are taken. Again, such mechanisms might alternatively be referred to as 'governance'.

[18] See O Hart, *Firms, Contracts, and Financial Structure* (Oxford: Clarendon Press, 1995).

entitlements.[19] One might ask why a discussion of enforcement should not restrict itself to formal (judicial) enforcement of this variety.

There are good reasons for not so restricting the analysis. First, informal enforcement or governance mechanisms are clearly substitutes for certain types of formal enforcement. Thus to focus on formal enforcement without recognising their role risks highly misleading comparisons. A second rationale for including informal enforcement is that, as we have seen, it maps onto public as well as private enforcers. This boundary is in fact porous: the history of the UK's experience suggests that informal private enforcement mechanisms may, over time, engender public enforcement of a progressively more formal variety. For example, the Takeover Panel existed for many years as a private trade association, with no recourse to legal sanctions.

Figure 2: The enforcement taxonomy applied to UK corporate governance

	Public	**Private**
Formal	(i) Criminal penalties (BERR, FSA) (ii) Director disqualification (BERR) (iii) Public interest winding-up (BERR) (iv) Civil penalties for market abuse, breaches of listing rules (FSA) (v) Court remedial orders (Takeover Panel, FRRP)	(i) Minority shareholder lawsuits (ii) Securities litigation (iii) Insolvency litigation
Informal	(i) Private request for remedial action (FSA, FRRP, Takeover Panel) (ii) Public censure (FSA, FRRP, Takeover Panel) (iii) 'Cold-shouldering' (Takeover Panel)	(i) Stock price sanction (Combined Code) (ii) Executive turnover following inferior performance ('rights issue', hostile takeover) (iii) Shareholder voting (related party transactions)

For these reasons, the paper proceeds with the two-by-two classification outlined above. Clearly, there are other ways of organising the material. Equally clearly, the boundaries between the categories are porous, so that a 2-dimensional scatterplot might be a more precise analytical tool than a 2x2 matrix: most real-world systems are likely to be 'mixed' in the sense that they have some aspects of each of the four categories. However, the work to be done by the taxonomy here is simply to

[19] See EB Rock and ML Wachter, 'Islands of Conscious Power: Law, Norms and the Self-Governing Corporation', (2001) 149 *University of Pennsylvania Law Review* 1619; J Armour and MJ Whincop, 'The Proprietary Foundations of Corporate Law' (2007) 27 *Oxford Journal of Legal Studies* 429.

organise the material that follows, and to provoke thought about what can be learned from the UK's experience. To give an overview of what follows, Figure 2 shows a tentative allocation to our 2x2 taxonomy of the various mechanisms that will be discussed.

2. Measuring enforcement

In comparing the 'significance' of different enforcement strategies, how should we proceed? One approach is to consider the law (or rules) on the books: that is, how extensive the enforcement powers of a particular actor, or group of actors, are at a point in time, and what remedies are potentially available.[20] This approach, however, suffers from a number of potential limitations. First, as elementary law and economics teaches us, the deterrent effect of a legal rule is a function not only of the size of the potential penalty, but of the probability of its enforcement.[21] Therefore, to understand the efficacy (or otherwise) of various enforcement strategies in a given context, we need to have some understanding of the relative frequency of their use,[22] and an understanding of the procedural and contextual factors that may affect this.

Restricting our focus to the law in books has another limitation. In the presence of informal enforcement, it may yield results that are not just misaligned with, but indeed wholly orthogonal to, reality. This is because the content of substantive rules will interact with the enforcement mechanism. Informal enforcement strategies are less likely to lend themselves to the public articulation of particularised rules. Where such strategies predominate, therefore, the scope of the substantive rules may appear to be narrower.

The approach taken in this paper, which is dictated largely by considerations of data availability, is in the first instance to focus on the *numbers* of enforcement interventions, across the range of different enforcement modalities observed in the UK. This is supplemented, where available, with data on the size, or quantum, of typical enforcement actions. The measures employed are clearly very rough, but the goal is modest: to provide a preliminary overview of the empirical incidence of the

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[20] See, e.g., Djankov et al, *supra* n 2; La Porta et al, *supra* n 2.

[21] See, e.g., Gary Becker, 'Crime and Punishment: An Economic Approach', (1968) 76 *Journal of Political Economy* 169.

[22] See sources cited *supra* n 3.

different categories of enforcement mechanism, so as to form the basis for further discussion about their respective significance.

To set the scene, it may be helpful to begin with a measure of the population of firms in the UK. As Table 1 shows, private companies vastly outnumber public companies. Moreover, the population of private firms has risen rapidly over the past five years, whereas that of public companies has remained almost constant. Public companies are *capable* of issuing shares to the public, whereas private companies are prohibited. As also shown in Table 1, only a minority choose to exercise this option, whether by listing on the Official List (the London Stock Exchange Main Market) or the Alternative Investment Market (AIM).[23] Some modalities of enforcement encompass all companies; others relate only to listed firms. This means that, should we wish to interpret the significance of 'raw' numbers of enforcement interventions in terms of enforcement *rates*, care must be exercised in the selection of denominators.

Table 1: Companies registered in the UK, 2001-2006 (thousands)

Year	Type of company					Total
	Private	Public	Listed			
			Official List	AIM	Total	
2001-02	1479.1	12.4	1.7	0.7	2.4	1491.5
2002-03	1627.9	11.8	1.6	0.7	2.3	1639.7
2003-04	1831.1	11.7	1.6	0.9	2.6	1842.2
2004-05	1968.5	11.6	1.4	1.2	2.5	1980.3
2005-06	2118.7	11.5	1.3	1.3	2.6	2130.2
2006-07	n/a	n/a	1.3	1.3	2.6	n/a
Mean	1805.1	11.8	1.5	1.0	2.5	1816.8

Sources: DTI, *Companies in 2005-6* (2006); London Stock Exchange, *Official Statistics*. Notes: Figures rounded to one decimal place. Figures for 'listed' companies include only UK-incorporated companies. Figures for 'total' companies incorporated in UK are sum of private and public companies incorporated in the UK.

III. FORMAL PRIVATE ENFORCEMENT

We begin with the modality of enforcement of constraints on managerial agency costs that is the focus of much of the existing law and economics literature: namely, formal private enforcement. In this section, we consider three different types of action that

[23] The figures for listed companies in Table 1 exclude 'cross-listings'—that is, UK-listed firms incorporated in other jurisdictions—and are therefore a subset of the population of public companies.

investors may bring against errant managers: (i) shareholder actions to enforce breaches of directors' fiduciary duties; (ii) securities litigation to enforce breaches of disclosure laws and (iii) insolvency litigation relating to breaches of directors' duties. In each case, we consider data on their incidence as revealed by the numbers of cases producing one or more judgment of some variety (final or interim).[24] The set of judgments sampled is that contained in the major databases: LexisNexis, Westlaw UK, and Lawtel.[25] It turns out that, in the UK, private litigation against directors of listed companies is conspicuous by its absence.

1. Minority shareholder actions

Shareholders in UK companies have the ability to bring a minority shareholders' action against errant directors in one of two forms: either as a derivative action, or in the form of a statutory petition for relief from 'unfair prejudice'.

In a derivative action, a minority shareholder is authorised to commence litigation in the company's name. It is used as a means of redressing wrongs done to the company. The decision whether or not to commence litigation in the company's name is a corporate action, and one which is usually made by the company's board of directors, or failing that, by its general meeting.[26] A derivative action, if authorised, bypasses these procedures so as to permit a minority shareholder to bring an action on the company's behalf. As such, it constitutes an exception to the ordinary principle of corporate action—namely, majority rule.

English law traditionally took a very restrictive approach to derivative actions.[27] Although the position has now been altered by the Companies Act 2006,[28] it

[24] Cases which produce more than one judgment (e.g. appellate decisions) are counted only once, and are recorded according to the date of the most recent judgment.

[25] These databases aim to cover all decisions (both final and interim hearings) in which a written judgment has been delivered, or where an official transcript has been authorised by the judge. Coverage prior to 1996 includes only decisions selected for inclusion in law reports. From 1996 onwards, the databases include transcripts of unreported decisions. This transcript coverage becomes comprehensive as regards the Court of Appeal and High Court from 2001, when standardised numbering of transcripts was introduced.

[26] *Marhsall's Valve Gear Co Ltd v Manning, Wardle & Co* [1909] 1 Ch 267; *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204, 221; *Breckland Group Holdings Ltd v London & Suffolk Properties Ltd* [1989] BCLC 100.

[27] *Foss v Harbottle* (1843) 2 Hare 461, 67 ER 89; *Mozley v Alston* (1847) 1 Ph 790, 41 ER 833.

is necessary to describe the old law in outline because it governed all the actions reported in this section. In order to be permitted to bring a derivative action, it was necessary for a minority shareholder to establish, at a preliminary hearing,[29] a reason why the matter was not something that was capable of being properly resolved by the board or the general meeting.[30] Doing so would require the minority shareholder to show that the company was controlled by a party that had benefited from the alleged wrong to the company—thereby establishing a reason why the board and/or general meeting's decision-making apparatus could not be trusted to make the choice in the best interests of the company.[31] This ruled out actions in cases where the board breached their duties without conferring any benefit on a controlling shareholder,[32] because the harm would be felt proportionately by all stockholders and consequently the majority rule principle applied.[33] This requirement of 'wrongdoer control' made the derivative action a wholly unsuitable mechanism for enforcing directors' duties in listed companies, where there is typically no controlling shareholder. In effect, the law forced shareholders to take action via the general meeting rather than the courts.

Minority shareholders considering a derivative action also face financial disincentives.[34] If such an action is successful, then the recoveries will go to the company. The minority shareholder's benefit will therefore only be *pro rata* to their shareholding. However, the 'loser pays' principle applies to costs. This means that if a derivative action is unsuccessful, the minority shareholder faces potential liability not only for their own legal costs, but for the defendant's as well. This asymmetry was partially mitigated in 1975, when the Court of Appeal in *Wallersteiner v Moir (No.*

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[28] CA 2006 ss 260-64 (in force from 1 October 2007). See *infra*, text to nn 208-213.

[29] *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204, 221; CPR, r. 19.9.

[30] See *Edwards v Halliwell* [1950] 2 All ER 1064, 1066-67; *Barrett v Duckett* [1995] 1 BCLC 243, 248. The mere possibility of the matter being resolved by a general meeting—as opposed to its in fact having done so—sufficed to bar a derivative action. This was to encourage the minority shareholder to bring his or her grievance before the general meeting for resolution according to the wishes of the majority.

[31] *Russell v Wakefield Waterworks Co* (1875) LR 20 Eq 474, 482.

[32] *Pavlides v Jensen* [1956] Ch 565.

[33] See *Prudential v Newman, supra* n 29, 212-19.

[34] These have not been altered by the Companies Act 2006: see A Reisberg, *Derivative Actions and Corporate Governance* (Oxford: OUP, 2007), 166.

2)[35] ruled that a minority shareholder was, in an appropriate case, entitled to an indemnity from the company against litigation expenses incurred on the company's behalf in pursuing a derivative action.[36] However, any such entitlement would not be established before the initial application to the court for permission to commence a derivative action.[37] Hence the claimant shareholder would still bear a significant risk relating to the costs of the preliminary hearing.[38] This is unarguably a powerful deterrent.

In quantifying shareholder actions to enforce breaches of directors' duties, it is appropriate also to take into account use of the statutory remedy for 'unfair prejudice'.[39] This gives the court a wide remedial discretion in circumstances where the affairs of the company have been carried on in a way that is 'unfairly prejudicial' to the interests of a minority shareholder or the shareholders generally. The relevant provision, which was originally introduced in 1980,[40] then re-enacted as section 459 of the Companies Act 1985, is now section 994 of the Companies Act 2006. Although most petitions brought for such statutory relief have been based upon breaches of informal understandings between participants in 'quasi-partnership' companies,[41] it was established by the mid-1980s that a remedy might also lie for breaches of fiduciary duty by boards controlled by majority shareholders.[42] Over time, the circumstances under which an unfair prejudice petition could be used to remedy such wrongdoing by a majority have been clarified. As regards breaches of directors'

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[35] [1975] QB 373.

[36] According to Buckley LJ, this would be if the action was one which, in the court's view, a reasonable independent board of directors would authorise on the company's behalf: *ibid.* 403. See also *Smith v Croft* [1986] BCLC 207, 217-21; *Jaybird Group Ltd v Greenwood* [1986] BCLC 319, 321; DD Prentice, '*Wallersteiner v Moir:* A Decade Later' [1987] Conv 167.

[37] CPR r. 19.9

[38] See Reisberg, *supra* n 34, 234-42.

[39] Companies Act 2006 ('CA 2006') s 994.

[40] Companies Act 1980 s 75. It replaced a previous provision (Companies Act 1948 s 210) which had required a minority shareholder to demonstrate show 'oppression' by the majority and had been interpreted very restrictively by the courts: see DD Prentice, 'The Theory of the Firm: Minority Shareholder Oppression: Sections 459-461 of the Companies Act 1985' (1988) 8 OJLS 55.

[41] See *O'Neill v Phillips* [1999] 1092; Prentice *supra* n 40.

[42] *Re A Company* [1986] BCLC 68.

duties, the contours came to look quite similar to those under which a derivative action may be brought. That is, the courts were willing to grant a remedy for wrongdoing by directors where this had also benefited a majority shareholder.[43]

The typical remedy for a petition based on unfair prejudice is an order for the majority shareholder to buy the minority's shares, rather than a remedy for the company. However, there is considerable overlap with the derivative action in cases where there has been misappropriation of corporate assets.[44] Where a petition is based on such misappropriation, the petitioner will usually seek such an order requiring the majority shareholder to purchase his shares at a price that reflects the value they held before the conduct began.[45] From the petitioner's point of view, this is economically equivalent to corporate recovery following a derivative action.[46] Alternatively, an order may be sought requiring the respondent to sell their shares to the petitioner, in which case the petitioner will also seek an order on the company's behalf to recover misappropriated corporate assets.[47] Whilst an indemnity for costs is not usually available to a minority shareholder bringing an unfair prejudice petition,[48] it was suggested by Arden LJ in *Clark v Cutland* that where the relief sought is in substance on the company's behalf then the petitioner may be entitled to an indemnity from the company.[49] As a result of these instances of overlap, it is apposite to bracket together

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[43] Compare *Re Elgindata Ltd* [1991] BCLC 959, 993-94 (simple mismanagement does not constitute unfair prejudice) with *Re Macro (Ipswich) Ltd* [1994] 2 BCLC 354, 393-95, 404-7; *Bhullar v Bhullar* [2003] EWCA Civ 424, [2003] 2 BCLC 241(misappropriation of corporate assets by respondent shareholder). See also *Re Saul D Harrison & Sons plc* [1994] BCC 475, 489-91, 499-500 (breach of directors' duties must be sufficiently serious as to be 'unfairly' prejudicial) and *Gamlestaden Fastigheter AB v Baltic Partners Ltd* [2007] UKPC 26, [2008] 1 BCLC 468, at [13] ('self-serving' negligence).

[44] See CA 2006 s 996(2)(e). The court also has power to order litigation to be commenced in the company's name: *ibid*, s 996(2)(c). However, this would generate the unnecessarily expensive result of two sets of proceedings to yield one remedy, and courts have tended simply to order a remedy directly.

[45] See *Re Little Olympian Each-Ways Ltd (No 3)* [1995] 1 BCLC 636; *Profinance Trust SA v Gladstone* [2001] EWCA Civ 1031, [2002] 1 BCLC 141 at [33]-[45], [59]-[61].

[46] See *Prudential v Newman, supra* n 29, 223.

[47] As in *Bhullar v Bhullar, supra* n 43.

[48] *Re a Company (No 005136 of 1986)* [1987] BCLC 82.

[49] [2003] EWCA Civ 810, [2003] 2 BCLC 393 at [35]. See J Payne, 'Shareholders' Remedies Reassessed' (2004) 67 MLR 500.

unfair prejudice petitions alleging breach of duty by directors along with derivative actions.

Table 2: Decisions on UK minority shareholder enforcement of directors' fiduciary duties, 1990-2006

Year	All companies			Listed companies		
	Derivative	Unfair prejudice	Total	Derivative	Unfair prejudice	Total
1990	0	1	1	0	0	0
1991	0	1	1	0	0	0
1992	0.5*	0.5*	1	0	0	0
1993	0	0	0	0	0	0
1994	1	1	2	0	0	0
1995	1	1	2	0	0	0
1996	0	1	1	0	1	1
1997	1	1	2	0	0	0
1998	1	2	3	0	2	2
1999	2	1	3	0	0	0
2000	0	4	4	0	0	0
2001	2	2	4	0	0	0
2002	3.5*	0.5*	4	0	0	0
2003	4.5*	1.5*	6	0	0	0
2004	1	5	6	0	1	1
2005	5.5*	2.5*	8	0	0	0
2006	2	1	3	0	0	0
Mean	1.5	1.5	3.0	0.0	0.2	0.2

* Scores of 0.5 indicate action framed jointly as derivative action / petition for relief from unfair prejudice.
Sources: author's analysis of transcripts of decisions available on LexisNexis, WestlawUK, Lawtel.

Table 2 shows the reported incidence of derivative actions and unfair prejudice petitions concerned with remedying breaches of directors' duties (that is, fiduciary duties and/or duty of care) over the period 1990-2006. There were only three reported judgments during this period in which a minority shareholder action was brought in relation to misfeasance by the directors of a listed company.[50] In none of these cases were the claimants successful. This implies that the average amount of damages paid annually by directors of listed companies following minority

[50] The status of companies as 'listed' was determined manually, as the vast majority of UK 'public' companies are not listed. Cases involving public companies ('plcs') were first identified, and the transcripts and contemporary newspaper reports were cross-checked for evidence as to their status as listed or unlisted companies.

shareholder actions is zero. Moreover, because minority shareholders have been unsuccessful in recorded litigation, it implies that there is likely to be little settlement bargaining taking place in the shadow of the law.

Table 3: Decisions on statutory petitions for relief from 'unfair prejudice', 1998-2006

Year	All unfair prejudice petitions	
	Total	Listed co
1998	4	2
1999	11	0
2000	11	0
2001	15	2
2002	6	0
2003	15	1
2004	16	1
2005	10	0
2006	13	0
Mean	11.2	0.66

Sources: author's analysis of transcripts of decisions available on LexisNexis, WestlawUK, Lawtel.

Petitions alleging unfair prejudice are in fact used to seek redress for a wide range of other forms of wrongdoing by majority shareholders against minorities.[51] The most common type of complaint alleges the existence—and breach—of some agreement or understanding between all the shareholders that is not reflected in the company's formal constitution.[52] Such unanimous understandings are practically impossible to sustain as respects listed companies, where shareholders' identities are constantly changing.[53] Nevertheless, as a check on the robustness of the findings in Table 2, the incidence of judgments in *all* minority shareholder petitions alleging 'unfair prejudice' is reported in Table 3.[54] This reinforces the findings in Table 2.[55]

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[51] See generally, PL Davies, *Gower and Davies' Principles of Modern Company Law*, 7th ed. (London: Sweet & Maxwell, 2003), 517-23.

[52] See *ibid* and sources cited *supra* n 41.

[53] See, e.g., *Re Blue Arrow plc* [1987] BCLC 585, 590.

[54] In contrast, Table 2 includes only those petitions that related to breach of directors' fiduciary duties.

It might be thought that the foregoing data under-represent the true level of private enforcement activity, as they include only those decisions which reached judgment. Claims which are settled do not, of course, appear on the official record in the same way, nor are the details of the settlements recorded. Further insight into levels of private enforcement activity may, however, be derived from two studies which have sought to examine the number of claims filed, as opposed to those resulting in a judgment of some type.

The first was a study conducted by the Law Commission into 'unfair prejudice' petitions filed with the Companies Court during the 1994 and 1995 calendar years, analysed following inspection of the court records.[56] These revealed a total of 156 petitions (that is, 78 each year) presented during this period, approximately seven times the mean annual rate implied from the reported case data. Of these, only six petitions (three per year) related to public companies. Just over a quarter of public companies are listed, so this implies just under one unfair prejudice petition—of any sort—filed against a listed company per year.

In a more recent study, Armour, Black, Cheffins, and Nolan investigated numbers of claims filed in the Companies Court involving allegations of breach of duty by directors of public companies during the calendar years 2004 to 2006, again by searching records at the High Court.[57] They found a total of 11 claims brought by private parties (just under four per year) alleging breaches of duty by directors, of which three (one per year) were against directors of listed companies.[58]

These two studies encompass different categories of claim. The Law Commission include all unfair prejudice petitions—whether based on breach of duty by directors or not. In contrast, Armour *et al* include all claims brought by shareholders against directors for breach of duty, whether framed as a derivative

[55] Table 3 reported three additional cases in relation to listed companies during the period 1998-06. These involved allegations either of informal understandings between all the shareholders, or of breaches of the articles.

[56] See Law Commission, *Shareholder Remedies*, LCCP 142 (London: TSO, 1996), 235-238.

[57] Armour et al, *supra* n 9.

[58] *Ibid.*, 18-20. Whilst all petitions for relief from unfair prejudice must be launched in the Companies Court, derivative actions may alternatively be commenced in the main list of the Chancery Division of the High Court. Armour et al also conducted a shorter sample of three months' worth of claims filed in the Chancery Division during 2006 (*ibid*, 20-21). No claims against directors of a listed company were found.

action or as a statutory petition alleging unfair prejudice. However, the results of both studies reinforce the conclusion that the level of private enforcement of directors' duties by shareholder litigation is close to nil for listed companies.

2. Securities litigation

Private rights of action against company directors also exist in relation to misleading statements or omissions in disclosures relating to securities. As regards primary disclosure, section 90 of the Financial Services and Markets Act 2000 ('FSMA') provides that an acquirer of securities who suffers loss as a result of a false or misleading statement, or an omission of required information, in any prospectus or listing particulars may recover damages from any person responsible, including both the issuing company and its directors. However, there are to date no recorded instances of judgments being given under this provision or its predecessor, section 150 of the Financial Services Act 1986. Two instances of actions being brought appear from an analysis of transcripts in online databases over the period 1990 to 2006.[59]

Alternatively, directors might face liability at common law for negligent misstatement,[60] or possibly deceit,[61] in respect of prospectus disclosure.[62] Here, however, reviews of electronic databases reveal only three instances during the period from 1990-2006 in which claims resulting in a judgment were brought against directors for allegedly negligent misstatements in prospectus disclosures.[63] These

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[59] See *Re Barings plc (No 6)* [2001] 2 BCLC 159 at [4] (claim brought against Barings plc in 1996); *Axa Equity and Law Life Assurance Society plc v National Westminster Bank plc,* (CA) 7 May 1998 (unreported) (claim brought against Coopers & Lybrand).

[60] Under the principles articulated in *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465 and developed in *Caparo Industries plc v Dickman* [1990] 2 AC 605.

[61] *Derry v Peek* (1889) 14 App Cas 337.

[62] Liability for false or misleading statements or material omissions in respect of continuing disclosure was practically ruled out by requirements that the defendant must have known the identity of the claimant: see P Davies, *Liability for Misstatements to the Market: A Discussion Paper* (HM Treasury, London, 2007), 18-21. A statutory cause of action for misstatements in relation to continuing disclosure was introduced in November 2006: see Financial Services and Markets Act 2000 ('FSMA 2000') s 90A (inserted by CA 2006). However this liability falls only on the issuer, and not on and individuals—such as directors—involved in making the statement (FSMA 2000 s 90A(3)).

[63] A survey by Ferran of Lexis-Nexis revealed three cases: *Al-Nakib Investments (Jersey) Ltd v Longcroft* [1990] 1 WLR 1390; *Possfund Custodian Trustee Ltd v Diamond* [1996] 1 WLR 1351; and

results imply that levels of private enforcement of the obligations of directors of listed companies as regards mandated disclosures are also close to nil.

3. Insolvency litigation

Corporate insolvency may be a trigger for litigation against errant directors. In addition to being able to enforce retrospectively any breaches of duty a director may have committed against the company,[64] an insolvency practitioner may also be able to utilise a range of causes of action that arise only in relation to insolvent firms, relating to actions that directors took, or ought to have taken, in the period immediately prior to the firm's demise. In particular, liability for fraudulent or wrongful trading may be incurred by directors continuing to trade at a point when there is no reasonable prospect of avoiding insolvent liquidation.[65]

Analysis of judgments delivered in UK cases during 2006 indicates that there were significantly more insolvency-related actions against directors than there were minority stockholder suits. In 2006, for example, in a year when there were just 3 judgments in minority shareholder suits against errant directors,[66] there were 11 judgments in suits launched by insolvency practitioners.[67] However, if attention is restricted to listed firms, only one case resulting in a judgment appears in the electronic databases during the entire period 1990-2006.[68] Similarly to minority shareholder actions and securities law claims, levels of private enforcement of the obligations of directors of listed companies consequent upon insolvency proceedings appear to be close to nil.

Axa Equity and Law Life Assurance Society plc v National Westminster Bank plc, CA 7 May 1998 (unreported) (E Ferran, 'Cross-border Offers of Securities in the EU: The *Standard Life* Flotation' (2007) 4 ECFR 461, 476-77). An extension of this survey to Westlaw UK and Lawtel did not reveal any further cases.

[64] See Insolvency Act 1986 s 212.

[65] Insolvency Act 1986 ss 213-14. Fraudulent trading connotes that the directors were aware of the company's true financial position; wrongful trading that they negligently failed to be so aware.

[66] See Table 2, *supra*.

[67] Author's analysis of Lexis, Westlaw and Lawtel transcripts.

[68] *Bairstow v Queens Moat Houses plc* [2000]1 BCLC 549, [2001] EWCA Civ 712, [2001] 2 BCLC 531.

Having established the practical absence of formal private enforcement, we now turn to consider the incidence of public enforcement.

IV. PUBLIC ENFORCEMENT

A number of mechanisms of public enforcement also exist in the UK, and, judging from their empirical incidence, they are rather more important in practice than those of formal private enforcement just described. There are four principal public enforcement agencies in relation to UK companies: the Financial Services Authority ('FSA'), the Financial Reporting Review Panel ('FRRP'), the Takeover Panel ('the Panel'), and the Department for Business Enterprise and Regulatory Reform ('BERR'). The enforcement activities of each of these agencies comprise a mixture of formal and informal actions. We will consider the activities of each in turn.

1. The Financial Services Authority ('FSA')

In relation to listed companies, the FSA has responsibility for drafting and enforcing the Listing Rules, the Disclosure and Transparency Rules, and the Prospectus Rules.[69] It also enforces prohibitions on insider dealing and other forms of market abuse.[70] The FSA has very wide formal enforcement powers, including the ability to pursue both civil and criminal sanctions against wrongdoers.[71] It also has the ability to sanction professionals by prohibiting them from conducting investment business in the UK.[72] For listed firms, an analogous sanction is the power to require de-listing of securities.[73] The FSA also has power simply to issue a public censure,[74] which will have a reputational effect on the individual or firm concerned.

The FSA prefers where possible not to exercise formal powers, but rather to achieve a settlement with the defendant—which will be a matter of public record—or

[69] FSMA 2000 Part VI, esp. ss 72, 77, 89, 91.

[70] FSMA 2000 Part VIII, esp. ss 123, 129.

[71] See FSMA 2000 ss 401-02 (criminal prosecution powers, particularly in relation to insider dealing under the Criminal Justice Act 1993 Part V), 91, 123 (civil penalties for breaches of Listing Rules or market abuse), 66 (civil penalties against authorised persons). See also ss 380-384 (ancillary powers to seek injunctions and/or restitution orders).

[72] FSMA 2000 ss 56, 63.

[73] FSMA 2000 ss 77, 87K-87L, 89L.

[74] FSMA 2000 ss 66, 87M, 89, 89K.

simply to send a private warning regarding the misconduct.[75] These more informal enforcement tactics are used where the defendant expeditiously remedies the wrong concerned and the FSA considers that they pose little risk of repeating the conduct.[76] The FSA only publicises cases that result in public censure, prohibition, or a civil or criminal penalty. The FSA does, however, publish statistics on the number of cases investigated by its enforcement department each year. These give an approximate upper bound on the number of informal engagements that take place each year in relation to the type of conduct in question.

(i) Insider dealing and market abuse

Table 4: Investigation and enforcement of insider dealing and market abuse, 1996-2007

Year	Investigations	Prosecutions	Convictions	# Civil penalties	Civil penalties / £k
1996-7	(21)[a]	*	*	n/a	n/a
1997-8	(22)[a]	*	*	n/a	n/a
1998-9	(15)[a]	*	*	n/a	n/a
1999-0	(18)[a]	*	*	n/a	n/a
2000-1	(3)[a]	(14)[a]	(10)[a]	n/a	n/a
2001-2	(8)[a]	(5)[a]	(2)[a]	n/a	n/a
2002-3	15	(5)[a]	(2)[a]	0	0
2003-4	30	(27)[a]	(3)[b]	3	985
2004-5	17	0	(1)[b]	10	17,994
2005-6	22	1	1	3	13,996
2006-7	22	0	0	6	8,286
Mean	17.5	7.4	2.7	4.4	8,252

* Data not available.
Figures not in parentheses refer to investigation and enforcement activity conducted by the FSA relating to insider trading and market abuse since December 2001. Sources: FSA, *Annual Reports*, 2001-2007; *Final Notices*, 2002-2004.
[a] DTI investigation and enforcement of insider trading carried out until December 2001, and prosecutions following on from that work. Source: DTI, *Companies in 2000-2006.*
[b] Convictions for insider trading secured following referrals by DTI to Serious Fraud Office (prosecutions initiated by DTI). Source: SFO, *Annual Reports* 1997-2006.

[75] See FSA, *The Enforcement Guide* (London: FSA, 2007), 23-36.

[76] *Ibid*., 34-36. See also FSA Handbook, DEPP 6.2

Insider dealing is a criminal offence carrying a maximum penalty of seven years' imprisonment.[77] Further offences exist in relation to fraudulent misstatements and market manipulation.[78] The FSA took over from the DTI at the end of 2001 as principal prosecutor of these offences.[79] Moreover, since 2001, insider dealing and market manipulation have also formed subset of a wider category of proscribed activities known as 'market abuse', punishable by the levy of an unlimited civil fine by the FSA.[80]

Criminal convictions for insider dealing are said to be difficult to secure, owing to the frequent complexity of the facts, and the need to satisfy the jury that the criminal standard of proof has been met.[81] Whilst the number of convictions shown in Table 4 is certainly modest, it is nevertheless higher than the numbers of instances of private enforcement reported in Table 2. One of the intended benefits of the shift to a civil penalty was the possibility of a greater 'strike rate' against defendants, as the civil burden of proof is lower.[82] Whilst the FSA does not appear to investigate many more cases each year than the DTI formerly did, it has been able to use the new civil enforcement powers to impose sizeable civil penalties. However, it is doubtful whether this has had much impact on the underlying level of misconduct. A recent FSA study reported that levels of unusual price movement *prior* to takeover announcements for UK listed firms had not decreased since the introduction of the

[77] Criminal Justice Act 1993 Part V. See esp. s 61(1).

[78] FSMA 2000 s 397

[79] See DTI, *Companies in 2002-3* (2003), 22. The Serious Fraud Office ('SFO') also has power to investigate and prosecute insider dealing where this involves serious or complex fraud: see Criminal Justice Act 1987 s 1(3).

[80] FSMA ss 118, 123.

[81] See H McVea, 'Fashioning a System of Civil Penalties for Insider Dealing: Sections 61 and 62 of the Financial Services Act 1986' [1996] JBL 344, 349-50.

[82] M Filby, 'The Enforcement of Insider Dealing under Financial Services and Markets Act 2000' (2003) 24 Co Law 334

FSA's enforcement powers.[83] Such price movements are thought to be a likely indicator of insider trading activity.[84]

(ii) Enforcement of the Listing Rules

In addition to enforcing the market abuse regime, the FSA is also charged with enforcing breaches of the Listing Rules applicable to firms quoted on the Official List. Details of enforcement activity for the past five years are available from the FSA's Annual Reports, and are set out in Table 5.

Table 5: FSA enforcement of breaches of the Listing Rules, 2002-2007

Year	Investigations	# Enforcement actions	Civil penalties/£k
2002-3	12	1	0
2003-4	2	3	45
2004-5	7	3	550
2005-6	6	2	240
2006-7	3	1	250
Mean	6	2	217

Sources: FSA, *Annual Reports*, 2004-2006; *Final Notices*, 2002-2004.

To date, little in the way of formal enforcement activity appears to have been pursued by the FSA in relation to breaches of the Listing Rules. There have been more cases and higher levels of penalties imposed in relation to market abuse. Overall, however, the FSA's total level of enforcement activity still seems rather low.

2. The Financial Reporting Review Panel ('FRRP')

The Financial Reporting Review Panel is another public enforcement agency with an important role in constraining managerial opportunism in listed companies. It is one of several operating bodies working under the aegis of the Financial Reporting

[83] N Moneiro, Q Zaman and S Leitterstorf, 'Updated Measures of Market Cleanliness', FSA Occasional Paper No 25 (2007).

[84] However it is of course possible that they simply reflect good 'guesswork' by sophisticated investors.

Council.[85] The FRRP was established in 1991 in order to investigate material departures from accounting standards by large companies,[86] and to persuade companies to rectify these where appropriate.[87] Should such persuasion fail, it was given power to apply to court for an order mandating revision of such statements.[88]

Table 6: Investigation of financial statements by the FRRP, 1992-2007

Year	Financial statements investigated		Action taken	Public notices issued	Court orders
	Following referral	Following pro-active selection			
1992	78	-	31	10	0
1993	45	-	42	9	0
1994	46	-	43	6	0
1995	43	-	34	4	0
1996	49	-	40	8	0
1997	24	-	32	5	0
1998	32	-	30	8	0
1999	29	-	26	2	0
2000	32	-	25	5	0
2001	53	-	27	7	0
2002	57	-	15	2	0
2003	51	-	36	2	0
2004-5	42	184	77	3	0
2005-6	60	224	64	3	0
2006-7	45	266	128	4	0
Mean	45.7	224.7	43.9	5.2	0

Source: FRRP, *Annual Reports*, 1992-2007. The number of cases in which action was taken in 2003 is not reported. The figure in this column for 2003 is an estimate based on average ratio of cases investigated to action taken for years 1992-2002.

[85] This was set up in response to a number of corporate failures and scandals involving poor accounting and financial reporting during the 1980s. In particular, statutory recognition was granted to accounting standards produced by the FRC's Accounting Standard Board, and power was devolved to the FRRP to enforce breaches of these standards in respect of financial statements by companies.

[86] This includes all public companies and large private companies. Responsibility for oversight of accounting requirements in relation to small private companies was left to the DTI (now BERR): see Memorandum of Understanding between the FRRP and the FSA, 6 April 2005, para 3.

[87] See Financial Reporting Council, *The State of Financial Reporting: A Review* (London: FRC, 1991), 24-25, 49-50.

[88] Companies Act 1989 s 12, inserting ss 245-245C into Companies Act 1985. Equivalent provisions now appear as CA 2006 ss 456-57. The FRRP was authorised to exercise these powers by the Companies (Defective Accounts) (Authorised Person) Order 1991, SI 1991/13.

For over a decade, the FRRP performed these functions on a reactive basis by launching investigations in response to investors' complaints about particular financial statements.[89] However, in 2004-5, following a review of financial reporting sparked by the Enron scandal, legislation was introduced requiring the FRRP to adopt a more pro-active approach to investigation in relation to listed firms.[90] The FRRP now scrutinises more than 250 sets of financial statements a year, which are selected on the basis of a risk assessment based on sectoral, firm-specific, and statement-specific risk factors.[91] Most of the accounts reviewed are of listed companies.[92]

Table 6 gives figures for the FRRP's enforcement activity since its inception in 1992. In no case has the FRRP yet relied on its power to seek a court order. Equally striking is the very low proportion of cases in which action is taken resulting in any form of public notice. For each public notice, there are approximately ten cases in which action is taken. In the vast majority of cases, therefore, companies under investigation remedy defective accounting practices without the need for a public notice. In other words, the bulk of the FRRP's enforcement activity is informal.[93]

3. The Takeover Panel

A third significant regulatory body, from the standpoint of listed companies, is the Panel on Takeovers and Mergers (the 'Panel'). The Panel, its Executive and various Committees, are collectively responsible for writing, adjudicating, and enforcing the City Code on Takeovers and Mergers (the 'Code'), which governs the conduct of

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[89] See, e.g., Financial Reporting Council, *Annual Review 2002* (London: FRC, 2003), 58-59; Financial Reporting Council, *Annual Review 2003* (London: FRC, 2004), 55-57.

[90] The scope of the FRRP's investigatory role was also increased to include compliance with accounting requirements imposed by the Listing Rules as well as the general Companies Legislation. Companies (Audit, Investigations and Community Enterprise) Act 2004 s 14 (requiring prescribed body to 'keep under review' periodic accounts and reports that are produced by issuers required to comply with accounting requirements imposed by the Listing Rules); Supervision of Accounts and Reports (Prescribed Body) Order 2005, SI 2005/715 (naming FRRP as prescribed body).

[91] See, e.g., Financial Reporting Review Panel, *Activity Report 2006-7* (London: FRRP, 2008), 4-6

[92] *Ibid.*

[93] See generally, K Cearns and E Ferran, 'Non-Enforcement Led Public Oversight of Financial and Corporate Governance Disclosures and of Auditors', ECGI Law Working Paper No. 101/2008, 20-27.

take-over bids in relation to domestically incorporated companies listed in the UK.[94] The Panel's operation is perhaps the best example of informal public enforcement in the UK. Informality is evident both as regards the Panel's status, and as regards its mode of operating. The Panel was, for most of its history since its inception in 1968, a purely self-regulatory organisation with no formal legal basis. [95] Over time, it came to be viewed as performing an essentially public function,[96] and was finally put on a statutory footing in 2006 as part of the UK's implementation of the EU Takeover Directive.[97]

The Panel's mode of operating is also highly informal. The Code consists of a series of principles, fleshed out by more specific rules, and parties are expected to comply with its 'spirit' as well as the 'letter'.[98] As such, it is deliberately drafted so as to be over-inclusive, but with the understanding that waivers are frequently granted by the Panel. This encourages parties to consult with the Panel Executive *ex ante*, who make decisions regarding compliance in 'real time' during transactions.[99] The Panel publish in their Annual Reports data on the number of such *ex ante* rulings they are required to make each year. In the vast majority of cases such guidance will be given in private, although in a few cases, the Panel will make a public ruling concerning the conduct of a particular bid situation.[100] Figure 3 shows (black line) the number of

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[94] Takeover Code, A3. Since 2006, the Code has also applied to companies incorporated elsewhere within the EEA which have a primary listing in the UK: *ibid*, A3-A4.

[95] See, e.g., T Tridimis, 'Self-Regulation and Investor Protection in the United Kingdom: The Takeover Panel and the Market for Corporate Control' (1991) 10 CJQ 24; TP Lee, 'Takeover Regulation in the UK' in K Hopt and E Wymeersch (eds), *European Takeovers: Law and Practice* (London: Butterworths, 1992), 133.

[96] *R v Panel on Take-overs and Mergers, Ex parte Datafin plc* [1987] QB 815.

[97] CA 2006 Part 28.

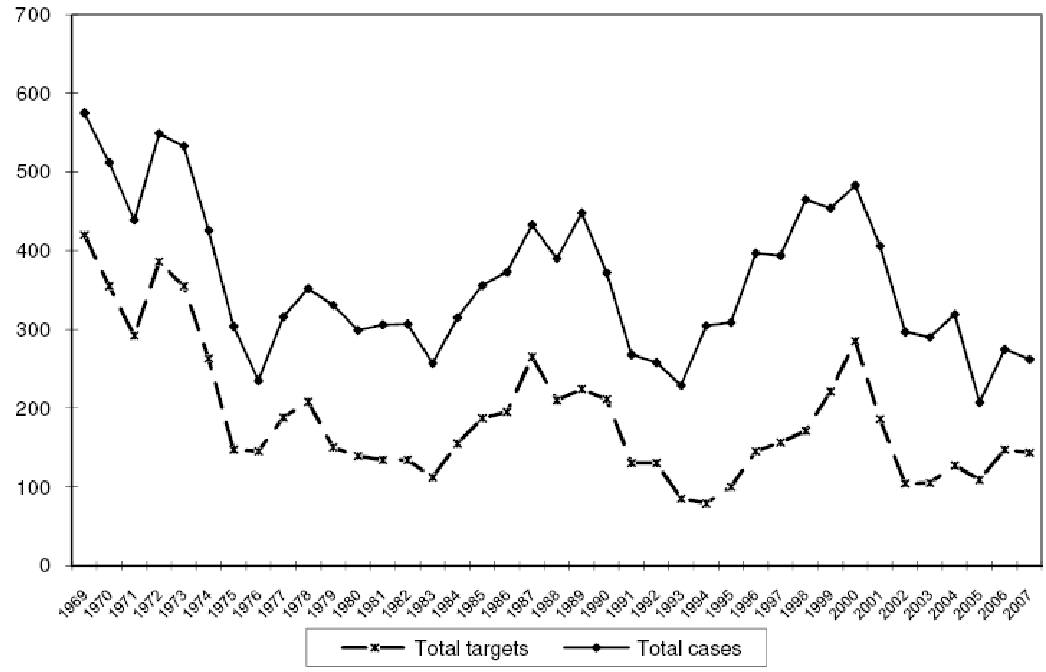
[98] Takeover Code, A2.

[99] A party dissatisfied with a decision of the Executive may request a decision of the full Panel. An appeal from a Panel decision is available to the Panel's Hearings Committee, and then to the Takeover Appeals Board (see Companies Act 2006 ss 951, 957). It is also possible to seek judicial review of a decision of the Panel, but, in relation to decisions regarding the conduct of a bid, any relief will be in the form of prospective guidance, so as not to interfere with the outcome of events that have occurred: see *Datafin*, supra n 96, 842.

[100] For example, in relation to speculation surrounding potential interest by CVC Partners and others in J. Sainsbury & Co plc, the supermarket, the Panel on 6 March 2007 gave CVC until 13th April 2007 to "put up or shut up": that is, either to declare a firm offer for the company, or to decline to bid for a

Panel engagements over time, and (dashed line) the number of actual bids made. This implies that nearly 50% of the Panel's activity relates to situations where a bid does not actually materialise. Moreover, the general picture that emerges is that such informal *ex ante* rulings by the Panel are, in numerical terms, the most significant form of regulatory activity in relation to UK listed companies.

Figure 3: *Ex ante* engagements by the Takeover Panel, 1969-2007



Source: Takeover Panel, Annual Reports, 1969-2007. Total numbers of cases are not reported after 2004; figures given are estimates based on ratio of total cases to targets for period 1970-2004.

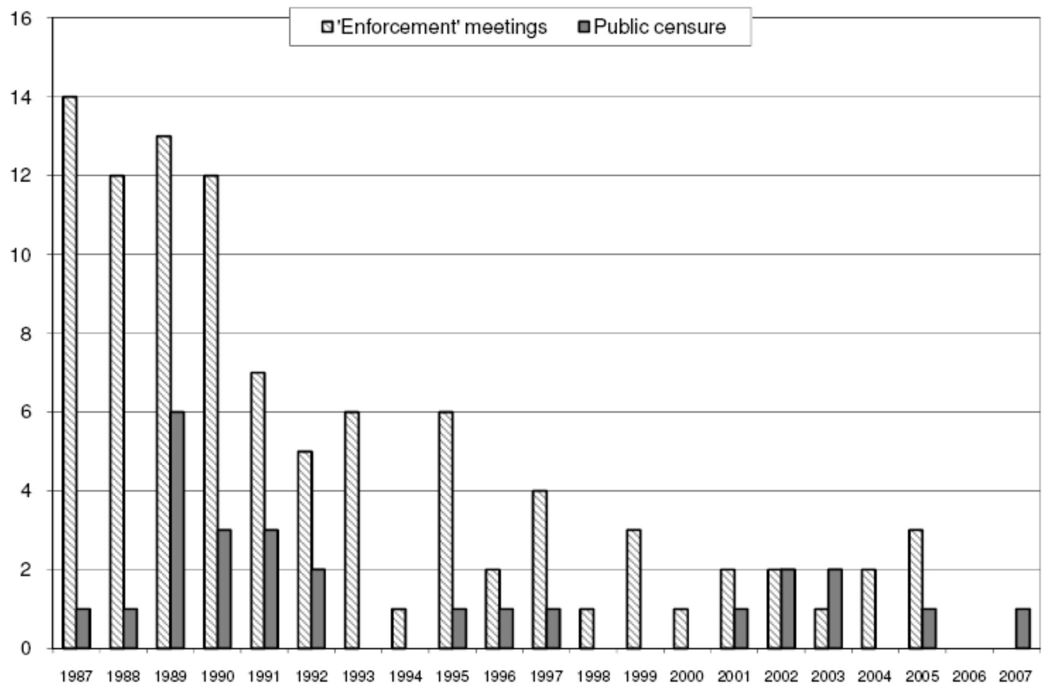
The Panel also imposes *ex post* sanctions on parties who fail to comply with the Code or its rulings.[101] Similarly to the FSA and the FRRP, the Panel have a range of responses at their disposal, depending on the conduct of the parties. For minor breaches, a quiet reprimand in private is likely to be delivered. For more significant matters, a statement of public censure may be made. As well as general harm to

further year: see Takeover Panel, 'Sainsbury (J) plc', Panel Statement 2007/8; E Rigby and L Saigol, 'Pressure on CVC to Make Sainsbury Bid', *Financial Times,* 5 April 2007.

[101] See CA 2006 s 952. The same appeal structure (see *supra* n 99) is available regarding disciplinary decisions. Moreover, retrospective relief may also be available by way of judicial review in relation to such decisions, as this will not affect the outcome of any takeover transactions: see *R v Panel on Take-overs and Mergers, ex parte Guinness plc* [1990] 1 QB 146, 158.

reputation, a conclusive statement by the Panel that advisers were at fault may expose them to civil liability to clients who suffered loss in relation to the bid concerned. For example, following a public censure by the Panel of NM Rothschild & Sons Ltd in early 2007, it was reported that clients of the investment bank had sought to renegotiate their fees.[102]

Figure 4. Takeover Panel *ex post* enforcement, 1987-2006



Sources: Takeover Panel, *Annual Reports* 1987-2006; *Panel Statements*, 1987-2006

In relation to bidders or targets that have breached the Code, the Panel may issue a direction, intended to bring to an end the non-compliant activity, or an order requiring a party in breach to pay compensation to those who have suffered loss as a result.[103] Such remedial orders may involve large sums of money. For example, Guinness plc was required to pay approximately £85m (around £185m in today's

[102] See Takeover Panel, 'British Telecommunications plc offer for Plusnet plc', Panel Statement 2007/6, 2, 5-6; D Jordon, 'BT Reviews Rothschild's Fees as Takeover Panel Criticises Bank', *The Times*, 13 February 2007.

[103] See now CA 2006 ss 946, 954.

money) to former shareholders in Distillers plc, which it took over in 1986, in order to comply with a Panel ruling.[104]

In order to secure compliance with such remedial orders, the Panel also has at its disposal a battery of more severe regulatory sanctions. These include the threat of 'cold-shouldering' a delinquent party —in effect, excommunication from the London financial markets. This is done by prohibiting persons authorised to conduct investment business in the UK from acting for the party in question in future transactions regulated by the Code.[105] The Panel's rulings are endorsed by the FSA, with the result that authorised persons face withdrawal of their investment licenses if they do business with a 'cold-shouldered' party.[106] This combination of sanctions has generally been sufficient to ensure not only that professionals who are members of the City's investment community comply with the Panel, but also any firm with a London listing or any overseas investor who wishes to do business in London again in the future.[107] Since 2006, the Panel has also had the ability to seek a court order to enforce its rulings, a power which it has not yet exercised to date.[108]

Figure 4 shows two measures of enforcement activity by the Panel: (i) the number of meetings held by the Panel annually to consider either Appeals against its decisions, disciplinary matters raised on its own initiative, or matters referred to it for

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[104] See Takeover Panel, *Annual Report 1988-89* (London: Takeover Panel, 1989), 8. The breaches concerned failure to disclose purchases of shares in Distillers by a party acting in concert with Guinness.

[105] For example, the Panel's statement in relation two Scottish financiers involved in numerous Code breaches in relation to an attempted takeover of Dundee Football Club plc in 1991, read as follows In the Panel's view neither Mr Drummond nor Mr Prentice nor any company which is in practice, directly or indirectly, controlled by either or both of them is likely to comply with the standards of conduct for the time being expected in the United Kingdom concerning the practices of those involved in takeovers and mergers. Therefore … persons or firms authorised to conduct investment business are prohibited from acting for Mr Drummond or Mr Prentice or companies which are … controlled by either or both of them in connection with transactions regulated by the City Code …': Takeover Panel, 'Mr Andrew P Drummond and Mr Robert D Prentice: Re Dundee Football Club plc', Panel Statement 1992/9, 15.

[106] See FSA Handbook, MAR 4.3.

[107] To be sure, a calculating 'one shot' player, who determines that they will cynically breach the Code and has no interest in returning to the stock market, will not be deterred by such threats. However, most bidders in control transactions are repeat players.

[108] CA 2006 s 955.

decision by the Executive ('enforcement' meetings); and (ii) the number of firms or individuals receiving public censure from the Panel.

4. The Department for Business Enterprise and Regulatory Reform ('BERR')

The fourth body responsible for public enforcement in relation to UK companies is the Department for Business Enterprise and Regulatory Reform, known until 2007 as the Department of Trade and Industry ('DTI').[109] BERR is a department of the civil service, and has a wide range of enforcement powers, including the ability to launch investigations and inspections, to bring criminal prosecutions, and to disqualify delinquent directors. Its enforcement capabilities are handled by its Companies Investigation Branch, which since April 2006 has been part of the Insolvency Service, an executive sub-agency of BERR.[110]

BERR's enforcement activity differs from those of the other three agencies considered so far in two important respects. First, it is on the whole much more formal in character: all of the enforcement activity has a statutory basis, and almost all of it is publicly announced and subject to legal process. Secondly, almost all of BERR's enforcement takes place in relation to unlisted and private companies. Insofar as the enforcement of constraints on managers of listed companies is concerned, BERR is a minor player. We now consider the exercise of its various enforcement powers.

(i) Investigations and inspections

BERR has powers under the companies legislation to order administrative investigations of any company.[111] Such investigations typically follow a complaint

[109] Prior to 1970, the DTI was known as the Board of Trade.

[110] See DTI, *Companies in 2005/6* (London: TSO, 2006), 7.

[111] Companies Act 1985 s 447. These powers were extended in 2004 to permit the inspectors to require the disclosure of information as well as documents: see generally, DTI, *Companies (Audit, Investigations and Community Enterprise) Act 2004: A Guide to the New Investigations Provisions Introduced by the Act* (London: DTI, 2005); S Sheikh, 'Company Investigations: Powers for the 21st Century' (2002) 13 ICCLR 228. Part XIV of the 1985 Act has not been repealed by the CA 2006.

from a member of the public, and will be launched where there are reasonable grounds to suspect fraud, serious misconduct, or a material accounting irregularity.[112] If appropriate, BERR may follow up by initiating a prosecution of the directors and/or exercising its power to petition the court for the winding-up of the company in the public interest.

Table 7: Company investigations, 1996-2006

Year	Requests	Investigations
1996-7	3294	220
1997-8	3673	238
1998-9	3659	220
1999-0	3632	209
2000-1	4010	175
2001-2	4433	160
2002-3	5256	419
2003-4	4732	200
2004-5	4272	171
2005-6	3702	148
Mean	4066	216

Source: DTI, *Companies in 2000-2006*

At first blush, the raw numbers of investigations reported in Table 7 seem relatively high. However, it should be borne in mind that these investigations are restricted to private companies. In the case of a listed company, the FSA investigates allegations of fraud in relation to investors, and the FRRP would deal with accounting irregularities. Given the size of the population of UK private companies, the 'investigation rate' is actually relatively low.

BERR also retains—at least in theory—a statutory power to order a more extensive form of enquiry, known as an 'inspection'.[113] In contrast to investigations, which are conducted in private, such an inspection involves a very public appointment of accountants and lawyers to conduct a detailed inquiry into the goings-on at a particular company and eventually publish a detailed report of findings. However, the

[112] The largest category of referrals comes from the general public (60-80%) and the most frequent reason for referral is an allegation of fraud: see, e.g., DTI, *Companies in 2004/5* (London: DTI, 2005), 9-10.

[113] Companies Act 1985 s 432.

cost and time associated with such an inspection, coupled with the availability of alternative enforcement mechanisms via the FSA, FRRP, and BERR's investigation powers mean that company inspections are now practically a dead letter.[114] The last time a new inspection was initiated was in 2000.[115]

(ii) Criminal sanctions and public interest winding-up

There are potential criminal liabilities associated with breaches of many aspects of the Companies Legislation. BERR initiates prosecutions by two primary routes. The first is where an investigation has taken place and evidence of criminal (in)activity is uncovered. The second is following a compulsory liquidation. Insolvency practitioners are required to investigate the reasons for the demise of companies they work on, and to submit their findings to the BERR, who can then decide whether or not to take the matter further.[116] BERR also has a statutory power to petition for the compulsory winding-up of a company in the public interest.[117]

The most frequent prosecutions against individuals associated with companies relate to the following categories of offences:[118] (i) failure to comply with Companies Acts requirements concerning accounting records;[119] (ii) fraudulent trading;[120] (iii) fraud or non-cooperation in the conduct of insolvency proceedings;[121] and (iv) being concerned in the management of a company whilst subject to a disqualification order or an undischarged bankrupt.[122] Summary statistics are shown in Table 8 (categories

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[114] See, e.g., Companies House, 'Tackling Corporate Abuse: Companies Investigation Branch (CIB) at Work', *Register* No 67, February 2007, 12-13.

[115] See, e.g., DTI, *Companies in 2003/4* (London: DTI, 2004), 17 (Table 2). Recently published reports include those on Queens' Moat Houses plc (530pp.), Mirror Group Newspapers plc (762pp.) and Transtec plc (452pp.). http://www.insolvency.gov.uk/cib/inspectorsreports.htm.

[116] Insolvency Act 1986 s 218(3); see also ss 132-33.

[117] Insolvency Act 1986 s 124A. See generally V Finch, 'Public Interest Liquidation: PIL or Placebo?' (2002) 5 Insolv L 157.

[118] More frequent still are prosecutions of companies for regulatory offences such as late filing of accounts.

[119] CA 2006 s 387.

[120] CA 2006 s 993.

[121] Insolvency Act 1986 ss 206-11.

[122] Company Directors Disqualification Act 1986 ss 11, 13.

(i) and (ii) are grouped as "accounting offences/fraud" and (iii) and (iv) as "insolvency offences/trading when disqualified"). As with investigations, these data relate solely to private or unlisted companies, because equivalent enforcement in relation to listed companies is undertaken by the FSA and/or the FRRP.

Table 8: DTI-initiated criminal prosecutions against company directors and public interest winding-ups, 2000-2006[123]

Year	Accounting Offences/Fraud		Insolvency Offences/ Trading when Disqualified		Public interest winding-ups
	Prosecutions	Convictions	Prosecutions	Convictions	
2005-6	159	66	228	133	46
2004-5	141	57	233	124	71
2003-4	156	60	205	134	80
2002-3	182	74	311	192	371
2001-2	212	84	350	231	107
2000-1	170	81	248	183	121
Mean	170	70	263	166	133

Source: DTI, *Companies in 2000-2006*

A range of other proscribed matters also—at least in theory—attract criminal sanctions, in particular breaches of a number of directors' statutory duties.[124] However, prosecutions are in practice never brought for these offences.[125] Whilst an empirical study commissioned by the Law Commission in 1998-99 reported that legal advisors considered the existence of criminal sanctions to assist in 'focusing minds' of directors,[126] it is perhaps telling that fewer than 50% of directors surveyed reported that their firms disclosed directors' service contract to shareholders for inspection, seemingly unaware of the fact that it was a criminal offence not to do so.[127]

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[123] For statistics relating to the enforcement of insider dealing, see *infra*, text to notes 77-82.

[124] See, e.g., CA 2006, ss 183 (failure to disclose interest in self-dealing transaction); 228, 237 (failure to keep copies of directors' service contracts or indemnity arrangements available for inspection); 248 (failure to keep minutes of directors' meetings); 291-93 (failure to circulate resolutions).

[125] Law Commission, *Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties*, LCCP 153 (London: TSO, 1998), 223 (noting that during period 1991-96, DTI records show only one prosecution for criminal offences resulting from breaches of directors' duties).

[126] S Deakin and A Hughes, *Directors' Duties: Empirical Findings. Report to the Law Commissions* (1999), section 5.3.5, available at http://www.lawcom.gov.uk/docs/153study.pdf

[127] *Ibid*, section 6.1; Companies Act 1985 s 318 (now s 228 of the 2006 Act).

(iii) Disqualification of directors

Empirically the most significant form of enforcement by BERR is disqualification of directors. This mechanism results in individuals being banned—disqualified—from either being a director, or being 'concerned in the management', of companies for a period of 1 to 15 years.[128] Disqualification follows automatically if an individual is convicted of certain offences in relation to the running of a company. The court also has power to disqualify a director of an insolvent company if satisfied he or she is 'unfit to be concerned in the management of a company'.[129]

Table 9: Directors' disqualification, 1996-2006

Year	Total disqualified	Undertakings given
1996-97	1219	n/a
1997-98	1460	n/a
1998-99	1484	n/a
1999-00	1744	n/a
2000-01	1770	n/a
2001-02	1929	1213
2002-03	1777	1275
2003-04	1527	1154
2004-05	1317	967
2005-06	1197	900
Mean	1542	1102

Source: DTI, *Companies in 2000-2006*

Since 2001, it has been possible for BERR to follow an expedited procedure for disqualification.[130] Under this route, the director gives an undertaking not to participate in the management of a company for a specified period of time, and the court proceedings are dropped. In effect, it is a form of plea-bargaining, whereby the

[128] See generally, A Walters and M Davis-White, *Directors' Disqualification and Bankruptcy Restrictions* (London: Sweet & Maxwell, 2005).

[129] Company Directors Disqualification Act 1986, s 6. This latter power accounts for 80-90% of disqualifications (*Companies in 2005/6*, *supra* n 110, 23 (Table D1)).

[130] Company Directors Disqualification Act 1986 s 1A (inserted by Insolvency Act 2000).

director avoids the prospect of an adverse costs award. As Table 9 indicates, this route now accounts for just under half of all disqualifications.

Unlike the investigation and prosecution powers, disqualification proceedings can in principle be pursued against (former) directors of listed companies.[131] Yet because most disqualification orders follow a corporate insolvency, and listed company insolvencies are very rare, there are very few disqualifications of listed company directors.[132] Thus, Armour et al report that only one claim per year for disqualification of a director of a listed company was filed during the period 2004-6, based on an examination of all claims filed in the Companies Court.[133] BERR is not, therefore, an empirically significant enforcement actor in relation to directors of listed companies.

4. Summary

Part IV, when viewed alongside Part III, implies that public enforcement is much more empirically significant than is formal private enforcement. The number of instances of formal private enforcement, as far as we are able to estimate, is practically zero in relation to listed companies. If the focus shifts to public enforcement, then a different, and much more lively, picture emerges.

Table 10 gives an approximation of the relative empirical incidence of the various modalities of enforcement so far considered.[134] We distinguish between formal and informal public enforcement: informal public enforcement consists of an investigation or guidance that results in no more than a private conversation between the regulator and the firm(s) in question. Formal enforcement, on the other hand, results in a public notice, award of compensation, or other remedial order. As can be seen, informal enforcement vastly outnumbers formal enforcement. By dividing the

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[131] For example, several former directors of Barings plc were disqualified in 1998 for having failed to implement a system of control adequate to restrain the activities of Nick Leeson, whose ‘rogue trades’ brought down the bank: see *Re Barings plc (No 5)* [1999] 1 BCLC 433; [2000] 1 BCLC 523.

[132] See M Carapeto and L Stuflesser, ‘The Information Content of Administration and Administrative Receivership Filings in the UK’, working paper, Cass Business School (2006), 20 (approx 10 UK-listed firms entering receivership or administration each year during period 1996-2003).

[133] Armour et al, *supra* n 9, 24.

[134] These figures may over-estimate the contribution of the FRRP, some of whose investigations concern unlisted firms, and under-estimate the contribution of the FSA in relation to the Listing Rules, where the relevant population of firms does not include AIM-listed companies.

Table 10: Public enforcement activity in relation to listed firms, 2002-2007

Year	Listed firms #	Private enforc -ement	Public enforcement											
			Informal						Formal					
			FSA		FRRP		Panel		FSA		FRRP		Panel	
			#	rate	#	Rate	#	Rate	#	Rate	#	Rate	#	Rate
2002-3	2,251	0	27	1.2%	57	2.5%	290	12.9%	3	0.1%	15	0.7%	3	0.1%
2003-4	2,550	1	32	1.3%	51	2.0%	319	12.5%	9	0.4%	36	1.4%	2	0.1%
2004-5	2,537	0	24	0.9%	226	8.9%	240	9.5%	14	0.6%	77	3.0%	4	0.2%
2005-6	2,606	0	28	1.1%	284	10.9%	317	12.2%	6	0.2%	64	2.5%	0	0.0%
2006-7	2,613	0	25	1.0%	311	11.9%	303	11.6%	7	0.3%	128	4.9%	1	0.0%
Mean	2,511	0.2	27.2	1.1%	185.8	7.4%	293.8	11.7%	7.8	0.3%	64	2.5%	2	0.1%

Notes: ‘Listed firms #’ shows number of UK-registered firms listed on Official List and AIM (from Table 1). ‘Private enforcement’ shows actions brought (i) by minority shareholders to remedy breaches of directors’ duties (from Table 2); (ii) by investors alleging misdisclosure in relation to securities; and (iii) by insolvency practitioners to remedy breaches of directors’ duties. ‘Informal public enforcement’ shows investigations launched by FSA and FRRP and guidance given by Takeover Panel (from Tables 4-6 and Figure 3). ‘Formal public enforcement’ is penalties imposed by the FSA and remedial actions by the FRRP and Takeover Panel, respectively (from Tables 4-6 and Figure 4). In each case, “#” is raw number of engagements; “rate” is percentage of population of listed firms subject to investigation.

number of actions by the population of firms, we derive an approximation of the enforcement rate—that is, the proportion of listed firms subject to a particular type of enforcement in a year. This is only an approximation, because the data may contain an element of double counting: the same firm may be subject to more than one enforcement action during a given year.

The Takeover Panel has the highest informal enforcement rate, approximating to 12% of the population of listed firms in any year. The FRRP also has a relatively high informal enforcement rate, averaging 7.4% over the period, although there was a significant increase with the introduction of pro-active investigation in 2004, to nearly 12%. The FSA, in contrast, has a relatively low rate of informal enforcement, just over 1%. All three agencies have much lower formal enforcement rates; of these, theFRRP has the highest at 2.5%. By combining the average enforcement rates, we can derive an upper bound for the overall level of public enforcement activity: around 20% for informal enforcement and 3% for formal enforcement. Of course, there is likely to be double counting in these figure so the true levels will be somewhat lower. Nevertheless, it seems clear that to focus solely on formal enforcement, and on the FSA, as some commentators have done,[135] is to miss the bulk of the enforcement activity that occurs in the UK.

We now turn to informal private enforcement in the UK.

V. INFORMAL PRIVATE ENFORCEMENT

The structure of English corporate law, as we have seen, has tended to restrict shareholders from pursuing a derivative action if there is no blockholder.[136] Yet at the same time, it gives considerable power to the shareholders in general meeting. In the case of listed companies, this is further enhanced through various provisions of the Listing Rules, the Combined Code of Corporate Governance, and the Takeover Code. Together, these combine to permit shareholders to control many aspects of the managerial agency problem without the need for litigation.

We can identify a variety of ways in which such informal 'enforcement' by investors takes place. One distinction concerns the action taken by the enforcer: whether to 'exit' by selling their shares, or use 'voice' by exercising control rights.

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[135] See Coffee, *supra* n 3, 268-72.

[136] See discussion *supra*, text to notes 29-33.

We can also distinguish enforcement of rules—such as the Combined Code of Corporate Governance, which prescribes corporate governance practices without any associated formal enforcement mechanism—and enforcement simply of standards of good management.

1. Informal private enforcement of corporate governance rules

As is well-known, the Combined Code on Corporate Governance sets out a number of substantive corporate governance requirements that apply to listed companies incorporated in the UK.[137] The Combined Code consists of a framework of over-arching principles, fleshed out by a series of more specific provisions. Key provisions include the separation of the CEO and Chairman of the board, the inclusion of a minimum number of independent non-executive directors, and the establishment of separate nomination, remuneration, and audit committees, which must be populated by a majority of independent directors.[138]

It is also well-known that the Code is not formally 'binding' on listed companies. The Listing Rules give firms the option to 'comply or explain'—that is, if they do not comply, they must give reasons for non-compliance.[139] Whilst it is therefore a breach of the Listing Rules for a firm to fail to state *whether* they comply, or *why* they do not comply, in practice there are no reported instances of the FSA taking action against companies for non-compliance with these requirements.[140] Notwithstanding the FSA's lack of enforcement, a high proportion of firms either comply with the Code's provisions, or explain why they do not.

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[137] See FRC, *The Combined Code on Corporate Governance* (London: FRC, 2006) ('Combined Code 2006'), available at: http://www.frc.org.uk/documents/pagemanager/frc/Combined%20Code%20June%202006.pdf.

[138] See Combined Code 2006, *supra* n 137, A.2-A.4, A.7, B.2, C.3.

[139] The Listing Rules require that listed companies incorporated in the UK state in their Annual Reports (i) how the *principles* of the Code have been applied (LR 9.6.8(5)), and (ii) a statement as to whether the *provisions* of the Code have been complied with or not, and if not, the reasons for non-compliance (LR 9.6.8(6)).

[140] See Weil, Gotshal & Manges, *Comparative Study of Corporate Governance Codes Relevant to the European Union and its Member States: Final Report & Annexes I-III* (Brussels: European Commission, 2002), 71; Financial Services Authority, *Annual Report 2004-5*, 140 (2005); Financial Services Authority, *Annual Report, 2005-6*, 141 (2006) (annual breakdowns of enforcement activity).

Table 11 summarises findings reported in two empirical studies of compliance with the Combined Code. Most companies comply with most of the Code's provisions. Arcot and Bruno report that amongst FTSE350 companies over the period 1998-2004, compliance levels increased over time, with the mean number of provisions with which companies were not in compliance in 1998 being 2.05, falling to 1.57 in 2004.[141] Moreover, the shift towards compliance was most rapid amongst those companies giving no, or poor-quality, explanations for non-compliance.[142] Yet if there is no FSA sanction for failure to state compliance, why has stated compliance increased over time?

Table 11:Compliance with the Combined Code, 1998-2004

Provision	% stating compliant		% non-compliance explained
	PIRC (2004) 2003-4	Arcot & Bruno (2006) 1998-2004	
Separate CEO/Chairman	92	90	86
Proportion/# NEDs	97	95	74
Majority of NEDs independent	94	92	72
Service contracts	n/a	57	86
Nomination committee	85	88	91
Remuneration committee	87	87	69
Audit Committee	88	92	91
Mean	90.5	85.9	81.2
All provisions	47	33	83

Sources: PIRC (2004); Arcot and Bruno (2006).[143]

Whilst a number of studies report no general link between stated compliance with provisions of the Code and operating performance,[144] Arcot and Bruno report

[141] SR Arcot and VG Bruno, 'In Letter but not in Spirit: An Analysis of Corporate Governance in the UK', working paper, London School of Economics (2006), 56 (Table 7).

[142] *Ibid*, 34.

[143] PIRC, *Corporate Governance Annual Review 2004* (London: PIRC, 2004), discussed in I MacNeil and X Li, '"Comply or Explain": Market Discipline and Non-Compliance with the Combined Code' (2006) 14 *Corporate Governance: An International Review* 486, 488-89; SR Arcot and VG Bruno, 'In Letter but not in Spirit: An Analysis of Corporate Governance in the UK', working paper, London School of Economics (2006), 57 (Table 8).

[144] See N Vafeas and E Theodorou, 'The Relationship Between Board Structure and Firm Performance in the UK' (1998) 30 *British Accounting Review* 383, 395-99; C Weir, D Laing, and PJ McKnight,

that non-compliant firms that fail to explain their status tend to *under*perform the sample generally.[145] On the other hand, non-compliant firms that give detailed explanations outperform those that simply comply mechanistically. This implies that shareholder pressure has encouraged managers of previously non-compliant firms to procure their firms to comply.[146] This is, in our terms, an example of informal private enforcement. It also implies that the optimal level of compliance is less than 100%: that is, different substantive corporate governance measures appear to be appropriate for different types of firm.[147]

2. Securing compliance: the exercise of shareholder power

We turn now to a different category of activity that helps to secure compliance by managers with pro-shareholder behaviour: that is, the exercise of governance rights by shareholders. As we have seen, such actions by some accounts should not be classed as 'enforcement' at all: they are, rather, the exercise of shareholders' rights under company law. Whether this is termed 'enforcement' or not is merely a semantic question: what matters for our purposes is that the exercise of such rights, or their threat, may be expected to modify managers' assessment of the likely payoffs from

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'Internal and External Governance Mechanisms: Their Impact on the Performance of Large UK Public Companies' (2002) 29 *Journal of Business Finance and Accounting* 579, 594-603; C Padgett and A Shabbir, 'The UK Code of Corporate Governance: Link Between Compliance and Firm Performance', working paper, University of Reading ICMA Centre Finance Discussion Paper No DP2005-17 (2005), 18-25; SR Arcot and VG Bruno, 'One Size Does Not Fit All, After All: Evidence from Corporate Governance', working paper, London School of Economics (2007), 18 (no link between stated compliance with provisions of Code and operating performance for samples of UK-listed firms, respectively in 1994, 1994-96, 2000-03, and 1998-2004).

[145] Arcot and Bruno, *supra* n 144, 18-20, 24-25. This effect is reported both as regards operating performance and market value. See also Padgett and Shabbir, *supra* n 144, 18-25 (reporting positive correlation between stated compliance and total shareholder returns).

[146] See also Arcot and Bruno, *supra* n 141, 31-34 (discussing anecdotal evidence of shareholder pressure for firms to state compliance).

[147] For example, the model of the independent director may be less helpful for high-growth firms; non-executive directors with a significant interest in the company may be better-motivated to assist executives in strategy and in networking. See MA Lasfer, 'On the Monitoring Role of the Board of Directors: The Case of the Adoption of Cadbury Recommendations in the UK' (2004) 9*Advances in Financial Economics* 287, 310-314 (adoption of Code's board structure recommendations negatively associated with operating performance for firms in high-growth sectors, but positively associated for firms in mature industries with free cash flow, for which monitoring by independent directors may be beneficial).

self-serving behaviour in just the same way as does a potential lawsuit. We now consider several features of the corporate governance environment within which UK listed companies operate that make such 'informal private enforcement' by shareholders a workable substitute for legal action.

(i) Board vulnerability

It is a mandatory rule of UK company law that directors may be removed at any time by an ordinary resolution of the general meeting.[148] This makes 'staggered boards'—that is, a biennial or triennial rotating appointment procedure under which only a part of the board are subject to reappointment each year—ineffective to entrench boards, unlike the position in the US.[149] Moreover, a shareholders' meeting to vote on such a resolution may be requisitioned by 10% of the company's voting shares; being a meeting of the company, this would entail the proposed resolution being circulated at the company's expense.[150] A recent empirical study of shareholder meeting requisitions in the UK found that these tend to focus very closely on applications to remove or elect specific directors, and in a significant number of cases, the entire board.[151]

Non-voting and dual-class shares, another well-known entrenchment mechanism in other jurisdictions, are rarely used in the UK.[152] Whilst not expressly prohibited by the UK Listing Rules, they are strongly discouraged by the investment

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[148] CA 2006 s 168.

[149] In the US, where there is no mandatory provision granting shareholder the right to remove directors, it may take two to three years to wrest control from a staggered board following a takeover: see LA Bebchuk, JC Coates IV, and G Subramanian, 'The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants' (2002) 55 Stan LR 885.

[150] CA 2006 ss 303-305. Moreover, shareholders in holding more than 5% of the voting rights in public companies may require resolutions to be put onto the agenda for the AGM, and circulated to shareholders in advance, also at the company's expense (CA 2006 ss 338-339).

[151] B Buchanan and T Yang, 'A Comparative Analysis of Shareholder Activism in the US and UK: Evidence from Shareholder Proposals', paper prepared for Oxford/Yale conference on UK-US corporate governance (2007), 44-45.

[152] See, e.g., 'Error Deprives Schroders of FTSE 100 Place', *Financial Times*, March 15, 2007 ('Unusually for a UK company, Schroders has voting and non-voting shares.')

community.[153] A recent study by Deminor, a proxy voting consultancy, reported that in 2004, 88% of large listed UK companies conformed strictly to the 'one share, one vote' principle.[154] Although it is possible in theory to nullify the shareholders' power of removal with appropriately-structured differential voting rights,[155] it would in practice be very difficult to market an IPO with such a capital structure, or to change the articles in a listed company so as to introduce one.

(ii) Takeovers

The board's vulnerability to removal by shareholders is coupled with firm restrictions on their range of responses to takeover challenges. The Takeover Code prohibits the managers of a target company, once a bid is launched or anticipated, from taking any actions that might have the consequence of frustrating its success, without first obtaining the consent of shareholders.[156] Figure 5 shows the total number of takeovers and hostile bids reported by the Takeover Panel for each year over the period 1992-2007, [157] plotted against the total population of UK-incorporated listed firms. During this period, an average of 6% of this population per annum was subject to a takeover bid, and 0.8% to a hostile takeover bid.[158] Whilst there has been a secular decline in

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[153] See 'Views on Non-Voting Shares', *The Times*, 23rd Aug 1957, 12; GP Stapledon, *Institutional Shareholders and Corporate Governance* (Oxford: Oxford University Press, 1996), 58–59; J Franks, C Mayer, and S Rossi, 'Spending Less Time with the Family: The Decline of Family Ownership in the UK', in RK Morck (ed), *A History of Corporate Governance Around the World* (Chicago: University of Chicago Press, 2005), 581, 582-83; W Underhill (ed), *Weinberg and Blank on Take-Overs and Mergers* (London: Sweet & Maxwell, 5th ed. 1989 & Supp. 2006), § 4-7077.

[154] Deminor, 'Application of the One Share – One Vote Principle in Europe' (Brussels: Deminor, 2005), 17. Whilst in the region of 5% of UK companies still have some non-voting stock in issue (*ibid.*), the proportion has been declining over time, and those that remain are legacy issues, as opposed to new issues (Franks *et al*., *supra* n 153, 603-4).

[155] As in *Bushell v Faith* [1970] AC 1099.

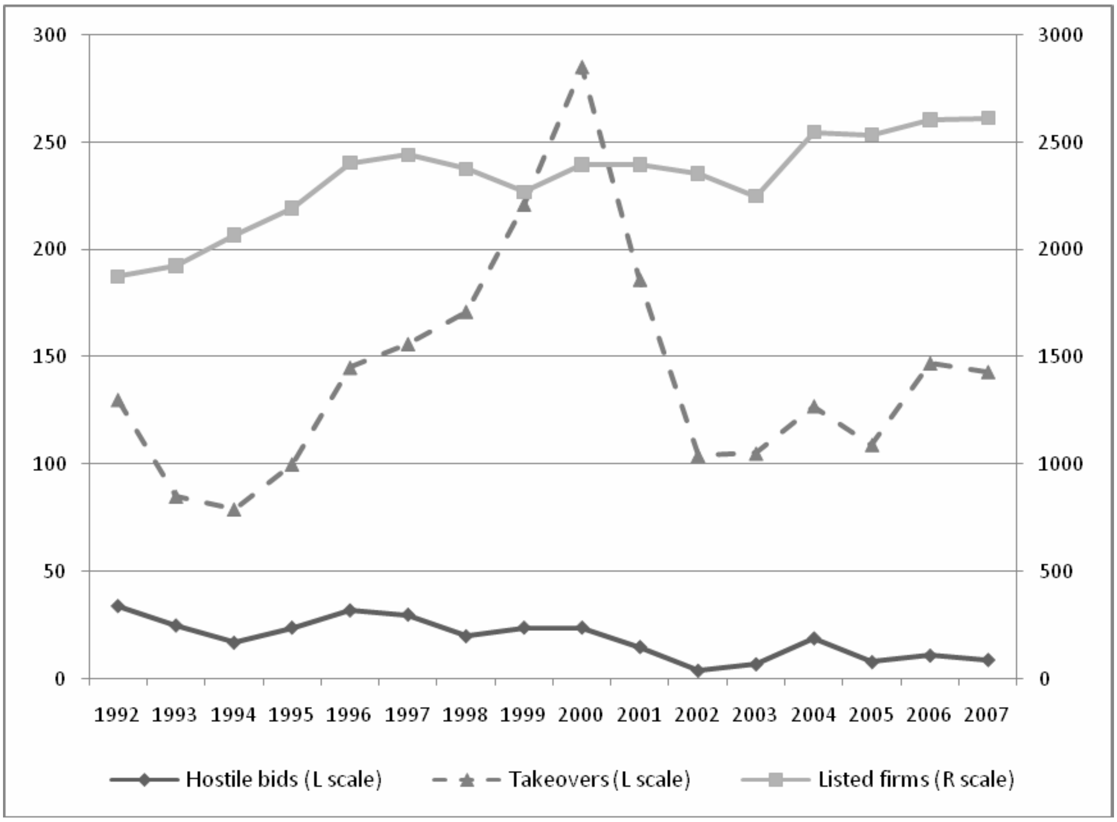
[156] City Code, GP 7 and Rule 21. See also J Armour and DA Skeel, Jr., 'Who Writes the Rules for Hostile Takeovers, and Why? The Peculiar Divergence of US and UK Takeover Regulation' (2007) 95 Geo LJ 1727, 1734-38.

[157] Bids are only counted as 'hostile' if the target management remains opposed until the bid is resolved.

[158] See also R Nuttall, 'An Empirical Analysis of the Effects of the Threat of Takeover on UK Company Performance', working paper, Oxford University (1999), 38 (Table 1) (approximately 1% of sample of firms during 1988-96 subject to hostile bid each year); *cf* Armour and Skeel, *supra* n 156,

the number of hostile bids over this period, there remains a significant probability that any listed firm may be subject to a bid. Moreover, the likelihood of a publicly-traded UK firm being a takeover target, particularly of a hostile bid, appears to increase if its performance worsens.[159]

Figure 5: Takeover bids against UK targets, 1992-2007



Sources: Takeover Panel, *Annual Reports*, 1992-2007; London Stock Exchange.

(iii) Shareholder decision rights

UK company law and the Listing Rules also contain a number of provisions geared towards ensuring shareholder involvement *ex ante* with respect to situations where agency costs are highest. Thus under company law, substantial property transactions

1738 (reporting much lower proportion of takeover bids as hostile, based on transactions reported in *SDC Platinum* database).

[159] J Franks, C Mayer, and L Renneboog, 'Who Disciplines Management in Poorly Performing Companies?' (2001) 10 *Journal of Financial Intermediation* 209, 238. However, target management are very likely to be replaced following a successful takeover, regardless of whether or not it is friendly, and of the firm's performance, suggesting that, as a disciplinary mechanism, the takeover bid is very unfocused: *ibid*, 233-234.

and loans between a company and a director or associated company must first be approved by the shareholders in general meeting.[160] This is supplemented by more extensive continuing obligations for UK listed firms to seek shareholder approval in respect of certain transactions which may affect the value of their investments: namely, related party and significant transactions.[161]

Issues of fresh capital are also subject to shareholder control—first, through making new issues conditional on shareholder approval, and secondly through the use of pre-emption rights for existing shareholders.[162] The latter are supplemented by additional provisions in the Listing Rules for firms on the UK Official List.[163] Pre-emption rights may be waived by shareholder authorisation, requiring an ordinary resolution.[164] The grant of such a waiver is, however, subject to a well-established set of voting guidelines adhered to by institutional investors in the UK.[165]

The exercise of pre-emption rights also appear to perform a significant governance, or informal private enforcement role. This appears to be because the announcement of a 'rights issue' serves to concentrate investors' minds. A discounted rights issue creates a threat of dilution for investors who do not subscribe. On the other hand, for investors who do subscribe, it creates a potentially profitable investment opportunity. Crucial to the determination of how profitable the investment will be are the reasons the company is seeking further finance. Thus the period prior to a rights issue will typically be one in which there will be dialogue between a

[160] CA 2006 ss 190, 197.

[161] LR 10, 11.

[162] CA 2006 ss 549-551, 560-577.

[163] LR 9.3.11-12. Moreover, shares may not be issued at a discount of more than 10% to their current market price unless as a 'rights issue' or specifically approved by shareholders: LR 9.5.10.

[164] CA 2006 ss 570-571, LR 9.3.12(1).

[165] For the latest version, see Pre-Emption Group, *Disapplying Pre-emption Rights: A Statement of Principles* (London: FRC, 2006), available at http://www.pre-emptiongroup.org.uk/documents/pdf/DisapplyingPre-EmptionRightsStatementofPrinciples.pdf.

company and major institutional investors.[166] Seemingly for this reason, rights issues are strongly correlated with managerial turnover.[167]

(iv) Share ownership and voting patterns

Share ownership in the UK is dispersed by international standards.[168] Moreover, the ownership of shares in UK-listed companies is dominated by institutional investors, to a degree that has historically been unique.[169] Institutional investors' voting participation appears to have increased during the 1990s for all types of institution.[170] Some are more activist than others: insurance companies vote more frequently than pension funds, which in turn are more active than investment funds.[171] Voting tends to focus on issues which are generalisable across firms, allowing institutions to economise on their decision-making costs by adopting a standardised policy.[172] Listed firms commonly meet regularly with their major institutional investors, at which sessions executives will be quizzed by the institutions about governance practices, strategy and financial issues.[173] The exercise of 'influence' through such informal communication is usually achieved in the *shadow* of shareholders' ultimate right to requisition a meeting and remove managers.[174] In cases of severe

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[166] Stapledon, *supra* n 153, 129-30; P Myners, *Pre-Emption Rights: A Final Report*, URN 05/679 (2005).

[167] Franks *et al*, *supra* n 159, 234-235; D Hillier, SC Linn and P McColgan, 'Equity Issuance, CEO Turnover and Corporate Governance' (2005) 11 *European Financial Management* 515.

[168] See sources cited *supra*, n 5.

[169] See, e.g., PL Davies, 'Institutional Investors in the United Kingdom' in DD Prentice and PRJ Holland (eds), *Contemporary Issues in Corporate Governance* (Oxford: OUP, 1991), 69.

[170] R Crespi-Cladera and L Renneboog, 'Corporate Monitoring by Shareholder Coalitions in the UK', ECGI Finance Working Paper 12/2003 (2003), 6.

[171] Stapledon, *supra* note 153, 92-98; Crespi-Cladera and Renneboog, *supra* n 170.

[172] See Davies, *supra* n 169; BS Black and JC Coffee, 'Hail Britannia?: Institutional Investor Behavior Under Limited Regulation' (1994) 92 Mich LR 1997, 2034-55; Armour and Skeel, *supra* n 156, 1771.

[173] See, e.g., Stapledon, *supra* n 153, 101-6; J Holland, 'Influence and Intervention by Financial Institutions in their Investee Companies' (1998) 6 *Corporate Governance: An International Review* 249; A Pye, 'Changing Scenes In, From and Outside the Board Room: UK Corporate Governance in Practice from 1989 to 1999' (2000) 8 *Corporate Governance: An International Review* 335.

[174] See *supra*, text to nn 148-155; M Becht, J Franks, C Mayer and S Rossi, 'Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund', ECGI Finance Working Paper 138/2006 (2006).

underperformance—the bottom decile of accounting performance or dividend yield—it appears that institutions will go so far as to provoke CEO turnover.[175]

3. Summary

English company law gives shareholders considerable power in relation to corporate managers. In this section, we have characterised the exercise of this power as a means of 'informal private enforcement', because it is a powerful means by which managerial compliance with pro-shareholder conduct is secured. We have seen that managerial 'discipline' by turnover is associated with financial underperformance, coalition formation between institutional investors, takeover activity, and the issue of seasoned equity.

VI. WHY DOES THE UK'S SYSTEM LOOK THE WAY IT DOES?

We have characterised the UK's approach to the enforcement of constraints on managerial agency costs as one in which informal enforcement is far more important than formal measures; insofar as formal enforcement activity takes place, public authorities do most of the work. The system does not, to any significant extent, rely on formal private enforcement. This raises further a question: how did this system emerge? There is not space to do justice to the problem here; what follows is no more than an impressionistic sketch of key historical antecedents.

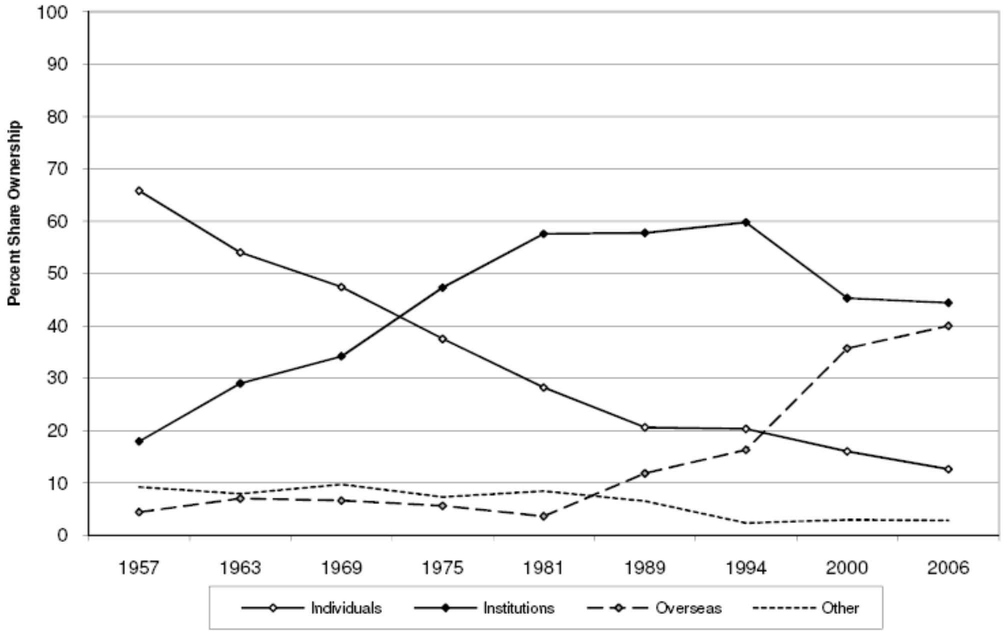
1. The development of informal private enforcement

Institutional investors have been significant actors in the governance of UK listed companies since the 1950s. The proportion of UK stocks owned by pension funds, insurance companies and unit trusts (the British equivalent of mutual funds) rose dramatically from the 1950s through the 1960s and 1970s, as Figure 6 illustrates. The emergence of institutional investors as the most significant class of shareholder in Britain seems to have been an unintended consequence of a combination of fiscal measures designed both to redistribute income and to promote private pension

[175] See Crespi-Cladera and Renneboog, *supra* note 170, 16-17; Franks *et al*, *supra* n 159, 229; MJ Conyon and A Florou, 'Top Executive Dismissal, Ownership and Corporate Performance' (2002) 32 *Accounting and Business Research* 209, 223-24.

schemes.[176] As Figure 6 shows, by the early 1970s, institutional investors were the most largest class of shareholders in UK-listed companies,[177] and the proportion of the shares in listed companies that they owned continued to rise until the early 1990s.

Figure 6: Ownership of listed company shares in the UK, 1957–2006



Sources: Moyle (1971); ONS (2007).[178]

For much of this period, institutional investors have been a catalyst for developments in UK corporate governance; their preferences lay behind many of the informal mechanisms of enforcement we have detailed. Institutions holding a significant proportion of the shares in the UK market have a collective interest in the good governance of the firms in question. Thus they have an incentive to press for

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[176] BR Cheffins and SA Bank, 'Corporate Ownership and Control in the UK: The Tax Dimension' (2007) 70 MLR 778.

[177] See, e.g., 'Equity Investment and its Responsibilities', *Economist*, 4th July 4 1964, 75 ('Collectively these bodies have a power to influence boards of directors that a large number of small investors can never have.')

[178] J Moyle, 'The Pattern of Ordinary Share Ownership: 1957–1970', University of Cambridge Department of Applied Economics Occasional Paper No 31 (1971), 6-7; Office for National Statistics, *Share Ownership: A Report on Ownership of Shares as at 31st December 2006* (ONS, London, 2007), 9.

measures that will facilitate such governance.[179] It is therefore not surprising that the emergence of various mechanisms that assist in controlling managerial agency costs should have coincided with the emergence of institutional investors as a significant force in UK share ownership.

Institutional investors have indeed been the driving force behind many of the rules that permit the kind of informal private enforcement considered in section IV. First, pre-emption rights were introduced to the Stock Exchange's Listing Rules before they were embodied in general company law, apparently following pressure from institutional investors.[180] The institutions subsequently took an active role in regularising expectations over the exercise of these rights, through the publication of the *Pre-Emption Guidelines*.[181]

Secondly, the advent of hostile takeovers in the UK in the early 1950s, and managers' defensive responses, provoked institutional investors to become active in promoting rules to regulate the conduct of bids. Following a particularly ugly take-over battle for British Aluminium Ltd in 1958-9, a group of institutional investors met and issued a public statement that in their view, it was inappropriate for boards to take significant steps (such as issuing stock to a favoured bidder) without shareholder consent. Following this battle, representatives from institutional investors were instrumental in the preparation of the predecessor to the City Code, the *Notes on the Amalgamation of British Businesses* in 1959. The institutions' role—and pro-shareholder stance—was carried over into the setting up, and operation of, the Panel on Take-overs and Mergers in 1968.[182]

Thirdly, institutional investors were responsible for the introduction, in the late 1970s, of provisions in the Listing Rules requiring shareholder approval for

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[179] Whilst 'free-rider' problems exist in fostering collective action, these are likely to be much less significant in relation to mechanisms that ameliorate managerial agency costs generally, as opposed to doing so in relation to specific firms: Black and Coffee, *supra* n 172, 2034-55; Stapledon, *supra* n 153, 56-77; Armour and Skeel, *supra* n 156, 1770-71.

[180] See Stapledon, *supra* n 153, 56; LCB Gower, *Gower's Principles of Modern Company Law*, 4th ed. (Stevens & Sons, London, 1979), 223, 343.

[181] See Stapledon, *supra* n 153, 56; Association of British Insurers, *Pre-Emption Group Guidelines* (London, ABI, 1987); Myners, *supra* n 166; Pre-Emption Group, *supra* n 165.

[182] Armour and Skeel, *supra* n 156, 1756-64, 1772-76.

significant corporate transactions.[183] This followed a fight between institutions and the board of Allied Breweries Ltd, over their proposed takeover of J. Lyons & Co Ltd in 1978.[184] The introduction of the 'Class 1 transaction' rule served to ensure a shareholder veto on transactions of this sort.[185]

Fourthly, the institutions have been active in policing the use of devices capable of entrenching managers. Following the advent of the hostile takeover in the early 1950s, Franks *et al* document a significant increase in the use of non-voting shares—a defensive measure—by UK firms during the 1960s.[186] However, there followed an equally striking decline in the use of such shares during the 1970s. This appears to have followed a vigorous response from institutions, wishing to preserve the operation of the market for corporate control.[187]

Finally, perhaps the best-known of the institutions' influential additions to the UK corporate governance regime, however, has been the Combined Code on corporate governance. This was first appended to the Listing Rules on a 'comply or explain' basis as the 'Cadbury Code' in 1992.[188] However, Sir Adrian Cadbury, whose report had been commissioned following a series of well-publicised scandals in the early 1990s that had shaken investors' faith in the City, had organised its principles largely around the pre-existing guidelines of the Institutional Shareholders' Committee's *Statement on Directors*.[189]

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[183] See 'When Should the Institutions Intervene?', *The Times*, 28th Jan 1981, 19; Stapledon, *supra* n 153, 60.

[184] 'Pension Funds May Force a Vote on Allied's Lyons Bid', *The Times*, 23rd Aug 1978, 17. The National Association of Pension Funds objected strongly to the merger, which they considered did not present a sufficiently good business case and would transform the nature of Allied's operations.

[185] The change was not one that the Stock Exchange made willingly: see 'Rules of Definition Unaltered after Allied Bid', *The Times*, 30th Aug 1978, 15.

[186] Franks *et al*, *supra* n 153, 601-4.

[187] *Ibid.* See also 'City Ethics and the Law', *The Times*, 24th Jun 1981, 19 (noting 'steady thunder of disapproval which emanates from the institutions' regarding non-voting shares); 'Non-voting Shares: Thumbs Down for ACC', *The Times*, 5th Jan 1982, 13 ('The National Association of Pension Funds has conducted a campaign against [non-voting shares] for years').

[188] Committee on Corporate Governance, *Report of the Committee on the Financial Aspects of Corporate Governance* ('Cadbury Report') (London, Gee, 1992).

[189] J Holland, 'Self-Regulation and the Financial Aspects of Corporate Governance' [1996] JBL 127, 131-32; Stapledon, *supra* n 153, 67-69.

The institutions' activism in favour of rules conferring power on shareholders to engage in what we have termed informal private enforcement makes sense given their relative sophistication and status as repeat players in the market. These characteristics make them relatively well-placed—as compared, for example, to 'retail' investors in the US—to monitor corporate performance and engage in action designed to correct managerial failings. However, because of economies of scale and free-rider problems, there is a tendency for institutions to adopt a universal, rather than a firm-specific, policy. This is evident, for example, in the suggestion that investors take into account stated compliance (which may be assessed on a 'tick-box' basis) with the Combined Code, but fail to pay sufficient attention to the (firm-specific) reasons given for non-compliance;[190] and in the finding that intervention by shareholders to replace underperforming managers only occurs *in extremis*.[191] In contrast, a standardised approach seems to operate more effectively in relation to seasoned equity issues and hostile takeovers.

2. The lack of formal private enforcement

The restrictions on derivative actions date from the very beginning of English company law.[192] Two principal policy rationales for these were articulated in the contemporary case law. First, resolving disputes in the courts, as opposed to the general meeting, would lead to a proliferation of litigation expenditure.[193] Secondly, the resolution of most disputes involved issues that were at root business decisions, and the proprietors of the business were usually more competent to address these than the courts.[194] These rationales seem plausible enough when set against the backdrop

[190] See Arcot and Bruno, *supra* n 144, 24-25.

[191] See *supra*, n 175 and text thereto.

[192] *Foss v Harbottle* (1843) 2 Hare 461, 67 ER 189. The rule in turn drew upon earlier caselaw relating to joint stock partnerships: see generally KW Wedderburn, 'Shareholders' Rights and the Rule in *Foss* v. *Harbottle*' (Part 1) [1957] CLJ 194; (Part 2) [1958] CLJ 93; Law Commission, *supra* n 56, 27-53.

[193] Unless such a restriction were adopted, 'as many different bills might be filed as there were shareholders in a company, all praying different things': *Mozley v Alston* (1847) 1 Ph 790, 799; 41 ER 833, 837, *per* Lord Cottenham.

[194] As Lord Eldon, denying on similar grounds an earlier suit by an individual partner in a large joint stock partnership, put it: '[t]his Court is not to be required on every Occasion to take the Management of every Playhouse and Brewhouse in the Kingdom': *Carlen v Drury* (1812) 1 Ves & Bea 154, 157; 35 ER 61, 62.

of nineteenth century English courts and corporations. Contemporary civil procedure rules were extremely complex, and litigation was tortuously slow. Moreover, most companies at the time had closely-held share ownership,[195] meaning that the general meeting would be relatively effective at taking action to remedy mismanagement. The only circumstance in which it would be ineffective if the controlling shareholder was themselves the miscreant: in which case, the 'fraud on the minority' exception would permit the minority shareholder to bring a derivative suit.[196]

Thus stated, the traditional rule relating to derivative actions seems reasonably well-adapted to a concentrated ownership structure. This was indeed the dominant ownership pattern in English companies, both listed and unlisted, in the late nineteenth and early twentieth centuries.[197] However, although share ownership of UK listed companies subsequently became more widely dispersed,[198] the law relating to derivative actions did not evolve. In the US, the law relating to derivative actions—which had originally been similarly restrictive as that in England—evolved as share ownership became more dispersed, such that it is no longer necessary for a minority shareholder in a publicly-traded firm to show that the wrongdoers control the company's general meeting. Instead it suffices to show that they control the board.[199] Why has no similar evolution occurred in the UK?

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[195] See JB Jefferys, Business Organisation in Great Britain, 1856-1914, Doctoral dissertation, University of London (1938), 383-93; BR Cheffins, 'Law, the Market, and Corporate Enterprise: The Case of the Industrial Revolution', in this volume,__, [9-11]. See also J Franks, C Mayer and S Rossi, 'Ownership: Evolution and Regulation', ECGI Finance Working Paper 9/2003 (2006), 46-47 (Tables 3 and 4) (ownership of sample of listed firms highly concentrated in 1900).

[196] *Atwool v Merryweather* (1867) LR 5 Eq 464. See also cases cited *supra*, nn 30-33.

[197] Exceptions to this pattern, in which share ownership had become more widely dispersed in the second half of the nineteenth century, existed amongst railway companies, public utilities, some shipping companies, and banks: see Jeffreys, *supra* n 195, 408-9; L Hannah, 'The "Divorce" of Ownership and Control from 1900 Onwards: Re-calibrating Imagined Global Trends' (2007) 49 *Business History* 404, 407-14.

[198] This appears to have begun for some firms during the interwar period, as controlling shareholders were diluted by issues of fresh equity to finance merger activity (see L Hannah, *The Rise of the Corporate Economy*, 2nd ed. (Methuen & Co, London, 1983), 90-100; Franks *et al.*, *supra* n 195, 19-27). After World War II, the transition became more general as high rates of taxation on individuals' investment income encouraged family blockholders to sell out: BR Cheffins and SA Bank, 'Corporate Ownership and Control in the UK: The Tax Dimension' (2007) 70 MLR 778.

[199] See, e.g., RC Clark, *Corporate Law* (Boston, Little, Brown & Co, 1986), 640-50.

One undoubtedly relevant factor is that the UK's civil procedure rules regarding litigation funding and costs tend to work against potential plaintiffs in derivative actions: contingency fees are not permitted, and the 'loser pays' costs rule means that an unsuccessful party faces a hefty payout if he is unable to persuade the court to grant an indemnity from the company.[200] Yet this seems unlikely to be the whole story. Institutional investors are, as we have seen, repeat players in the UK corporate governance milieu, who stand to benefit from rules that tend to reduce managerial agency costs. Such investors might be able to take into account not just the immediately expected costs and benefits of a particular action, but also the expected future benefits of establishing a more favourable precedent.

It seems that this did not happen because institutional investors found it easier to co-ordinate to change measures comprised in the Listing Rules, and to introduce 'soft law' measures such as the Takeover Code and the Combined Code, than to seek to use test cases to change the common law rules about derivative actions. Judges can only decide cases that come before them, and so a party seeking to bring a test case must wait until a suitable set of facts present themselves. More fundamentally, standing rules make it difficult for a group of interested parties—such as institutional investors in the UK—to challenge common law rules. This is illustrated by the one well-documented case where an institutional investor did try to bring a test case, *Prudential Assurance Co Ltd v Newman Industries Ltd (No.2)*.[201]

Prudential, one of the UK's largest fund managers, launched a derivative action against the board of Newman Industries Ltd alleging a fraudulent conspiracy to use Newman's assets to support another company, TPG Ltd, which the directors controlled. The defendant directors did not, however, have a controlling stake in Newman. At first instance, Vinelott J was nevertheless prepared to permit a derivative action, in a judgment which seemed to open the way to use of litigation as a tool shareholder activism.[202]

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[200] See Reisberg, *supra* n 34, 222-43; Armour *et al*, *supra* n 9, 31-37.

[201] [1981] Ch 257 (Vinelott J); [1982] 1 Ch 204 (CA).

[202] See Editorial, 'Questions of Company Law', *The Times*, 20th Feb 1980, 21 (decision '...opens up a new area of activity to disaffected shareholders...'); R Pullen, 'When Should Institutions Intervene?', *The Times*, 28th Jan 1981, 19 ('...an important victory in standing up for the rights of small and large shareholders'). Prudential themselves boasted of their success in promoting shareholder rights in the case: see 'A Significant Presence in World Insurance', Advertisement in *The Times*, 29th Apr 1980, 20

However, the Court of Appeal found that most of the allegations against the defendants were ungrounded, and that Newman had suffered a loss of only £45,000 as a result of their actions.[203] In contrast, the total costs of the litigation were said to be in excess of £750,000.[204] To the extent that the defendants had insufficient assets to cover these costs, Newman would have to indemnify Prudential. These figures did not include indirect costs incurred by Newman through diversion of management time.[205] From the point of view of Prudential, who held only 3 per cent of the shares in Newman, the action would presumably still have been justifiable, as an investment in a test case to make the derivative action a more effective tool. The Court of Appeal, however, were concerned not with the wider implications, but with the impact on Newman and its other shareholders, who had been forced to bear a considerable net cost. Clearly concerned to prevent this from happening again, their Lordships—in a joint judgment—roundly criticised Vinelott J for having permitted the case to proceed, and doubted his proposed relaxation of the 'wrongdoer control' requirement.[206] They then remarked:[207]

> 'We were invited to give judicial approval to the public spirit of the plaintiffs who, it was said, are pioneering a method of controlling companies in the public interest without involving regulation by a statutory body. In our view the voluntary regulation of companies is a matter for the City. The compulsory regulation of companies is a matter for Parliament.'

Following this debacle, UK institutional investors evidently took the view that further attempts to pursue shareholder litigation were not worthwhile. Instead, they continued to channel their energies into the informal enforcement mechanisms we have considered.

('...[T]he case has shown that legal action may be more effective than an inquiry by the Department of Trade Inspectors...')

203 [1982] 1 Ch 204, 234.

204 *Ibid*, 225. The Court hinted that they might even be in excess of £1m: *ibid*, 236.

205 See 'Newman Counts Cost', *The Times*, 19th June 1980, 30.

206 [1982] 1 Ch 1982, 221-2.

207 *Ibid*, 224.

The mismatch between the standing requirements for derivative actions and ownership structure in listed companies has finally been addressed by the Companies Act 2006.[208] This has abolished the rule that the applicant must demonstrate that the alleged wrongdoers control the company.[209] The court is now charged with deciding whether or not an application to bring a derivative claim should be permitted to proceed, and in so doing is required to focus in particular on whether the pursuit of the action is in the interests of the company and the wishes of independent shareholders.[210] Whilst the new rules are better aligned with the ownership structure of listed companies, it seems unlikely that these reforms will lead to a dramatic increase in the incidence of shareholder litigation.[211] Much will turn on the willingness of the courts to permit such actions to proceed. The disincentives to shareholders created by funding and costs rules still remain.[212] Whilst it seems likely that the use of the derivative action will increase,[213] it also seems likely that the aggregate numbers will not be large.

3. The informal character of public enforcement

A third distinguishing feature of enforcement in UK corporate governance is the informality of approach favoured by public bodies. This too has its origins in history.

Since the earliest days of English company law, there has been some blurring of boundaries between public and private enforcement mechanisms. The Companies Act 1862 introduced a provision permitting the Board of Trade to appoint inspectors with plenary powers to investigate the company's affairs.[214] However, such investigations could only be initiated on the application of shareholders with at least 20 per cent of

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[208] CA 2006 Part 11 (in force from 1 October 2007).

[209] This was identified as a specific weakness in the previous law by the Law Commission: *supra* n 56, 139.

[210] CA 2006 s 263. See also Reisberg, *supra* n 34, 148-58.

[211] Indeed, the Law Commission, upon whose recommendations the new statutory framework was based, specifically stated that their recommendations were not intended to lead to a large increase in shareholder litigation: see Law Commission, *Shareholder Remedies*, LC 246 (London: TSO, 1997), 77

[212] See sources cited *supra*, nn 34-36, and text thereto.

[213] See, e.g., C Barrett, 'Small Shareholders of the UK, Unite', *Investors Chronicle*, 2nd April 2008 (available at http://www.investorschronicle.co.uk/).

[214] Companies Act 1862 ss 56-58.

the company's voting rights.[215] More significantly, the applicant shareholders were required to provide security for the costs of the inspectors.[216] As a result, this mechanism would only have been worth pursuing in the most serious of cases. Whilst *The Times* reported in 1911 that in only two instances since the power's introduction had inspectors been appointed in respect of a solvent company.[217]

After World War II, the Cohen Committee sought to increase the use of the Board's investigatory powers as a means of protecting shareholders.[218] Rather than reduce the voting threshold, this was done by giving the Board power to commence an inspection unilaterally, if they considered that the company's affairs were being carried on fraudulently or in a manner oppressive to any part of its members.[219] This gave the inspection more clearly a character of public enforcement. For a while, it may have seemed that this would become a significant enforcement mechanism, with several high-profile instances in the 1950s where inspectors were appointed.[220] However, the Board of Trade took a conservative approach to the exercise of their powers, motivated by the concern that the appointment of inspectors sent an adverse signal about a company to the market, even if no evidence of wrongdoing emerged.[221]

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[215] The threshold was reduced to 10 per cent in 1907 (Companies Act 1907 s 44), where it has since remained: see now Companies Act 1985 s 431.

[216] See Company Law Amendment Committee 1925-26 (Greene Committee), *Report on Companies Acts 1908 to 1917* (HMSO, London, 1926), paras 58-60.

[217] 'Company Law Defects: Lessons from the Measures Case', *The Times*, 7th Nov 1911, 21. It nevertheless appears that the threat to petition for the appointment of inspectors was used as bargaining leverage in some cases. See *ibid*, and 'City Intelligence', *The Times*, 15th Oct 1908, 16 ('A circular has been issued by a "Vigilance Committee" appealing for proxies and support, and stating that in case the response to this appeal for proxies proves insufficient to enable them to force a reconstruction of its directorate, the committee will endeavour to obtain a Board of Trade enquiry into the management of the [Corporation of Western Egypt Ltd].')

[218] Committee on Company Law Amendment 1945 (Cohen Committee), Report *of the Committee on Company Law Amendment*, Cmd 6659 (London, HMSO, 1945), paras 154-160.

[219] Companies Act 1948 s 165(b). The costs of the inspection would be borne by the company.

[220] These included the notorious Savoy Hotel takeover battle in 1953, where an inquiry was launched as a response to a dubious defensive strategy by the target board (see Armour and Skeel, *supra* n 156, 1757-58), and the Gordon Hotel case in 1957, where the board Chairman took it upon himself to 'disallow' proxies at the annual meeting: see 'Uproar at Gordon Hotels Meeting', *The Times*, 28th March 1957, 6.

[221] Company Law Committee, *Report of the Company Law Committee* (the 'Jenkins Report'), Cmnd 1749 (London: HMSO, 1962), paras 213-218.

As a result, an average of only 3-4 investigations were ordered each year during the period 1950-66, over the entire population of companies.[222] A power to conduct secret investigations was introduced in 1967,[223] but paradoxically the lack of publicity made this a less potent threat in the hands of minority stockholders. As a result, its use has gravitated towards issues of suspected fraud in smaller companies.[224] In any event, by 1967, the locus of enforcement in relation to listed companies was moving towards the now-powerful institutional investors.

Institutional investors traditionally favoured informal private enforcement. Until the 1980s, this private character extended not only to the mechanisms which operated to constrain managers—pre-emption rights; hostile takeovers and the like—but also to the institutions by which many of them were supported. Thus the London Stock Exchange and the Panel on Takeovers and Mergers were both entirely private, and self-regulatory, organisations.[225] The Bank of England acted to co-ordinate activity as between interested parties, and 'seed' understandings about good practice, but did not exercise any formal regulatory power over institutional investors.[226] It was instrumental in setting up the Takeover Panel,[227] and then in cajoling institutional investors to become more concerned with the governance of listed companies, through the formation of the Institutional Shareholders' Committee in 1973 and other initiatives.[228] Until the 1980s, the enforcement powers of the Stock Exchange, the Takeover Panel and other self-regulatory organisations consisted solely of reputational mechanisms—withdrawal of membership of professional organisations, de-listing, cold-shouldering, and the like.

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[222] RD Fraser, 'Administrative Powers of Investigation into Companies' (1971) 34 MLR 260.

[223] Companies Act 1967.

[224] See *supra*, nn 111-115, and text thereto.

[225] See R Michie, *The London Stock Exchange: A History* (OUP, Oxford, 1999), 567-69.

[226] See generally, A Cairncross, 'The Bank of England and the British Economy' in R Roberts and D Kynaston (eds), *The Bank of England : Money, Power and Influence 1694-1994* (Clarendon Press, Oxford, 1995), 56; C Hadjiemmanuil, *Banking Regulation and the Bank of England* (London, LLP, 1996), 308-21; J Armour and S Deakin, 'Norms in Private Insolvency: The "London Approach" to the Resolution of Financial Distress' (2001) 1 JCLS 21, 47-48.

[227] Armour and Skeel, *supra* n 156, 1758-59.

[228] See 'Bank Hails BIA Decision to Join City Investors' "Ginger Group"', *The Times*, 17th April 1973, 19; 'An Initiative from the Institutions', *The Times*, 20th Feb 1978, 19; Pullen, *supra* n 202.

Since the mid-1980s, most of these self-regulatory bodies have evolved into agencies that have a more clearly-defined public character. The first stage might be described as a formal sharing of regulatory authority between industry associations and the state. Under the Financial Services Act 1986, the Listing Rules of the London Stock Exchange were given the status of delegated legislation, and several sector-specific authorities were inaugurated, with personnel selected in part by the state.[229] Similarly, the Financial Reporting Council ('FRC'), another quasi-public regulator, was established in 1988 to oversee accounting standards, at the initiative of the accountancy profession.[230] In 1991, it was given statutory authority—through a subsidiary agency, the FRRP—to review financial statements of public companies. The FRC also became the organisation responsible for updating the Combined Code on Corporate Governance. Finally, even the Takeover Panel, arguably the most successful of the self-regulatory agencies, was put onto a statutory footing in 2006.[231] The process went further, as regards financial regulation, when the FSA, a purely public body, replaced the sector-specific financial regulators in 2001.[232] Amongst other things, it took over the writing and enforcement of the Listing Rules.

Despite this move towards formal/public enforcement, the *modus operandi* of most of these agencies remains highly informal. The Takeover Panel, clearly, still operates on a largely informal basis. So too does the FRRP, which clearly regards the fact that it has never had to exercise its powers to obtain judicial enforcement as a virtue. Even the FSA, which has imposed significant financial penalties on some firms, prefers where possible to maintain an informal approach, exhibiting commonalities with its self-regulatory predecessors.

This shift towards public enforcement has co-incided with a decline in the proportion of shares in UK listed companies held by domestic institutional investors,

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[229] See generally, BR Cheffins, *Company Law: Theory, Structure, and Operation* (Oxford: OUP, 1997), 365-78.

[230] J Freedman, 'Accountants and Corporate Governance: Filling a Legal Vacuum?' (1993) 64 *Political Quarterly* 285, 293.

[231] Companies Act 2006 Part 28.

[232] See FSA, *Financial Services Authority: An Outline* (London: FSA, 1997), 4-10; E Lomnicka, 'Reforming UK Financial Services Regulation: The Creation of a Single Regulator' [1999] JBL 480; E Ferran, 'Examining the United Kingdom's Experience in Adopting the Single Financial Regulator Model' (2003) 28 *Brooklyn Journal of International Law* 257.

and a rise in holdings by overseas investors.[233] In the face of this increasing heterogeneity amongst investors, reputational sanctions alone became less effective as the expected likelihood of repeated interactions reduces. The availability of formal legal sanctions can help to ensure that regulators retain a credible threat. In the future, therefore, we might expect the relative use of formal sanctions to increase.

VII. CONCLUSION

We have sought to present an empirical assessment of the relative significance of different modes of enforcement in UK corporate governance. Three stylised facts emerge about the UK's approach to enforcement of constraints on managerial agency costs. First, formal private enforcement, in the form of shareholder litigation, is conspicuous by its absence. Contrary to some accounts in the economic literature, private litigation appears to play almost no role in controlling managerial agency costs in UK-listed firms.

Secondly, rather more work is done by public enforcement agencies—in particular, the FSA, FRRP, and the Takeover Panel—than is commonly thought to be the case. Each of these tends to engage with firms in a way that is characterised by informality—that is, relying wherever possible on private conversations and *ex ante* intervention to secure compliance, rather than aggressive pursuit of *ex post* sanctions. Of the three, the FSA makes the greatest use of formal legal sanctions, but the Takeover Panel and FRRP are responsible for far more informal interventions. A rough estimate suggests that up to 20% of listed firms may be subject to some type of informal engagement, and 3% to formal enforcement, from one of these public agencies each year.

Thirdly, we emphasise the significance of informal private enforcement through the exercise of shareholders' governance entitlements—whether through the exercise of voting rights or facilitation of the market for corporate control. These mechanisms, which are used to remove managers who have underperformed, induce high compliance rates with the non-binding Combined Code of Corporate Governance. They derive efficacy from the high proportion of shares held by institutional investors, who are relatively sophisticated repeat players in the corporate governance arena.

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[233] See Figure 6, *supra*.

The role played by institutional investors also helps to explain *why* the UK's pattern of enforcement has such an informal hue, in both its public and private aspects. The rise of widespread institutional shareholding in the years following World War II brought with it a relatively small community of knowledgeable investors who interacted frequently with one another and with investee firms. This community, with prompting from the Bank of England, facilitated the establishment of self-regulatory bodies and lobbied for rules that protected shareholder entitlements. Over time, these self-regulatory bodies have gradually been put upon a formal legal basis, such that they are now public agencies. Yet their approach to enforcement still retains much of the informality and focus on reputation that characterised self-regulation. This process of gradual formalisation may be expected to continue.

There are three important messages for policymakers. First, at least in the UK, private litigation matters far less as a means for controlling managerial agency costs than the economic literature currently suggests. Secondly, the fact that at different points in time, different enforcement strategies have predominated in the UK strongly suggests that there are substitution effects between enforcement strategies and complementarities with other aspects of the corporate governance regime. And thirdly, the significance of informal enforcement in the UK implies that inferences about a system drawn solely from low formal enforcement rates are likely to be misleading.

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