

**The limitations of legislation in the field of business law: a study of developments in
company law, bankruptcy and diligence.**

**A thesis submitted in partial fulfilment of the requirements of Edinburgh Napier
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Abstract

This critical appraisal demonstrates three particular themes that are dominant in certain areas of business law, these themes being:

- achieving the balance between the interests of debtors and creditors,
- the use of legislation to alter business and social behaviour and
- the tension between the intention of the legislation and the actuality.

These themes are demonstrated throughout my two submitted publications, *Company Law*, and the *Annotated edition of the Bankruptcy and Diligence etc. (Scotland) Act 2007*. These form a corpus of work on Scottish business law and in particular, company law, bankruptcy law and diligence.

The critical appraisal is a review of certain aspects of this corpus, indicating how and for what purpose these books have been written, the use and effectiveness of the law in each area, and analysing the degree to which the legislation has been successful.

The process of writing this critical appraisal caused me to reflect on the drafting of the Companies Act 2006, recent developments in case law on the corporate veil and in particular the efficacy of section 172 of the Companies Act 2006. This encouraged me to carry out further research on how well (or not) s.172 had worked. This proved a particularly fruitful area of research and so has been given substantial treatment in its own right in Chapter 4.

The Bankruptcy and Diligence etc. (Scotland) Act 2007 is subjected to an analysis in the light of the three themes to show how the Act was intended to realign the priorities of the needs of debtors and creditors in the light of changed social views on creditors' rights and on bankruptcy.

An essential point of this critical appraisal is that legal theories are not as important in the drafting and passing of legislation as is sometimes suggested. This critical appraisal argues that within the areas under discussion, attempts to fit the final legislation into theoretical frameworks do not adequately take account of the political reality underpinning the passing

of the legislation. It also argues that there is a schism between political attempts to alter business and social behaviour, or, as the case may be, to alter the interests of debtors and creditors, through the use of legislation, and what actually happens. In the case of diligence, political considerations worked to defeat some ends of the proposed legislation; and in the case of bankruptcy, the reforms introduced by Bankruptcy and Diligence etc. (Scotland) Act 2007, though welcome, required further amendment. In the case of company law, the legislation was ambitious but naïve.

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Chapter 1

Summary

This chapter indicates the themes of the critical appraisal, explains the publications that will be used to illustrate the themes and explains how the research methodology ties in with the themes of the critical appraisal.

Introduction.

This critical appraisal proposes that there are three themes running throughout business law, with particular applicability to company law, bankruptcy law and the law relating to diligence (the enforcement of the payment of debt within Scotland).

These three themes are as follows:

- achieving the balance between the interests of debtors and creditors,
- the use of legislation to alter business and social behaviour and
- the tension between the intention of the legislation and the actuality.

These themes will be addressed throughout this critical appraisal by reference to two publications written by the author, namely *Company Law*, and the *Annotated edition of the Bankruptcy and Diligence etc. (Scotland) Act, 2007*. This critical appraisal will also take account of current developments within these areas of law since the books were written and since the legislation on which the books were based was passed. These three themes do not apply to the subjects under consideration and the publications mentioned equally, so that there is more to say on the second and third themes in the context of company law than there is in the context of diligence.

Achieving the balance between the interests of debtors and creditors

Finding the balance between the interests of debtors and creditors is as perennial a task as finding the balance between master and servant or landlord and tenant. From time to time laws are introduced, usually to benefit one side or the other, according to whose political interests are best served. Historically, generally speaking, creditors, commonly merchants or

landowners, were in a good position to frame laws that protected their interests¹, but as even merchants and landowners become debtors themselves, it was prudent to have laws that were not too draconian. Scotland adopted the Roman law of bankruptcy as part of its reception of Roman law, but while the law was not unfair to debtors, its main failing was that it was only suitable for substantial property owners. It was not designed for people living on benefits, or those with minimal assets or income, thus preventing poor people taking advantage of formal bankruptcy procedures to be relieved of their debts. Bankruptcy law has had to adapt. Recent changes have made bankruptcy available to most sectors of the population, although the fact that section 5 of the Bankruptcy and Debt Advice (Scotland) Act 2014 (the Minimal Assets Procedure) has recently been issued suggests that previous procedures were still not satisfactory for the very poor. At the same time, the relative ease with which debtors may soon seek relief from their debts may come at a price. Perhaps the traditional Scottish virtues of thrift, responsibility and honouring one's debts are being eroded.² This critical appraisal discusses the extent to which the law has altered the balance in this area between debtor and creditor.

Within diligence the rules traditionally favoured the creditor³, but the changes to the law within the Bankruptcy and Diligence etc. (Scotland) Act 2007 amended this. Now for creditors to assert their rights they have to follow complex procedures designed to give many opportunities to the debtor to avoid the diligence or to redeem the debt. This has improved the position for debtors, but it has also made it harder for creditors to get their money back, and pushed up creditors' costs of recovery. Such costs will be passed on to the debtors. The balance between debtor and creditor has shifted here too and this is explored later in this critical appraisal.

By contrast, the balance between debtor and creditor is very different in company law. A limited company bears its own debts and by law only under very restricted circumstances are

¹ For example, the Adjudication Act 1672.

² Traditionally on Hogmanay people in Scotland would settle their debts in order to start the new year afresh. See Donna Heddle, Director of the Centre for Nordic Studies at Orkney and Shetland College, University of the Highlands and Islands, at <http://www.bbc.co.uk/news/uk-scotland-highlands-islands-20596225> (accessed 4 January 2015).

³ For example, until the changes in the Bankruptcy and Diligence etc. (Scotland) Act 2007, a creditor effecting diligence on a debtor's bank account could freeze the entire sum in the bank account, even if it were in excess of sums due to the creditor, and even if the debtor needed the money in the account to feed his family.

the company's directors responsible for the company's debts. This can and sometimes does lead to a cavalier attitude to a company's creditors, and to shareholders, because the directors are very unlikely personally to be at risk.⁴ Especially in the field of banking, the effect of dubious business practices tend to be seen several years after the directors have obtained their own benefits, while the bank's shareholders and indeed customers remain at risk long after the directors have moved on. In the light of recent case law, the use of the corporate veil to make it difficult to obtain redress from directors is particularly explored in Chapter 4.

The use of law to alter business and social behaviour

The law is often used to make people behave in one way or another, usually for some perceived benefit. For example, the Clean Air Act 1956 was passed to prevent London being suffused in smog. There were penalties if people burned the wrong type of coal. There were clear aims and clear sanctions. Laws against smoking in public buildings⁵, laws against drink-driving⁶ and laws requiring people to wear seat-belts⁷ all come within the same "behavioural" category of law. Few could object to these laws. But interestingly, as will be explained, the last few years have seen the development of laws that are intended to make businesspeople behave "better" or to act in a moral, honourable or socially desirable way, sometimes with sanctions (as with the Equality Act 2010) for non-compliance. The best reason for behaving with integrity in business matters is that treating customers and other businessmen fairly, broadly speaking, helps a business-owner build up a prosperous business with a long term future.⁸ At the same time in business it is unrealistic to expect every businessperson to behave with such integrity. Although deceit or fraud is unacceptable, not volunteering information, or being "economical with the truth", is quite often seen as "fair game" or to be expected. Following Robert Maxwell's looting of the Mirror Group Pension Scheme and accounting chicanery in American companies such as Enron and Worldcom, it was clear that otherwise intelligent businesspeople were prepared to act indefensibly, even though in the long run it was not in their interests or their shareholders' interests to do so. In an effort to prevent this, the Companies Act 2006, and current rules on corporate governance, expect directors to act

⁴ For example, the takeover of ABN Amro by RBS in 2007.

⁵ Smoking, Health and Social Care (Scotland) Act 2005.

⁶ Road Safety Act 1967.

⁷ Transport Act 1981.

⁸ For example, witness the success of the retail store John Lewis and its supermarket partner, Waitrose, both renowned for the fairness with which they treat their staff and their customer service.

thoughtfully in the management of their companies and to take account of wider interests other than the benefit to themselves or the return to shareholders.

By contrast, the Bankruptcy and Diligence etc. (Scotland) Act 2007 hoped to provide debtors with a life-line, and by making sequestration more easily available to make bankruptcy less of a social stigma. Bankruptcy is sometimes the result of poor judgement, but it can also be because a blameless business's own debtors are unable to pay their bills to that business. It was also thought that making sequestration easier might make lenders less reckless in their lending policies. Finally, reducing the period of bankruptcy to only one year might encourage new businesses to be set up. We can see the same policy approach in the proposals in the Bankruptcy and Debt Advice (Scotland) Act 2015 to introduce compulsory financial education and compulsory debt advice for certain debtors.⁹ It is possible that this may yet prove to make a considerable difference to debtors' behaviour – depending on how it is implemented and how seriously it is taken by debtors.

Tension between intention of the legislation and the actuality

This theme is connected with the previous theme. The previous theme deals with the political will to use the law to force some form of apparently desirable behaviour. The third theme explores how well the law works in practice. Inevitably there is some degree of overlap.

While politicians use the law to try to change people's behaviour in business, the people at the receiving end of the law, the ones who are supposed to be obeying the law, the businesspeople, the company director, or indeed a creditor or debtor, may not necessarily share the politicians' enthusiasm for change, particularly if it is going to be inconvenient, expensive or contrary to their accustomed practice. They may be tempted to find ways round the law, to exploit any weaknesses in its drafting or to "tick the boxes" without actually engaging with the point of the new law. A perennial difficulty is trying to get people to obey not just the letter of the law but the spirit of the law, particularly if they cannot see any obvious immediate benefit to them in doing so.¹⁰ As indicated in the previous paragraphs, the

⁹ S.2.

¹⁰ A parallel arises in the 2012 Governmental review of the Equality Act 2010, to be found at <http://www.homeoffice.gov.uk/equalities/equality-act/>. Although there was considerable support for many of the

UK Government wants directors to be more thoughtful in their decision-making. This is demonstrated by s.172(1) of the Companies Act 2006 which explicitly requires directors to “have regard” to various stakeholder interests. This critical appraisal in Part 2 of Chapter 4 argues that the intentions of Parliament in that Act were in practice completely ignored, at least as far as certain large companies were concerned.

The reforms to bankruptcy in the Bankruptcy and Diligence etc. (Scotland) Act 2007 have in many respects on a practical basis made bankruptcy more accessible. However, as indicated above, one of the original intentions of the Act was to remove the social stigma of bankruptcy and to encourage entrepreneurs to put their difficulties behind them with relative ease.¹¹ It is not evident that the stigma has been removed or entrepreneurs encouraged; other social and economic considerations have to be taken into account before a judgement may be made on this matter. The changes to the law of diligence in the same Act were introduced to ensure that nearly all assets belonging to a debtor could be subject to diligence, thus making creditors more likely to get their debts paid, and possibly ensuring that debtors were more cautious in taking on debt. As will be explained later in chapter 4, politically this turned out to be unacceptable or impracticable.

Much of the law discussed within this critical appraisal is based on statute, which means that politicians were the ones who ultimately approved it. Business law is a pragmatic discipline which ideally recognises the interests of competing parties and tries to find a fair and workable, not necessarily a theoretical, balance between those interests. But business law is also a political matter. When what became the Companies Act 2006 was being debated in Parliament, there were attempts by the Conservatives to talk out parts of the Bill as they were perceived to be bad for business.¹² Although the attempted filibuster was not successful, as a

worthy features of the Act, particularly in larger businesses, the review established that there was much less support at small business level, where, for example, there was little support for employing people with disabilities, especially if such employees were likely to take time off for their disability or cause others to have to take on their workload. However admirable the Government policy, it clearly was not welcomed by employers.

¹¹ See The Scottish Government *Modernising Bankruptcy and Diligence in Scotland : Draft Bill and Consultation* July 2004, para. 5.3 and 5.8.

¹² See Jonathan Janogly’s admission of his own attempts at talking out at Hansard, HC, 17 October 2006 at column 755.

result, some parts were later not given the close scrutiny they might have been given.¹³ Similarly the law relating to diligence and bankruptcy was politicised: there were those who strongly favoured the interests of debtors against the interests of creditors such as banks, credit card companies and local authorities¹⁴, and those who pointed out that whether or not banks and credit card companies deserved their money, local authorities and many other small creditors needed it too.¹⁵ The reality is that any law that makes life easier for debtors makes life harder for creditors, but more votes are to be had from debtors than from creditors.

The publications that will be used to demonstrate the themes

1. Company Law

The first edition of my book, *Company Law*, was published in 2002 by W.Green. A second edition was published in 2005, a third in 2009 and a fourth edition in 2014. It has been successful, at least within Scotland. It is required reading at Edinburgh and Strathclyde Universities for undergraduate and post-graduate law courses and used at other Scottish universities as well. It is part of the reading for the Company and Commercial course in the Diploma in Legal Practice, a necessary training stage for all future lawyers in Scotland. It sells well to professional lawyers, many law firms buying a copy for their own shelves. It is also sold to, for example, public libraries and chambers of commerce.

The book itself is about 440 pages long (about 200,000 words) and explains and comments on all areas of company law, from a company's incorporation to its demise, taking in all the important points of law pertaining to a company, including capital maintenance, insolvency, the role and duties of directors, reporting requirements, audits, meetings, flotation of companies on the Stock Exchange, takeovers and acquisitions, and insider dealing.

Guiding purpose of the book

W.Green, the publishers of this book, had indicated that the readership of *Company Law* was to be both people coming to company law for the first time, or the first time for a while, whether as practising lawyers, company directors, or students, and also current practitioners

¹³ See Hansard, 17 October 2006, Col 744-754,

¹⁴ For example, see the Citizens Advice Bureau (Scotland) Briefing Paper 19, 2005, on arrestments.

¹⁵ As discussed at the Scottish Parliament Enterprise and Culture Committee 18 April 2006 and seen in the Official Report therefor.

of company law. It was agreed between the author and the publisher that the book would be written in the following way:

- the author should explain the law clearly, in sufficient breadth so that readers could see what the overall point of the law is, but in sufficient detail so that they could see the finer points of the law as well, and any practical impact;
- the author should explain the legislation so that when readers later came to read the legislation, it would make more sense than it might otherwise;
- the author should explain the facts of the important cases and their significance;
- the author should explain the practical benefits of the law and the negative consequences of failing to follow the law;
- the author should not assume that readers would automatically know or understand specialist legal, accounting or business terminology; such terminology should be explained, but in an informative rather than a patronising manner;
- the author should bring the subject to life by focussing, where possible, on the human side of the subject;
- the author should write in a way that would enable readers to read the text effortlessly.

More thoughtful readers might probably also expect to read:

- some history about the law;
- some analysis of the effectiveness of the law;
- forthcoming changes to the law;
- the reasons for those changes;
- areas of difficulties within the law, where the law remains uncertain or unsatisfactory;
- any ethical or moral issues thrown up by the law.

The applicability of Company Law for the demonstration of the themes of this critical appraisal

Company law is a particularly apt area for discussing the balance between creditor and debtor, because statute has specifically allowed for the possibility that companies will be unable to pay their debts, while most of the time creditors have no right of recourse against the companies' owners or directors. Recently we have seen the compelling corporate veil case of *Prest v Petrodel Resources Ltd.*¹⁶ This is extensively discussed in the fourth edition of *Company Law*. It is a telling example of the importance of the first theme, the balance between the debtor and creditor, and yet its implications are that company law allows directors, certainly of larger companies, to take advantage of their position to let their companies carry out socially and financially irresponsible activities without the law being able to restrain them – as will be discussed later in Chapter 3. Company law is also an apt area for discussing the use of the law to influence behaviour, as the Government specifically tried to do through the use of section 172(1) of the Companies Act 2006. This was the subject of considerable debate within the House of Commons on 17 October 2006, but the objections to the final wording were withdrawn not because the wording had been resolved but because the Members of Parliament who were debating it were unwilling to force changes which would have led to the risk of unwelcome confrontation between the House of Lords and the House of Commons.¹⁷ As a result of writing about it, I was moved to research further into it to see to what extent directors of leading companies had in practice paid attention to the requirements of (as opposed to being aware of) section 172(1), and to what extent it was working at all. This is discussed in Part 2 of Chapter 4.

2. *Annotated edition of the Bankruptcy and Diligence etc. (Scotland) Act 2007*

An annotated edition of an Act is one where the author writes an introduction to a new Act, and then explains every single section of the Act, commenting on any points of law or practice. This particular Act has 227 sections and five schedules and in its time was the longest Act from the Scottish Parliament.¹⁸ The Act substantially amended the law on bankruptcy and diligence, set up a framework for new regulation of sheriff officers and messengers at arms, proposed a new registration system for floating charges, and provided changes to admiralty actions within Scottish waters. Although the Act received royal assent,

¹⁶ [2013] UKSC 34

¹⁷ Hansard, HC, 17 October 2006, Col. 790.

¹⁸ The author's introduction and commentary amount to about 60,000 words in total.

not all the parts of the Act have been implemented, some for financial reasons, some for political reasons.

The 2007 Act was, as will be explained hereafter, explicitly designed to tidy up, update and improve the existing law on bankruptcy and diligence, to take account of changes in social circumstances since previous legislation and to enable creditors to be able, if necessary, to have rights over any assets of a debtor, other than those needed for the debtor's (and the debtor's family) immediate circumstances. The 2007 Act was intended to make the burden of bankruptcy less of a mark of social failure and to make it easier for debtors to be relieved of their debts when there was little prospect of them ever being able to redeem their debtors.

The book itself is a commentary on the Act generally together with notes on each section of the Act. The book is widely used in civil litigation.

Background to the 2007 Act

Following work originally carried out by Professor Maher at the Scottish Law Commission¹⁹, the 2007 Act was the result of a proposal in 2005 by the future Lord Wallace of Tankerness, at the time the Liberal MSP and deputy first minister of Scotland, that the Scottish Executive, as it then was²⁰, should review the laws relating to bankruptcy and diligence to make them more suitable for the changed circumstances of the 21st century. The Scottish Executive was instructed to draft a Bill which eventually became the 2007 Act. It was introduced to the Culture and Enterprise Committee (under the chairmanship of Alex Neil MSP) of the Scottish Parliament in late December 2005 and received royal assent in January 2007. It is conventional within the Scottish Parliament that when a select committee is taking evidence about a particularly complex matter, it invites people to apply for the position of legal adviser to the committee. I was fortunate enough to be appointed to this position.

Part of the intention of the 2007 Act was to improve the law relating to diligence (as explained in the previous chapter) and to enable debtors to apply for their own sequestration in a less formal manner than had been the case. Previously debtors had to petition their own sheriff court, a process that was more elaborate than was needed for some debtors. Since the 2007 Act there are now various simple methods for applying directly to the Accountant in Bankruptcy for one's own sequestration, and the sheriff court is only used when creditors or

¹⁹ Scottish Law Commission Report 207, May 2001,

²⁰ Now the Scottish Government.

trustees, dissatisfied with the lack of compliance of debtors with the terms of their trust deeds, wish to petition for debtors' sequestration. The 2007 Act also made other changes to bankruptcy, proposed a new register of floating charges, set up a new Scottish Civil Enforcement Commission, and made some changes to Debt Arrangement Programmes. Not all of these were brought into force, as will be discussed shortly.

The applicability of Annotated edition of the Bankruptcy and Diligence etc. (Scotland) Act 2007 for the demonstration of the themes of this critical appraisal

The 2007 Act provides a clear example of the Scottish Parliament trying to alter the balance between debtor and creditor, on the whole successfully, while setting up a coherent method of ensuring that debtors should pay their debts and being forced to do so by means of diligence against all their assets, or if that is not possible, by having a fair process of bankruptcy. However, as will be seen, political and practical considerations intervened to preclude the use of diligence against all assets, thus emphasising the gap between the legislative intention and the actuality of its implementation. The Act also hoped to alter social behaviour by reducing the stigma of bankruptcy and to encourage business generally by having a shorter period of bankruptcy than had been the case previously.

Methodology of legal research in the area of business law

Business law is an important area of law in practice, but a difficult one in which to carry out research in the traditional sense of discovering something new, writing it up and showing what could be done with it, as for example, a chemist discovering the properties of a new compound, or a musicologist discovering a hitherto lost piece of music. There is little statistical research on business law. Except in a few areas, mostly involving insolvency, it does not lend itself to measurement and quantification, and for reasons of commercial secrecy few lawyers reveal much information about their clients' activities. Even on a comparative basis, business law in one jurisdiction tends to be similar to that in other jurisdictions, because any business law system that is out of kilter with most other business law systems will not attract outside investment.

Accordingly my legal research in business law involves examining recent legislation, and in following the application of the law in the wider commercial world, in order to consider

- (a) what the law was intended to achieve according to the consultation exercises and white papers that preceded the first draft of the relevant legislation;
- (b) what the wider implications of the new legislation are likely to be;
- (c) what the law actually is on a close construction of the wording of the legislation or the close reading of any relevant case law arising from the legislation;
- (d) how the law is operating in practice;
- (e) to what extent the practice of the law has deviated from its original intentions;
- (f) whether or not the intentions of the politicians approving the legislation are capable of being realised;
- (g) if and how the law could be improved.

Although it is important to establish what the law actually is, the wider implications can be important too since they may require lawyers to revisit existing practice or warn their clients that what might have previously been legally acceptable may no longer be so (or conversely that something previously forbidden was now acceptable).

It will be noted that these seven approaches to research are not far removed from the three themes of this critical appraisal. The Companies Act 2006 and the Bankruptcy and Diligence etc. (Scotland) Act 2007 were both preceded by extensive consultation with the aim of improving and rationalising the law in these areas in order to achieve a better balance between the various interests, in particular debtor and creditor. In each case one can see those aspects of business and social behaviour that the Government was trying to influence. The research process as indicated reveals to what extent the Government's intentions were achieved, what happened instead, and the extent to which the law may be improved for the future.

The applicability of the three themes to this critical appraisal

There are different ways of carrying out a critical appraisal of legislation. Because of the Parliamentary process, it is also possible to chart a Bill's progress from discussion papers, to white and green papers, and finally to the Act itself. In the process the original ideas behind the Act are refined, improved or discarded, and in theory reflect the wishes of Parliament. The Parliamentary process in effect is a democratic method of making a critical appraisal. This does not necessarily mean that legislation subjected to such a critical appraisal is good legislation but at least it is carried out by people who have been elected to carry out this task, and who, one hopes, brings a breadth of experience to this activity. A drawback of this particular type of critical appraisal is that it ceases once the Bill is enacted, even if the legislation is subsequently reviewed.

Legislation can also be subject to other types of critical appraisal, such as a Marxist approach, a nationalist approach, or a belief-system (such as Christianity) approach, each of which would no doubt shine some limited light upon the legislation in question. What, however, they might lack would be breadth: they would be partial and only take account of certain aspects of the legislation.

By contrast, the advantage of using the three themes of this critical appraisal as a means of critiquing the legislation is that the broad combination of the themes both illuminates the intentions of the legislation, and the practicalities of how the legislation ended up being drafted in the way it was, but also casts light on how well the final legislation actually achieves what it was originally intended to do. In a sense these three themes enable a judgement to be made on the legislation on its own terms, past, present and future. Furthermore, although these themes are being used in this critical appraisal for these purposes, it is arguable that the latter two themes would be good yardsticks to use for many other types of legislation, and as regards the first theme, the balance between debtors' and creditors' interests, while this is specific to business, much other law is also about a balance between competing interests. For example, family law is a balance between parental rights and children's rights, and environmental law is a balance between the right to exploit the environment and the need for the environment not to be despoiled for future generations. The three themes are universal themes, and it is not entirely fanciful to say that good starting point for a successful review of most legislation would be always to use these three themes.

The research process in business law

A minister's immediate responsibility often ends with the press release that originally accompanied the introduction of his or her Bill through Parliament, though it is common for there to be a review of the legislation some years later. In the meantime, it is the task of researchers/commentators on the law to study the new Act to bring out the important parts that most practitioners, and indeed the public, will need to know about, and to render the words of the Act into terms that everyone can understand. This is because despite recent efforts by Parliamentary draftsmen to make legislation more user-friendly, it is rarely easy to express some legislation's more complex provisions.²¹

It is not usually enough for researchers/commentators to have read the new Act; it is normally necessary to have read the original recommendations from the Law Commissions or other bodies that prompted the legislation in the first place; and it is necessary to have read the previous case law that the legislation wished to overturn, plus to have read any new cases that have been decided since the new legislation came into force in order to see if the judges are understanding the new law properly. In addition it is important to have read the Parliamentary debates that underpinned the passing of the legislation in order to establish what the politicians thought they were doing when they approved the new law. Finally, depending on the type of publication, (and this particularly applies to *Company Law* and the *Annotated Edition of the Bankruptcy and Diligence etc. (Scotland) Act 2007*), the commentator has to consider any unforeseen or unintended consequences of the law, the correctness of any recent decisions and the ingenious routes that lawyers may use to thwart the intended effects of the law.

All these factors must be absorbed and considered, and then, and this is where true legal scholars show their art, the researcher/commentator must re-present the law by amalgamating the old law, the new laws, the original recommendations (from the Law Commissions or elsewhere) and the other matters referred to in the previous paragraph into newly-crafted text that tells the reader with at least some degree of certainty what the law now actually is, as well as (if appropriate) putting the law into its wider context, and analysing its likely effect and its effectiveness. It is not always possible to achieve this desirable state of certainty: in

²¹ For example, sections 197-214 of the Companies Act 2006 that relate to directors' loans are notoriously impenetrable.

this case, the best that can be done is to present the different interpretations of the law and either let readers make their own minds up, wait for a test case to resolve the issue, or postulate what in the author's view the law is likely to be or ought to be, or to suggest, usually on a practical basis, changes for the better.

Independence of the research

The publications referred to in this critical appraisal have been written independently. I have no co-authors.

Originality

The law on the matters referred to in this critical appraisal is already in the public domain. So is much of the material which is drawn upon in order to provide information for the commentary on the law in these books. When a new important case is decided or a new Act is passed there will be other legal commentators in different professional and academic journals making similar points to the author's. In addition, the Government nowadays provides explanatory notes on any new legislation, such notes being available online as an accompaniment to the legislation. But what makes this critical appraisal original is that the law referred to herein is examined in the context of the three themes, and as will be seen in due course, in some respects the legislation is found wanting and better remedies could be made available.

Chapter 2

The partial redundancy of theoretical underpinnings of corporate, bankruptcy and diligence law to the themes of this critical appraisal.

Company law

In the 1990s there was a resurgence of interest in company law theory, mainly at the instance of Brian Cheffins and his book, *Company Law: theory, structure and operation*.²² Up to that point, within the United Kingdom at least, little attention had been paid to theories of company law within legal scholarship. It is very noticeable that the main book on UK company law, *Gower and Davies: Principles of Modern Company Law*²³ still does not even touch on any theories. The book uses the practical approach of saying what the law is, not referring to the theories that might have lain behind the law, working on the principle, no doubt, that most corporate lawyers are more interested in the practicalities of the law as it stands at present than in any academic theories about company law. There were, and indeed there still are, good reasons for this. The reasons are well summed up in Cheffins's article, *Using theory to study law: a company law perspective*.²⁴ In the article, Cheffins draws a distinction between the doctrinal study of company law and theoretical study of law. Up to the time of the publication of his book, the emphasis in the teaching of company law within universities and elsewhere was on the practicalities of the law, as shown in case law and legislation. There was a disinclination to lift one's gaze to see how the law fitted into a wider social or economic context. One obvious reason for this was that students were not generally very interested in learning what they did not need to know in order to be qualified as a lawyer or to practise as a corporate law. Another reason is that much of the scholarship on company law theory was based in the United States, and drew heavily on the study of economics. Not only was this not a discipline not always familiar to practising lawyers, but it was of little use in resolving disputes or establishing relationships between the actors within a company.

While an economics-based approach to company law may indeed fail to resolve disputes or establish relationships, and while some of the scholarship may be divorced from the day to

²² The theories are well summed up in *Mayson, French and Ryan on Company Law*, 30th ed., OUP 2014, Ch.1 and discussed at length in Cheffins *Company Law: theory, structure and operation* Ch.1. OUP, 1996

²³ *Gower and Davies Principles of Modern Company Law*, 9th ed. Sweet and Maxwell 2012.

²⁴ 1999 C.L.J., 58(1), 197-221. He develops some of these ideas further in *The trajectory of (corporate)law scholarship* 2003 C.L.J., 2004 , 63(2), 456-506.

day concerns of practitioners, it does not mean that it is a bad thing to pause to reflect on the essential question “For whose benefit is a company being run?” Closely allied to this question is the normative “For whose benefit ought a company be run?” and the more practical, “Once we have decided for whose benefit a company ought to be run, how do we ensure that companies are run in this manner?” While this question might not necessary for the daily running of a company, it may become so for those, particularly politicians or certain lobby groups, hoping to shape the law in the hope that law will force companies to be run in a particular way.

For a long time, the assumption of contractarian lawyers was that companies were run essentially to make the investors money. Investors ceded control of their money to a company run by directors who would use the company’s resources and the investors’ capital to generate good returns for the investors. Due recognition was given to the agency problem, which arises when directors, taking undue account of their informational advantage relative to the investors, run the company primarily for their own benefit. For that reason laws had to be framed to remind directors of their fiduciary and other duties to the company as a whole, and render the directors liable to dismissal by the investors, assuming the investors had sufficient voting power to do so; and where the investors did not have the voting power to enforce the directors’ fiduciary or other duties or to dismiss the directors, this would be reflected in the price of the shares. As regards wider interests, such as the expectation of being a good employer, being a good “citizen” (to the extent that an artificial entity could be a citizen) by paying taxes, or helping the community from which its workforce is drawn, these were only expectations, not obligations, and should not detract from the essential duty of maximising returns for the investors.²⁵

The advantage of this theoretical approach is that it is easy to grasp. There is an assumption that each actor within a company is out for the maximum of what he can get from the company, and that an employee, a director, a creditor should be entitled to what they may have bargained for but the entire residual benefit should be for the investors alone. Unless any activity generates funds or provides a tangible benefit for the shareholders, or what is known colloquially as “ROI” (return on investment), it is not worth doing. Indeed, there is a conservative American organisation, the National Centre for Public Policy Research (“NCPFR”), whose main function is to act as a spokesman for investors who share these

²⁵ This particular approach is discussed further at Part 2 in Chapter 4.

views.²⁶ At the AGM of Apple in July 2014 one of its representatives objected to Apple's initiatives in energy sustainability, preparing devices for the blind, environmental issues and worker safety, none of which were profitable. To this Apple's CEO, Tim Cook, replied "If you want me to do things for ROI reasons, you should get out of this stock."²⁷ The Apple shareholders clearly agreed with Cook, for the NCPPR's proposals only received 2.95% of the vote.

History suggests that plenty of entrepreneurs never saw their duty as only to generate ever greater personal returns for shareholders. David Dale (and later Robert Owen), who designed the New Lanark cotton mills from 1786 onwards, considered that an important part of their enterprise's wealth should be ploughed back into the community that generated it. They instituted schools and health care, accommodation and other benefits which arguably kept the work force healthy, loyal, and valued. Other well-known entrepreneurs in the 19th century, particularly Quaker families such as the Cadburys, the Frys and the Rowntrees, made fortunes in chocolate and used company money to improve the conditions of their workforce beyond what was necessary to make them carry out their work properly. These families took pride in being socially responsible employers and businessmen.

The important point was that these families strongly identified with the companies that generated their wealth and they felt a moral duty to improve the world around them. They had substantial shareholdings in their family companies and incoming shareholders were aware of their activities; if they disapproved of such altruism they were at liberty to take their investment elsewhere to more lucrative and less public-spirited businesses. However, when shareholdings in large companies became increasingly divorced from the original and benevolent founders of those companies, it is not surprising that some shareholders become less concerned about the founders' philanthropic issues and more interested in return on investment. Even so, it does suggest that the contractarian approach of each actor being out for his own benefit, with the shareholders being entitled to the whole residual interest, by no means always describes the full picture, and the fact that at the Apple AGM so few investors shared that approach suggests that investors are becoming more sophisticated in their expectations of the benefits to be derived from being a shareholder. So to that extent this theory is unsatisfactory.

²⁶ See their website at <http://www.nationalcenter.org/> (accessed 4 Jan 2015).

²⁷ Forbes: <http://www.forbes.com/sites/stevedenning/2014/03/07/why-tim-cook-doesnt-care-about-the-bloody-roi/> (Accessed 4 Jan 2015)

With the rise in the generally agreed standards of corporate governance, mostly introduced as a result of failures of corporate governance, it became apparent that a more inclusive theory of company law was required. The current view in the United Kingdom, as espoused by the Company Law Steering Group's deliberations²⁸, which resulted in s.172(1) of the Companies Act 2006, is that of "enlightened shareholder value" which is effectively that companies on the whole prosper best when all the actors take account of each other's interests, and the directors, and indeed the investors, customers and employees, are mindful of the other stakeholders. So to the question "For whose benefit ought a company be run?" comes the more thoughtful, or possibly more common sense answer, "Ultimately a company should be run in a way that benefits the investors, but the best way to run a company, if it is to last for everyone's benefit, is to run it in a way that takes account of all the stakeholders, and is not run purely for the short-term benefit or self-interest of the investors". It is not difficult to see that a company that produces products whose profits are very good for the employees, the directors, and the investors, but are poor quality for the customers, ultimately loses the goodwill and trust of its customers – as the major UK banks over the last few years have discovered – and that this in turn will affect the investors. Similarly Tesco recently discovered that treating its suppliers harshly is bad for the company's share price.

A criticism of the enlightened shareholder approach/stakeholder approach is that the directors, in attempting to satisfy everyone, satisfy no-one; that by pretending to be trying to take account of everyone's interest they may cast a smokescreen over their own self-interest; and another is that it is not directors' role, or indeed their companies' role, to make the world a better place. A further practical point is that many business organisations tend to promote those who make most money for the organisation, and managers, trained in a culture of maximising returns, may find that on achieving directorial status a different and wider set of values is required, one that may be unfamiliar, unwelcome or slow to be adopted. These are admitted drawbacks of a stakeholder approach, but it is not generally disputed any longer that the stakeholder approach has much to commend it. This then leads to the bigger question of whether directors should be forced to run their company in the required manner by legislation. As will be argued later, legislation has not proved a successful way to make companies be run in such a manner: the market is actually a more effective driver of good practice than legislation. What I also seek to argue is that although there is virtue in trying to

²⁸ *Modern Company Law for a Competitive Economy: the Strategic Framework* (London DTI, 1999), para 5.1.12 and *Modern Company Law for a Competitive Economy: Developing the Framework* (URN 00/656) (London DTI 2000) para. 2.11.

apply theories of company law to how companies should be run, since the theories may reveals insights that might not otherwise be apparent, it is important to notice that theories have not in practice played very much part in political decision-making. When s.172(1) of the Companies Act 2006 was being discussed in Westminster, only marginal attention was paid to any of these theories by any of the politicians who voted for it.²⁹ That is why the research in this critical appraisal does not concern itself what any such theories were, or how they might be critiqued, but is focussed on the narrower grounds of what Parliament actually produced, and whether the wording (in the legislation) of what politicians approved was effective and achieved what the politicians intended.

Theories of bankruptcy law

As far as bankruptcy is concerned, there is a certain amount of scholarship on the principles of corporate insolvency, mostly based on the contractarian theory, namely that parties are free to contract with each other as they please, and that it is up to creditors to negotiate such means of minimising the risk that the debtor will become insolvent as they can manage. The common method of minimising risk is by persuading the debtor to grant a fixed security, typically a standard security (mortgage) over his property, or to obtain a personal guarantee from a suitable guarantor. This is all very well for creditors who are in a position to extract some form of security, but this is not generally available for unsecured creditors and particularly for involuntary creditors, not in any position to contract with their debtors. Unsecured creditors are treated on a *pari passu* basis, but the Government steps in to afford some protection to favoured creditors. Other principles are that bankruptcy should offer a “fresh start” and that bankruptcy is a social good. Since there is a possibility that all of us could become bankrupt through blameless misfortune or error, there should, as part of our common humanity to our fellow man, be a method of debt forgiveness. At the same time there should be some degree of penalty for reckless bankrupts, an example being seen in Bankruptcy Restrictions Orders and Undertakings, introduced in the Bankruptcy and Diligence etc. (Scotland) Act 2007. Bankruptcy systems are not noticeably different throughout the developed world. Different countries may give preferential status to different creditors, but overall most bankruptcy laws are not greatly different from their Roman law origins.

²⁹ The extent to which they were discussed is dealt with in Part 2 of Chapter 4.

As far as bankruptcy is concerned (and indeed diligence), I have been closely involved in the legislative changes in this area within Scotland over the last eight years, partly as legal adviser to two committees within the Scottish Parliament whose job was to oversee new bankruptcy bills, but also as an adviser to the Accountant in Bankruptcy. In none of the extensive documentation surrounding these bills did I see any consideration of any theories pertaining to bankruptcy law: all the legislative changes were based on nothing other than the practical process of making the law relating to bankruptcy and diligence fairer and more effective than before, and acceptable to a majority of the politicians who would be voting on the matter. It was clear that policy-makers within the then Scottish Executive Legal Department and the Accountant in Bankruptcy had looked at legislation in England and Wales (particularly as regards Bankruptcy Restrictions Orders) reducing the period of sequestration to one year only for most debtors, following changes to that effect in England and Wales in the Insolvency Act 2002. Theory was conspicuously absent in the discussions that took place on these matters: what was evident was a pragmatic desire not to place Scottish debtors at a disadvantage to English debtors in terms of the duration of the bankruptcy together with a fond but not necessarily justified belief that the reduction to one year would encourage entrepreneurs, and a desire to protect the public by having an easily accessible register of debtors subject to Bankruptcy Restrictions Orders. It was more a case of copying what seemed to work abroad rather than applying any theory of insolvency law to debtors' and creditors' situations. On this same basis of copying what is done elsewhere, the Accountant in Bankruptcy is proposing to introduce debtor education as part of the implementation of the Bankruptcy and Debt Advice (Scotland) Act 2014. This is already extensively available in the United States, where under the Bankruptcy Abuse Prevention and Consumer Protection Act 2005 debtors are required to undertake some education in the hope that it will increase debtors' financial literacy. Debtors need only undertake two-hour internet session and on payment of \$10 a certificate of completion of the education is produced. Although the American experience of debtor rehabilitation is compromised by the fact that a debtor with severe health problems is likely quickly to run into financial difficulties, and so the American experience is not necessarily replicable in Scotland, there was no reference in any of the recent Accountant in Bankruptcy documentation surrounding the Bankruptcy and Debt Advice (Scotland) Act 2014 to any theoretical research on the value of debt education or how it could be carried out successfully.

For these reasons, this critical appraisal does not address any further theoretical underpinnings of bankruptcy law.

Theories of law relating to diligence

If there was little evidence of any theoretical principles being applied to the law of bankruptcy within Scotland, there was even less within the law of diligence. The only concept approaching a principle, though not perhaps a theory, was that it should be possible in law for there to be a means of diligence exigible against every asset of a debtor's. For this reason the then Scottish Executive legal service department drew up legislation, duly enacted in the Bankruptcy and Diligence etc. (Scotland) Act 2007, which would have abolished adjudication for debt, and replaced it with land attachment. Residual attachment would then be used against any other asset of the debtor's not already subject to one of the other forms of diligence. These two forms of attachment were never brought into force, mainly for political reasons, since no politician wanted to be seen as the politician who brought forward legislation that caused debtors' homes to be sold for their debts. For this reason, theories of the law relating to diligence are not entertained in this critical appraisal and even if they exist, they were clearly redundant in this case.

Chapter 3

The balance between debtor and creditor.

Summary

This chapter explores the balance between debtor and creditor, in the context of company law by reference to an important recent case, and in the context of bankruptcy and diligence by reference to the changes introduced by the Bankruptcy and Diligence etc. (Scotland) Act 2007.

Company Law and the corporate veil

As is well known, the essential point of company law, as enshrined in the Companies Act 2006, is that the owners of a company (its members) are generally not obliged to bear any responsibility for their company's debts beyond what they have chosen to invest in the company. The company has a separate legal personality from its owners and managers, this division being commonly known as the "corporate veil". Directors generally bear no responsibility for a company's debts provided the company is solvent (and not approaching insolvency) and provided they are carrying out company business through their company. The qualification of "generally" is inserted to allow for those few occasions when liability may be attributed to the members or directors.

Not only is a director not liable for the debts of his companies, but the reverse is true too. By placing assets into a company, he ceases to be liable for those assets and they are beyond the reach of his personal creditors.

This was recently explored by the Supreme Court in the case of *Prest v Petrodel Resources Ltd*,³⁰ discussed in the fourth edition of *Company Law*. It is, however, a very apt demonstration of the first theme of this version of the critical appraisal.³¹ Although this case is primarily a case involving maintenance payments to an ex-wife, its importance from a company law point of view is that the Supreme Court took the opportunity to consider when the corporate veil may be pierced. Prest was the controlling shareholder in some companies

³⁰ [2013] 2 AC 415.

³¹ Some of the ideas and material which follows has been published in a slightly different form in *Piercing the corporate veil: Prest v Petrodel Resources Ltd*, 2014 Edin. L.R. 18(2), 275-279

which owned various properties within London. His ex-wife wanted an order from the courts enforcing the transfer of the properties by those companies to her. The companies that Prest controlled, and which owned the seven properties, had been in existence for some years, and in some cases had owned the properties before Prest's marriage. There was no suggestion that the companies had been set up as a method of avoiding any legal obligations, or that the companies were deliberately set up to evade an obligation or frustrate the operation of law, these being, at least in Lord Sumption's view, the occasions when the veil should be pierced.³²

The Supreme Court in due course found a means of ensuring that Mrs Prest received the order she wanted. This was done by the use of a deemed resulting trust under English law. In the process of coming to this solution to Mrs Prest's difficulties, Lord Sumption gave the concept of piercing of the corporate veil a thorough examination. Lord Sumption and Lord Neuberger were both determined to set out for the future the law on corporate veil-piercing, and they have restricted it only to those occasions when a company is being used to evade a legal obligation or frustrate the operation of law. Other recent corporate veil cases, *VTB Capital plc v Nutritek International Corpn.*³³ and *Chandler v Cape plc*³⁴ show a similar reluctance to pierce the veil, neither of these cases coming within these grounds.³⁵

In order to enlighten himself upon the manner in which other jurisdictions deal with the problematic issue of when the veil may be lifted, Lord Neuberger looked at piercing the veil in the Commonwealth and in the USA.³⁶ Defeated by the absence of consensus on when veil-piercing was permissible, he decided that it was almost impossible to specify exactly when the corporate veil should be pierced, and that perhaps the whole concept should be abandoned.³⁷ He then conceded that, given the weight of previous cases, Lord Sumption's

³² Per Lord Sumption at 36.

³³ [2013] UKSC 5, [2013] 2 WLR 398.

³⁴ [2012] 1 WLR 3111.

³⁵ It is interesting, however, that in the recent case of *Cramaso LLP v Viscount Reidhaven's Trustees*, (UK Supreme Court, 11 February 2014), the trustees tried to maintain that they could not be held liable for a statement made about the benefits of a lease of a grouse moor when the person to whom the statement was made was not the corporate body that ultimately leased the moor. The person to whom the statement was made used a limited liability partnership (of which he was a member) to take a lease of the moor. The statement turned out to be inaccurate. The Supreme Court did not accept the trustees' view, and held that it was foreseeable that the individual to whom the statement was made might not necessarily choose to take a lease of the moor in his own name but might instead use a corporate body in whose name the lease ultimately might be taken. Most cases of veil-piercing are to make a director or member liable for something that he is trying to avoid by using a corporate body. Here the veil is being "parted" (for want of a better word) to allow a benefit to a member to be attributed to his limited liability partnership.

³⁶ *Prest*, per Lord Neuberger at paras.75 to 78.

³⁷ Per Lord Neuberger at 79.

limited formula, of piercing the veil only where there was evasion of a legal obligation or the frustration of the operation of the law, was probably acceptable³⁸ – except where Parliament specifically allowed for it in statute.³⁹

An example of evasion of a legal obligation or frustration of the operation of law in Lord Sumption's eyes⁴⁰ was *Gilford Motor Co. Ltd v Horne*.⁴¹ However, many other past veil-piercing cases, in Lord Sumption's view, do not, strictly speaking, involve veil-piercing, but either are examples of concealment or occasions when some other legal method of resolving the matter, rather than veil-piercing, would achieve the proper result. In *Trustor A.B. v Smallbone*,⁴² for example, Lord Sumption said although this case came to an acceptable result, it was not a case where veil-piercing should have taken place. The proper remedy was that as the company was concealing the funds as agent or nominee for the director it was (in English law) a knowing recipient of the funds.⁴³ Where there is fraud, the presence of an intermediary company ostensibly committing the fraud is irrelevant, as the better remedy is against the fraudster with whom the company may be jointly and severally liable. This is because fraud never leaves the fraudster - as indicated in *Standard Chartered Bank v Pakistan National Shipping Corporation, (No.2)*⁴⁴ by Lord Rodger's pithy words: *Culpa tenet suos auctores*.⁴⁵

Overall, to use Lord Sumption's own words, "There is a limited principle of English law which applies when a person is under an existing legal obligation or liability or subject to an existing legal restriction which he deliberately evades or whose enforcement he deliberately frustrates by interposing a company under his control. The court may then pierce the corporate veil for the purpose, and only for the purpose, of depriving the company or its controller of the advantage that they would otherwise have obtained by the company's separate legal personality. The principle is properly described as a limited one, because in almost every case where the test is satisfied, the facts will in practice disclose a legal

³⁸ Per Lord Neuberger at para.81.

³⁹ As for example, Insolvency Act 1986 s.43, and Matrimonial Causes Act 1973 s.37.

⁴⁰ Or so he says at para.29. Ironically, Lord Neuberger does not seem to share Lord Sumption's view of this case, as may be seen at paras. 69-72 where Lord Neuberger seems to suggest that this case could have been decided by reference to agency rather than piercing the veil.

⁴¹ [1933] Ch. 935.

⁴² [2001] 3 All E.R. 987.

⁴³ In a sense, it makes no difference whether the funds were being hidden in a company or in any other agent's bank account: whoever had the funds was required to return the funds to the true owner.

⁴⁴ [2002] 3 W.L.R. 1547.

⁴⁵ This succinct phrase is not easily rendered into English. Not only does it mean that someone who does something improper cannot pass the blame or liability onto his subordinates, but it also means that the responsibility for an improper act attaches to or remains with the person who arranged it.

relationship between the company and its controller which will make it unnecessary to pierce the corporate veil. Like Munby J in *Ben Hashem*,⁴⁶ I consider that if it is not necessary to pierce the corporate veil, it is not appropriate to do so, because on that footing there is no public policy imperative which justifies that course.”⁴⁷

All the Justices of the Supreme Court agreed with Lord Sumption’s point in the paragraph above. Their reasons for doing so may not have been entirely consistent, Lord Neuberger in particular being at variance with Lord Sumption as to when exactly concealment took place. However, the overall point from the point of view of the first theme of this critical appraisal is that the corporate veil is not to be lightly pierced and where it is pierced it should be on the two grounds indicated. Outside those two grounds some other method of establishing liability must be found. It is of course a great deal easier to pierce the veil where both the company and the individuals are easily identified, (perhaps by being single member companies), and when it is possible to see the company being controlled by the individual concerned in an effort to avoid the individual’s obligations.

Where there is a difficulty (in terms of the first theme) with this decision is that if a company is large enough, and there is enough diffusion of responsibility for its actions amongst subordinate employees, where a company is used to evade a responsibility or to frustrate some enforcement of the law, provided the directors are not seen to be controlling such activity, or preferably not even knowing about it, the two permissible veil-piercing grounds might in theory apply, but while the victim may have grounds for relief against the company (assuming it is still solvent), he may have trouble proving that there was a controlling shareholder making the company evade a legal responsibility or frustrate the operation of law. In a small company controlled by one person there would be no difficulty as the evasion or frustrating can be clearly identified as coming from that person. In a large company this is another matter.

What is left unaddressed, not least because it would not have had any bearing on the *Prest* decision, is how wide the terms “evasion of legal responsibility to which a person may be subject” and “frustration of the operation of law” should be. Is this only restricted to relatively small scale operations, such as in *Gilford*, when an artful individual or a holding company interposes a (subsidiary) company as a way of getting round some (perhaps

⁴⁶ *Ben Hashem v Al Shayif* [2009] 1 FLR 115.

⁴⁷ *Prest*, per Lord Sumption at 35.

contractual or delictual) obligation which he or the holding company knows perfectly he or it should be fulfilling? The answer to this seems to be “Yes”, in which case the opportunities for veil-piercing are thin indeed. In particular, veil-piercing would not appear to be available as an option when dealing with directorial or controlling shareholder involvement in breaches by their companies of regulatory law. As will be discussed in Part 2 of Chapter 4, it is surprising that directors of controlling organisations where questionable activities are taking place remain, so far, free from liability for the activities over which they will have presided and known about in general, if not necessarily in detail. It also seems inequitable that a holding company, having enjoyed the profits of a subsidiary, can close the subsidiary down without responsibility for any wider consequences of that closure.

Conversely, if directors or controlling shareholders are liable to customers for every dubious action of that company, no-one would wish to become a director or controlling shareholder of a company and business would go to other more business-friendly jurisdictions. There is no solution to this conundrum. Lord Neuberger was understandably perplexed. There is no satisfactory balance to be found between the company as debtor and its creditors, and no perfect formula for veil-piercing. As far as companies are concerned, the balance is now firmly in favour of the debtor (the company). Our law has made an artificial construct, the limited company, and given it an advantage relative to other methods of running a business. This is the price for the promotion of trade within the United Kingdom. The greater good to society from having limited companies and the opportunities for commerce that they bring outweigh the occasional unfairness in individual circumstances.

Furthermore, whether or not one agrees with the Justices of the Supreme Court, what they have stated now becomes the law until such time as they revisit their own decision.

Bankruptcy Law and Diligence

Part of the intention of the Bankruptcy and Diligence etc. (Scotland) 2007 Act was to improve the law relating to bankruptcy and to enable debtors to apply to the Accountant in Bankruptcy for their own sequestration. The Act also made some changes to Debt Arrangement Programmes. It tidied up the law relating to diligence on the dependence and tried to extend the principle of the applicability of diligence to all assets of a debtor.

Reduction of bankruptcy to a period of one year

This part reduced the period of bankruptcy from three years to one year, save where the debtor has not co-operated with the trustee in sequestration.⁴⁸ The period was reduced to one year because that is the period in England and Wales. It is one year in England and Wales allegedly because the then Minister for Trade, Peter Mandelson, was in Texas and discovered that the period of bankruptcy there is one year. Mandelson was allegedly impressed by this on the grounds that a reduced period of bankruptcy would encourage the promotion of new businesses. The Enterprise Act 2002 therefore allowed for one year bankruptcy in England and Wales.⁴⁹ As stated in the previous chapter, there is no evidence to establish whether or not the reduced period of bankruptcy has made any difference to entrepreneurs or to their enthusiasm to start again in business. The UK is nevertheless a debtor-friendly country compared to Germany, where debtors remain as bankrupts for up to six years. The balance in this country has certainly been tipped in favour of the debtor.

Bankruptcy restrictions orders and undertakings⁵⁰

These have also been introduced from England and Wales and may be imposed by the sheriff to prevent the debtor carrying out various activities, such as being a company director, borrowing certain sums of money or holding public office for a period of time. Debtors may apply for their own undertakings, usually for a lesser period of time. The AiB now maintains a list of debtors subject to these orders and undertakings.⁵¹ Breach of the order or undertaking gives rise to criminal sanctions. Being on the AiB's list enables members of the public to find out useful information about the debtor and the AiB's website regularly reports occasions when debtors have been caught breaching their orders or undertakings. Although it is not perfect, it provides a degree of protection for creditors against unscrupulous debtors.

Debtor applications

These have already been mentioned and allow debtors to apply for their own sequestration from the Accountant in Bankruptcy instead of from a sheriff.⁵² The current three methods of

⁴⁸ 2007 Act s.1.

⁴⁹ At s.256.

⁵⁰ 2007 Act s.2

⁵¹ See <http://www.aib.gov.uk/About/annualtargets/BROBRU/bankruptcyrestrict>

⁵² 2007 Act s.14.

application, these being the standard one, the Low Income Low Asset application, and the Certificated application now make it relatively easy for debtor to apply on line for their own awards of sequestration, though ironically the £200 application fee still deters some debtors and there have been occasions when debtors have had to apply to charities to obtain the £200 needed to apply for their own sequestration.⁵³ But in principle, this has been beneficial for the indigent, and enabled debtors to be freed from the burden of debts they could never pay.⁵⁴ The recent changes in the Bankruptcy and Debt Advice (Scotland) Act 2014 with the Minimal Assets Procedure will make it even easier for debtors to apply for their own bankruptcy. The balance here has undoubtedly been tipped in favour of the debtor.

Various reforms to the debtor's position

The 2007 Act provided for various means of ensuring that if debtors were earning an income, some of their income could be applied towards their creditors, one of these means being debtors' employers deducting a portion of the debtors' wages and paying them to the trustee for the benefit of the creditors. However, it did not go far enough. The Bankruptcy and Debt Advice (Scotland) Act 2014 is to introduce a standardised means of assessing the extent of a debtor's contribution to his creditors out of his income. This is known as the common financial tool.⁵⁵ Standardisation of debtors' contributions should benefit debtors and creditors alike. The provision of debt advice to anyone considering sequestration should, ideally, at least improve debtors' understanding of the significance of sequestration or other means of repaying creditors⁵⁶: this too should benefit both debtors and indirectly creditors, as should (if it is carried out properly) financial education for the debtor.⁵⁷

Protecting the innocent purchaser from the consequences of his ignorance of a debtor's sequestration

One of the more enlightened matters introduced to the Bankruptcy (Scotland) Act 1985 by the Bankruptcy and Diligence etc. (Scotland) Act 2007 were the new provisions in s.32(9ZA) which were expressly designed to protect a person purchasing property from a debtor at a

⁵³ Private information from Penicuik Citizens Advice Bureau, May 2013.

⁵⁴ A further method, the minimal assets process, is proposed in the Bankruptcy and Debt Advice (Scotland) Bill at present before the Scottish Parliament.

⁵⁵ See Bankruptcy and Debt Advice (Scotland) Act 2014 s.3.

⁵⁶ S.1.

⁵⁷ S.2

time when the debtor was newly sequestrated but the purchaser was genuinely unaware of this, and had in good faith paid money to the debtor for the property – but the debtor had not delivered the disposition in favour of the purchaser before the sequestration took effect. Historically this would have been unfortunate for the purchaser. He would have lost both his money and his chance of the property, and the trustee in sequestration would have received the windfall of payment for the property while being able to retain the property. The purchaser might have had a remedy against his solicitor or searchers in the Register of Inhibitions and Adjudications. A legal remedy is all very well, but most purchasers would rather have the house that they wanted than a right to sue their solicitor. Scots law introduced an exception to the normal *pari passu* rule by saying that under these exceptional circumstances the purchaser has a limited window of opportunity within which to register his deed at the Land Register. Although, as far as is known, there has been no occasion when this sections has had to used, it is nevertheless a striking example of repairing the balance between debtor and creditor, in this case in the creditor’s favour.

Land attachment

This was possibly the most contentious part of the 2007 Act but it has yet to be brought into force and possibly never will be brought into force. Part 4 of the 2007 Act was intended to replace adjudication for debt, and to provide a remedy for a creditor to force the sale of heritable property owned by a debtor. A similar process exists in England, known as a charging order, and there are similar processes in most other countries. The process in Scotland was carefully worked out by the Parliamentary draftsman, with multiple opportunities for the debtor to object to any hardship or procedural flaw in the process, but once the SNP were in power in the Scottish Parliament, the then First Minister refused to bring Part 4 of the 2007 Act into force. Nominally this was because, as drafted, the Act allowed a creditor to carry out land attachment for as little as £3,000 and it had the effect of converting an unsecured debt into an unsecured debt. This was seen as fundamentally unfair. He was also not willing to let land attachment be used against a debtor’s own home, since that might potentially increase homelessness.⁵⁸ It is possible that the First Minister did not wish to implement, and therefore be responsible for, a new form of diligence that might

⁵⁸ See the First Minister’s speech to the Citizens Advice Scotland Conference, 15 August 2007, available at <http://www.scotland.gov.uk/News/Speeches/Speeches/smarter/CABx>

conceivably be used against his own party's supporters. Land attachment remains unimplemented and there have been no recent suggestions that the matter is to be revisited. A creditor who wishes to extract payment from a heritage-owning debtor must at present use the diligence of adjudication for debt. His alternative is to sequestrate the debtor which not only can have serious effects upon the debtor's family and indeed the debtor's business or employees, but may be more than the creditor wishes to achieve. What could have been a creditor-friendly move was rejected at a political level, though it might not have been impossible to restrict the use of land attachment to commercial property or second homes, or property owned by bodies other than natural persons.

Residual attachment

As land attachment was not brought into force, residual attachment could not be brought into force either. It was not wholly clear to what it would apply, other than to any property not subject to any other type of diligence. It is suggested that it might have applied to property such as the right of a landowner to grant fishing permits to those fishing on his water, or the right to charge admission to a country house. But as it looks unlikely to be brought into force, it is unlikely that the law will be tested to see what it does cover.

Debt arrangement programmes ("DAPs")

S.211 of the 2007 Act allowed the Scottish Ministers to make further regulations about DAPs. DAPs are means whereby a debtor, with the help of a money adviser, can set up a programme whereby a portion of his income is applied to a payments distributor who then makes payments to his various creditors, all as set out in the DAP devised by the money adviser. Creditors are informed of the proposed DAP and unless the required percentage positively object within a limited time, the DAP is deemed to be accepted by the creditors. Most creditors are relieved when they hear that a debtor is in a DAP because their chances of being repaid are usually much improved. Entering into a DAP prevents further diligence being carried out against the debtor and prevents him being sequestered (assuming the payments are kept up). The regulations referred to above allowed interest and charges to be written off from the date of the application to the creditors. They also allow payment holidays and breaks if the debtor is severely ill or unemployed. The take-up of DAPs has been very patchy throughout Scotland, some areas, noticeably Lanarkshire, having quite large numbers, and others very few. To some extent the take-up depends on the availability of money advisers. It also depends on the debtors having enough disposable income or a secure job to

enable them to enter into the DAP. DAPs seem to be suitable for debtors who are employed but are not good at managing their money and need help in looking after their financial affairs. The changes referred to above make DAPs very much more attractive to debtors, and in practice creditors are relieved that someone is ensuring that the debtor is paying something towards his outstanding debts.

Diligence on the dependence

The 2007 Act introduced various changes to the law of diligence on the dependence, in particular giving debtors much greater rights to object to diligence on the dependence. In the case of arrestments of non-corporate debtors' bank accounts, the first £415 is unarrestable,⁵⁹ and there are restrictions on the amount that may be arrested. It is for the creditor to prove that diligence on the dependence is necessary and should remain in place, if a challenge is mounted to it. Although the legislation is helpful to creditors in that it is put on a clear statutory basis rather than the previous common law, safeguards have been put in place to prevent its oppressive use.

The overall extent to which the 2007 Act affects the balance between creditors and debtors

The 2007 Act undoubtedly brought in some improvements for debtors. They can certainly more easily apply for their own sequestration and be relieved of their debts than was the case before. The rules for arrestment and inhibition have been clarified as have the rules for arrestment and inhibition on the dependence, and interim attachment. Whether or not those rules are better than they were before, they are certainly easier to find and they are broadly consistent with each other. There are many provisions to protect debtors from rapacious creditors, such as the ability of the sheriff to suspend diligence where it would be “unduly harsh” The balance does now favour the debtor more than it used to, and the legislation has achieved this by implementing a number of small but workable changes. The main exception to this is money attachment, which, although providing many opportunities for debtors or others to have their interests taken account of, is a further weapon in the armoury of creditors, and not one that existed before. However, as explained in the previous chapter, it is not a noticeably effective diligence and is easily evaded.

⁵⁹ Debtors (Scotland) Act 1987, s.73F. The benefit of this provision is somewhat reduced by the reality that most human debtors subject to arrestment have no money in their bank accounts anyway.

Had land attachment and residual attachment been brought into force, they would have added to the creditors' armoury, and consequentially reduced the range of assets that could not be handed over to a creditor. As land attachment has not been brought into force, it is not possible to know by how much creditors' positions would have improved; instead their alternatives remain inhibition, adjudication or sequestration.

Conclusion

In an Utopian world, creditors and debtors would have equal rights, neither would wish to take advantage of the other and there would be no opportunity to do so. The changes to the law within the Bankruptcy and Diligence etc. (Scotland) Act 2007 suggest that at least within the Scottish Parliament's eyes, the balance in respect of much bankruptcy legislation and the law of diligence was not as fair to the debtor as it might be. While easing the burden in some respects for debtors, the original intention was that nearly all of a debtor's overall assets could have been subject to diligence, and in particular their heritage or any other assets which could have been subject to residuary diligence. For political reasons, and perhaps mindful of debtors' interests, this intention was not fulfilled. The balance is more tipped in favour of the debtor than it was.

In company law, the *Prest* case tips the balance in favour of the company at the expense of the creditor. This has always been the case, and is the key point of limited liability – but this case makes it harder than it might have been previously for creditors to have a right of relief against the owners of companies except under the two limited circumstances outlined previously. While it is possible that this may lead to some degree of irresponsibility by company owners, the Supreme Court appears willing to trade that risk with the overall benefit to the economy of allowing limited liability to be as limited as it is.

Chapter 4

The use of the law to alter business and social behaviour

The tension between the intention of the legislation and the actuality

Summary

This chapter discusses the two above themes, which as noted in the Introduction, have some degree of overlap, first in the context of bankruptcy and diligence, and then, in much greater length in Part 2 in the context of company law and of directors' duties in particular. Section 172 of the Companies Act 2006 was introduced to try to influence directors' behaviour. The evidence is that despite what directors said they were doing, they were not paying any attention to the Government's wishes. The legislation was misunderstood by politicians, flawed and unrealistic. A better alternative drawn from Irish legislation is suggested instead.

Part 1.

Bankruptcy

As has been previously explained, historically bankruptcy in Scotland was only suitable for merchants and landowners.⁶⁰ The cost was high and an order for sequestration could only be obtained from the sheriff court or the Court of Session. The Bankruptcy and Diligence etc. (Scotland) Act 2007 made a significant change, allowing debtors to apply directly to the Accountant in Bankruptcy provided they came within certain parameters as to the extent of their indebtedness and their assets and provided they had not been sequestrated within the previous five years. Since 2007 there have been changes to the legislation to make it progressively easier for debtors to apply for their own sequestration.

The rationale behind making sequestration easier to obtain was because it was apparent that debtors were in an invidious position. It was not generally worth a creditor's while sequestrating a debtor, The only alternative was to execute diligence against the debtor, assuming he had any assets or earnings against which to carry out diligence. If the debtor had no such assets or earnings, the creditor either wrote off the debt, sold the debt, or continued to

⁶⁰ For a review of the law of bankruptcy in Scotland, see Grier *Bankruptcy Law in Scotland: past, present and future* 2014 Scottish Parliamentary Review 25.

pester the debtor until the debtor, in desperation, paid up. Many debtors were experiencing anxiety and ill –health as a result of pressure from their creditors.

The main creditors were finance companies and local authorities trying to obtain arrears of council tax. During the late 1980s and early 2000s credit became much more easily available and debtors took advantage of this, not always wisely. As for council tax arrears, the local authorities were in a difficult position. They needed the money to pay for the social services provided by the authorities, but council tax was and still is an unpopular tax, not always supported by the authorities' own councillors. Local authorities could not afford to be seen as a “soft touch” by debtors unwilling to pay the council tax, but equally it was politically unacceptable to be too draconian in trying to extract payment from clearly indigent debtors. Relaxing the rules on sequestration, to make it easier for debtors to be relieved of their debts, provided a face-saving solution for local authorities. It might also make finance companies marginally more cautious in supplying credit. It has enabled debtors to apply successfully for their own sequestration and provided relief where relief was not available before.

In 2007 it was hoped that the greater ease of sequestration would mean that it would become less socially unacceptable to be made bankrupt and that the stigma of bankruptcy would be removed. There does not appear to have been any research on social attitudes to the perceived stigma of bankruptcy and it is therefore difficult to know to what extent the stigma has been removed. Realistically it is unlikely to be removed entirely even when the bankruptcy is not the debtor's own fault. Few parents nowadays, even after attempts to destigmatise bankruptcy, would be entirely comfortable if their only child sought to be marry a bankrupt. It was also originally thought that reducing the period of sequestration to one year rather than the three years it had been previously would have the effect of encouraging entrepreneurial activity within Scotland. Again, there does not appear to be any research to have established whether or not the reduction to one year made any difference at all. What was apparent was that if in England and Wales bankruptcy only lasts one year, it would be anomalous if Scotland had a longer period. If the law was being used to alter business and social behaviour, its efficacy is not evident.

The introduction of bankruptcy restrictions orders and undertakings was done explicitly to protect the public and to persuade debtors to behave better. It is difficult to establish whether or not the latter laudable aim has been achieved. It would appear likely that it will have a positive effect on the more responsible debtors. Debtors are, however, not always very

responsible. By way of comparison, Craig Whyte, the erstwhile owner of Rangers Football Club, had previously received a company director's disqualification order of seven years' duration. It clearly did not prevent him indulging in the sort of activities that caused him to be given a further 15 year disqualification.

Diligence

In an ideal world, creditors would not need to use diligence as debtors would pay their bills on time. The reality is otherwise. Debtors do not always pay their debts. Diligence exists to make debtors realise that debts do have to be paid. Drafting the law on diligence is particularly complex as the law must both allow the creditor the right to be repaid by seizing some assets or earnings of the debtor, but it must not be done in such a way that it is oppressive and unfair on the debtor. But the more opportunities that are given to the debtor to frustrate, delay or prevent the creditor obtaining payment, the more costly the process is, and that cost is then factored into the cost of a loan or the availability of a loan, or the provision of goods or services to the debtor. The debtor ultimately will have to bear the costs of the process.

A further difficulty is that the law has to find a means of enforcing payment from the "won't pay" debtor as well as being merciful to the "can't pay" debtor. The aim behind extending diligence to all assets of a debtor's, including land, was to catch the "won't pay" debtor who has heritable assets. A hypothetical example would be that of an indebted and alarming gangster who is sufficiently threatening that sheriff officers are unwilling to carry out an attachment of moveable property at his home. By carrying out land attachment (had it ever been implemented) the gangster would ultimately have lost ownership of his house and his creditors might have been repaid. While there is clearly merit in extracting payment from debtors who own heritable property and could pay their debts but refuse to do so, the price for the introduction of land attachment would be the possibility that it could be used oppressively against debtors who have nowhere else to live and no means of repaying their debt. In those circumstances the creditors have the option of sequestering a debtor or inhibiting him, the latter usually being effective at some stage.

As was previously indicated, land attachment never was brought into force, mainly for political reasons, but also because it had the effect of turning an unsecured debt into a secured one. Notwithstanding that most countries have a method of forcing sales of debtor's property,

it was decided not to implement land attachment and leave creditors to the slower remedies of adjudication for debt, inhibition, or sequestration (or liquidation for companies).

As for the other new type of diligence that was introduced by the Bankruptcy and Diligence etc. (Scotland) Act 2007, money attachment, it has been already been mentioned that while the process can operate in terms of the legislation, in practice it is not very effective as debtors no longer keep cash in places such as tills where sheriff officers can seize the money. Anecdotally what appears in practice to be more effective is the presence of sheriff officers using any form of attachment in, say, a debtor's shop, causing the shop-owner extreme embarrassment and causing customers to go to other, more reliable, businesses for their purchases.

Part 2

Company law

This part analyses in detail s.172(1) of the Companies Act, 2006. Since the most recent edition of *Company Law* was written, there has been the opportunity to see to what extent s.172 has actually been used in practice. In order to review the effect of this section within the Act, it is necessary to consider the background to it.⁶¹

During the 1990s the then Department of Trade and Industry set up a Company Law Steering Group to look critically at many aspects of company law, at the time regulated under the Companies Act 1985. After much deliberation it produced *Modern Company Law for a competitive economy – the Final Report*.⁶² This Report took evidence from a wide range of interests and experts on how to improve company law. Existing company law was seen to be full of unnecessary rules, to be confusing for company directors, and not wholly conducive to the setting up of businesses or retaining businesses in the UK. The Companies Act 2006 eventually was developed from this Report. The opportunity was taken to enshrine in statute various European company law requirements⁶³ and to tidy up the law relating to capital maintenance. Many other uncontroversial, sensible and worthwhile reforms were made to the process of incorporating companies, managing them, and removing them from existence.

⁶¹ What follows forms much of my article, *Enlightened shareholder value: did directors deliver?* 2014 Juridical Review 85.

⁶² Published by the DTI in July 2001

⁶³ In particular the EC Thirteenth Company Law Directive on Takeover Bids (2004/25).

However, there were some controversial parts, and one that was at the time possibly the most controversial finally emerged as section 172(1), shown below.

Duty to promote the success of the company

(1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to—

(a) the likely consequences of any decision in the long term,

(b) the interests of the company's employees,

(c) the need to foster the company's business relationships with suppliers, customers and others,

(d) the impact of the company's operations on the community and the environment,

(e) the desirability of the company maintaining a reputation for high standards of business conduct, and

(f) the need to act fairly as between members of the company.

This sought to move the law away from the classic view that the paramount concern of directors was to maintain shareholder value: the directors were not obliged to take anything else into account except insofar as it benefitted the company and thereby indirectly the shareholders. In short, directors were not expected in their management of the company to display any particular sense of social responsibility: that might be a job for politicians but was not the job of directors. The best known exposition of this approach was put forward by the economist, Milton Friedman.⁶⁴ In his view anything other than making profits was effectively a tax on shareholders. Such a view was not held by the advancers of the CA 2006 s.172(1) who took the wider view that although directors should act in a way that benefits the shareholders, they should in the process positively take account of other stakeholders in the

⁶⁴ “There is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.” New York Times, 13 September 1970.

company, and should act in a thoughtful, inclusive way, looking to the future, considering the implications of their decisions for their customers, creditors, employees, the local neighbourhood, shareholders generally (as opposed to any favoured group of shareholders) and establishing a reputation for “high standards of business conduct”. The essential duty of the directors was to promote the success of the company and in the process to “have regard” to these various requirements. This was said to lead to “enlightened shareholder value” on the grounds that directors who did this in the long run would create favourable conditions for the long-term prosperity of the company itself, its shareholders and its employees.⁶⁵

Controversial wording

Section 172(1) attracted controversy for various reasons, mainly because from a lawyer’s point of view it is vague and confusing. It is not clear how much regarding is necessary, or how regarding needs to be evidenced. The legislation does not explain if it is necessary specifically to have regard to each item in turn and to have noted it down in board minutes. The list of matters to which the directors should have regard does not indicate what should happen if regarding one matter causes problems for another matter. The words “promote the success” of the company are not explained, nor is there any indication as to who decides what is meant by “success”.

The Government indicated that the regarding should not be a mere box-ticking exercise⁶⁶ and that directors should genuinely try to engage with the requirements of the legislation; it is clear that the choice of the words “have regard” was deliberate.⁶⁷ Regarding is also something more easily carried out in a large company by a large board of directors with a company secretary. It is less likely to be carried out, if at all, by a small unaudited company with one or two shareholders. In practice, at least in a large company where corporate governance is taken seriously, the minutes of board meetings will record the fact that directors duly took account of the requirements of s.172(1). If there is any particularly contentious matter that would have a significant impact on any of the matters in s.172(1) the minutes will generally go into more detail to prove that the directors genuinely did have regard to that matter and did not arbitrarily make their decision without proper consideration. The point is that directors should have been seen to have at least had “regard” to the matter, even if in fact they made a decision that was detrimental to the particular matter under

⁶⁵ See Lord Sainsbury of Turville’s speech in the House of Lords on 11 Jan 2006 HL Col.244.

⁶⁶ See Lord Sainsbury above at Col. 245.

⁶⁷ See Alastair Darling’s speech in the House of Commons at Hansard, HC Vol. 447, col.125 (June 6, 2006).

consideration. It would appear that provided that there is a paper trail to show that the matters have been thought about, that would be evidence enough to a court or to a liquidator that the directors had been carrying out their task properly. The problem with the phrase “have regard” would appear to lie in the fact that it meant one thing to politicians and another to lawyers. It is a phrase that can accommodate a wide range of meanings depending on what one wants it to mean. Such a phrase is not ideal in legislation.

The duty owed to the company

The obligation to “have regard” to the various matters in s.172(1) is a duty owed by the directors – but a duty that is not owed to, say, the environment or the employees, but, as specified in s.171, only to the company. This means that a representative of the environment (a local councillor, perhaps) or an employee affected by a decision of the directors, has no standing under s.172(1) under which to sue the directors. Only the company, the collective body of shareholders, (or a member exercising a derivative claim on behalf of the company) may exercise the sanction of suing the directors for the directors’ failure to “have regard” to those matters. This would presuppose that the collective body of shareholders (who might, in any case, be the same people as the directors) feels sufficiently strongly about the matter to bring an action against the directors for the directors’ failure to have regard to the environment or the employees.

A graver threat to the directors is that if the company went into liquidation, the liquidator would then represent the collective body of shareholders, and could investigate the then directors’ decision-making by reference to past minutes, and if necessary, take action against the directors for their failure to “have regard” to any of the matters in s.172(1).⁶⁸ The failure to have regard could also be seen as misfeasance under s.212 of the Insolvency Act 1986. Another threat to directors who have been failing to “have regard” is when the existing shareholders, or a majority thereof, sell their shares to a purchaser who then has control of the company. The purchaser might choose to examine the company’s past board minutes and see the extent to which the directors had failed to “have regard”. If the directors had taken some contentious decisions, and there was no evidence that in doing so they had had regard to the matters in s.172(1), it might be open to the purchaser, now representing the company, to raise an action against the directors for breach of their duty.

⁶⁸ It may also be open to the liquidator to use the provisions of s.172(3) against directors who under common law had failed to consider the interests of creditors when the directors could see the company was in financial difficulties: *Re HLC Environmental Projects Ltd*, [2013] EWHC 2876 (Ch).

This approach (that in principle only the company could sue the directors for their failure to take account the requirements of s.172(1)) was based on Companies Act 1985 s.309 which used the same principle. This was introduced into the Companies Act 1980 by the then Conservative government. While Professor Davies in Gower and Davies *Principles of Modern Company Law*⁶⁹ asserts that it was not clear whether the draftsmen of s.309 were adopting a pluralist approach (i.e. employees in their own right are a specific matter of consideration by directors, separate from the directors' concern for shareholders) or an enlightened shareholder value approach (i.e. that employees were a matter, but one of many others, that should be considered in terms of what was best for shareholders), it is suggested, though it cannot be unequivocally established, that the ambiguity of s.309 was deliberate. As part of the UK's entry to the EEC, now European Union, in 1973 there was an expectation that UK company legislation should give recognition to workers' rights⁷⁰, a view supported by some in Europe but not a view always held by directors within the UK. The UK Government, at that time under a Conservative administration, produced a form of wording for s.309 which looked as though directors had to consider workers' interests (thus apparently satisfying the EU requirements) but the requirement to do so was actually a duty owed to the company, not to the workers themselves (thus not actually fettering directors' capacity to manage their companies).⁷¹ In practice, this rendered the section almost worthless, as may possibly have been intended. Unless the employees formed a majority of the shareholders, there would be little occasion for the shareholders to exercise their rights under s.309. Despite the fact that s.309 was toothless, when the time came to reform the law for the CA 2006, the then Government (by this stage under Labour control) chose to use the same principle for s.172(1).

The predicament for Parliament

The decision to limit the extent of directors' responsibility to having "regard", and for only the company to be able to enforce this duty, was taken in the knowledge that anything more

⁶⁹ At 16.33

⁷⁰ *Employee participation and company structure in the European Community*. COM (75) 570 final, 12 November 1975. Bulletin of the European Communities, Supplement 8/75

⁷¹ The wording of s.309 was as follows:

- (1) The matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company's employees in general, as well as the interests of its members.
- (2) Accordingly, the duty imposed by this section on the directors is owed by them to the company (and the company alone) and is enforceable in the same way as any other fiduciary duty owed to a company by its directors.
- (3) This section applies to shadow directors as it does to directors.

onerous could be seen as a positive deterrent to entrepreneurs setting up companies in the UK or existing businesses staying in the UK. If any stakeholder, as opposed to the company, could sue the directors for the directors' failure to have regard to the stakeholder's interests, few directors of companies would wish to keep their businesses in the UK. This was a good reason for not extending rights to the stakeholders themselves.⁷² It is also possible, but probably impossible to establish, that the restricting to the company of the right to sue directors for breach of their duty to have regard to the various matters in s.172(1) was a legal point not wholly comprehended by all MPs at Westminster. Owing a duty to a company to promote the success of a company by having regard to various matters is a complex concept for those not versed in company law. However, it gives the superficial impression that stakeholders' interests will at least be considered, or ought to be considered by the directors, and that there is a sanction for non-performance by the directors.

As already indicated, the sanction for non-compliance, an action by the company against the directors, is very unlikely to take place unless the general body of shareholders is uncharacteristically selfless. The fact that its previous iteration in s.309 of the Companies Act 1985 had not obviously proved effectual in safeguarding employee interests did not prevent its use in s.172(1). It is as if the politicians promoting it touchingly thought that this time it might work – or perhaps no-one could think of any better solution to the incompatible objectives of politicians' not wishing to stifle directors' desire to manage their companies without too much hindrance from the law, and politicians' desire to make directors take account of wider social interests when managing their companies. Although there were attempts to clarify the meaning of the section by amendment at the time that it was being voted upon by the House of Commons, the amendment was withdrawn to avoid a potential later battle within the House of Lords, with Margaret Hodge giving a spirited defence of the existing wording, confident that it would achieve its intended purpose. The wording was duly approved without further discussion and with a comfortable majority.⁷³

The extent to which s.172(1) has been discussed in the courts

⁷² At the time of the House of Commons second reading discussion on this section of what was then the Companies Bill, (17 October 2006) various MPs alluded to lobbying by the Trade Justice Movement and the Corporate Responsibility Coalition both of which would have preferred stronger sanctions against directors: see <http://www.tjm.org.uk/trade-issues/past-campaign-success/28-massive-public-campaign-changes-accountability-law-for-corporations-2006/229-companies-act-a-move-forward-to-right-corporate-wrongs-.html> and http://corporate-responsibility.org/wp-content/uploads/2009/09/Companies_Bill_Supporter_Verdict_Long_Nov06.pdf

⁷³ Hansard, House of Commons, 17 October 2006, column 790.

Since s.172(1) of the Companies Act 2006 came into force⁷⁴, as explained in the next paragraph, there have been a few cases that refer to s.172(1)(f), where the petitioner is a member of the company and seeking redress for the benefit of the company for not being treated properly⁷⁵, but only one⁷⁶ where there was an attempt to raise an action for the failure to have regard to the various matters in s.172(1)(a)-(e). This could mean that:

- although the right to raise an action in respect of any of those matters exists, such a right is not a realistic way of solving a problem involving directors' neglect of the stakeholder interests indicated in s.172(1)(a)-(e);
- liquidators have other, generally more certain, means of seeking redress from past directors (in particular, s.172(3));
- liquidators and incoming shareholders are not particularly interested in whether or not the past directors had regard to any other stakeholders, or are not prepared to spend money finding out;
- most shareholders do not know about s.172(1)(a)-(e) or if they do, do not care about it enough to do anything about it;
- the cost of bringing a petition puts potential litigators off;
- even if the petitioner has a point, the bad publicity that would be attracted to the company by a court case would probably have a deleterious effect on the company's share price;
- if there are problems with a listed company's directors, by far the easiest solution is to sell its shares⁷⁷;
- directors are often not worth suing.

The derivative claim

⁷⁴ 1st October 2007.

⁷⁵ For example, *West Coast Capital (LIOS) Limited*, Petitioner, [2008] CSOH 72.

⁷⁶ *R.(on the application of People and Planet) v H.M. Treasury*, [2009] EWHC 3020 (Admin), discussed shortly. This was not actually an action against the directors but a review of the way that the Government as the majority shareholders was running the company.

⁷⁷ Petitioning the court about the directors' decision-making would be expensive and might even lead to the share price being adversely affected.

Hitherto it has been suggested that to enforce s.172(1), the company would have to take action against a director. This could be done by a derivative claim, a statutory procedure, provided for under ss.365-369 of the Act, which allows a shareholder, on behalf of the company, to raise an action on the company's behalf and for its benefit against a director. There already has been a number of cases, in every case so far in small companies, where a shareholder has taken advantage of the new derivative claim to petition the court for redress for some mischief done to the company by a director.⁷⁸ Under the derivative claim, an aggrieved shareholder who believes that a director has neglected his duty to promote the success of the company for the benefit of its members as a whole may petition the court for permission to represent the company in an action against that director. The petitioner has to persuade the court that he has a *prima facie* case⁷⁹ against the director for the director's breach of duty, and if the petition is successful, and the court allows the case to proceed with the shareholder now representing the company, any damages payable by the director for his failure to promote the success of the company would be payable to the company.⁸⁰ A good example is *Hughes v Weiss*⁸¹ where a company was set up by two lawyers with the intention of providing consultancy advice on various financial matters. Both lawyers had equal shares in the ownership and management of the company, and both were directors, but Weiss took it upon himself to seize a large proportion of the company's funds, claiming that he was entitled to it for various reasons which the judge found unconvincing. The court held that Hughes had made out a *prima facie* case that Weiss had failed to act fairly as between the members in terms of s.172(1)(f).⁸²

Indeed, the case law to date on derivative claims at present seems to be limited to members being treated badly by the directors in terms of s.172(1)(f) (acting fairly as between members of the company). Only one reported case so far has been an attempt to get anyone to pay attention to the matters in s.172(1), (a)-(e). This case was *R.(on the application of People and Planet) v H.M. Treasury*,⁸³ where a pressure group sought judicial review of the way that a Government company, UK Financial Investment Ltd, which represented the Government's

⁷⁸ For example, *Wishart Ptnr* [2009] CSOH 20; *Phoenix Contracts (Leicester) Ltd* [2010] EWHC 2375;

⁷⁹ For an explanation of what would be considered a *prima facie* case, see *Gillespie v Toondale Ltd*, 2006 S.C. 304.

⁸⁰ Not to the member himself. He is merely acting on the company's behalf and obtains little personal benefit except insofar as any redress from the director benefits the company and thereby indirectly the value of the member's shares.

⁸¹ [2012] EWHC 2363 (Ch).

⁸² At paras 34-41. A similar case exemplifying the use of s.172(1)(f) is *Phillips v Fryer* [2013] B.C.C. 176.

⁸³ [2009] EWHC 3020 (Admin)

interest in Royal Bank of Scotland, and which owned 70% of that bank's equity, was run by the Treasury. The pressure group felt that as the Government effectively owned so much of the Royal Bank, the Bank should be run in accordance with the interests of Companies Act 2006 s.172(1) in mind, in particular paying attention to climate change and human rights. The application was unsuccessful, and permission for judicial review was not granted, on the grounds that the Treasury had taken some account of such matters, but there were many other matters also to be considered by directors and due weight had to be given to them too. Climate change and human rights could not have a priority when it came to the amount of regard directors were required to pay to the various matters in s.172(1). A balance had to be found with all the other interests. In any case, while the Treasury could put its views across to the board of directors of the Royal Bank of Scotland, ultimately it was for the directors to manage the bank and not for the Treasury.⁸⁴ If this is the only case that even approaches the use of s.172(1)(a)-(e)⁸⁵ it suggests that in the seven years since it has been enacted, either these provisions have not proved useful from the point of view of the various stakeholders concerned, or that no-one has been willing to launch a test case.

However, merely because stakeholders have paid little attention to s.172(1) in the courts does not mean that directors are completely unaware of stakeholders' interests, or are unaware that the legislation is trying to persuade directors to consider stakeholders' interests. The Government commissioned a review of the Companies Act 2006 in 2010. The review established that most company directors were aware of s.172(1) of the Act, but were not necessarily putting it into practice.⁸⁶

Apart from s.172(1), what other guidance for directorial decision-making is there?

There is no lack of guidance in the UK to encourage the proper and honest management of companies by directors. The Financial Reporting Council has a strong interest in ensuring the probity of accounts. Listed companies are obliged to follow the UK Corporate Governance Code.⁸⁷ Its requirement for directors to "comply or explain" with generally accepted good practice within the terms of the Code is well understood. Finally, many large companies over

⁸⁴ At para.35. For a critique of this decision, see Copp, *S.172 of the Companies Act 2006 fails people and planet?* *Comp. Law.* 2010, 31(12), 406-408.

⁸⁵ In any case, this application was for judicial review, and was not a derivative claim.

⁸⁶ S. Fettiplace and R. Addis, *Evaluation of the Companies Act 2006* (2 August 2010), at p.3 of summary, available at <http://www.bis.gov.uk/assets/biscore/business-law/docs/e/10-1363-evaluation-companies-act-2006-summary-main-findings.pdf>

⁸⁷ Available at <http://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx>

the last few years have adopted “statements of values” or internal ethical codes in an effort to make directors and employees to treat their customers, suppliers and fellow staff members properly.⁸⁸

Scandals

However, notwithstanding the existence of CA 2006 s.172(1), the Corporate Governance Code and various statements of values, business history suggests that in certain sectors of business, in particular banking, directors of companies were not paying any attention to any of these requirements. Some recent scandals include the following:

- A report for the US Senate indicated that HSBC had been laundering money (particularly of “hot” South and Central American money) for years.⁸⁹ The report indicated that the US arm of the bank was woefully understaffed and out of its depth in its compliance and anti-money laundering departments.⁹⁰ While the bank did not hide its involvement in these questionable practices in its 2010 annual report,⁹¹ its compliance statement did not reveal any difficulties.⁹² Its compliance statement in that

⁸⁸ For examples, see Barclays Bank at

http://www.barclays.com/supplier/aiming_high_commercial_principles.html

⁸⁹ *US Vulnerability to Money-laundering, drugs, and terrorist financing: HSBC case history*, Permanent Subcommittee on Investigations, US Senate, December 2012 available at

<http://www.hsgac.senate.gov/subcommittees/investigations/media/levin-statement-on-hsbc-settlement>

⁹⁰ David Bagley, the UK head of compliance during the time of the money-laundering, resigned during the Senate Sub-committee hearing on HSBC’s money-laundering activities, blaming the bank’s rapid growth and challenging circumstances, implicitly admitting his own ability to prevent the abuses that had been taking place under his watch.

⁹¹ See HSBC’s annual report for 2010 at page 82.

⁹² The following is from the 2010 HSBC annual report at p.154 under the heading of “Compliance risk”.

“Compliance risk falls within the definition of operational risk. All Group companies are required to observe the letter and spirit of all relevant laws, codes, rules, regulations and standards of good market practice. These rules, regulations, other standards and Group policies include those relating to anti-money laundering, counter terrorist financing and sanctions compliance. The Group Compliance function supports line management in ensuring that there are adequate policies and procedures, and is responsible for maintaining adequate resources to mitigate compliance risk. The GMO Compliance department oversees the global compliance function and is headed by the Head of Group Compliance who in turn reports to the Group Chief Risk Officer. There are compliance teams in all of the countries where we operate. These compliance teams are principally overseen by Regional Compliance Officers located in Europe, North America, Latin America, the Middle East and Asia-Pacific. Group Compliance policies and procedures require the prompt identification and escalation to GMO Compliance of all actual or suspected breaches of any law, rule, regulation, Group policy or other relevant requirement. These escalation procedures are supplemented by a requirement for the submission of compliance certificates at the halfyear and year-end by all Group companies detailing any known breaches as above. The contents of these escalation and certification processes are used for reporting to the Risk Management Meeting,

report said that all group companies were required to comply with the requirement to observe the letter and spirit of all relevant laws, but it did not indicate that they had actually done so.

- Standard Chartered bank, despite the existence of sanctions against dealing with Iran, persistently ignored those sanctions over a period of ten years up to 2010.⁹³ This is in contrast to the values espoused by the bank in its annual report for the year 2010.⁹⁴
- The US subsidiary of UK company, GlaxoSmithKline, was fined \$3 billion in July 2012 for deliberately withholding vital safety data about its best-selling diabetes drug, Avandia, and in particular the effect of that drug on hearts. The company had also been paying bribes to doctors and recommending unsuitable anti-depressants to children.⁹⁵
- SSE, formerly South of Scotland Electricity, formally admitted breaches of mis-selling electricity and was fined £10.3 million by Ofgem on 3 March 2013. While there was no suggestion that senior management actively participated in the mis-selling or was wilfully in breach of the company's licence conditions, senior management was criticised for its non-involvement in compliance and oversight of sales activities, and its reluctance to consider that commission-hungry salesmen might not be treating the company's customers properly.⁹⁶

These are some scandals that are known. There may be others still hidden or sufficiently successful that they have yet to surface. All these scandals took place within British banks and other British companies or in their foreign but British-controlled subsidiaries. With regard to CA 2006 s.172(1), these scandals have not been good either for the shareholders or customers, let alone the banks' reputations for high standards of business practice. New management has been imposed in some of these banks since the scandals, and there have

the Group Risk Committee and the Board and disclosure in the *Annual Report and Accounts* and *Interim Report*, if appropriate.”

⁹³ See BBC business news 10 Dec 2012.

⁹⁴ See in particular, page 39, where the following is stated: “Our brand promise, Here for good, reaches out to all our stakeholders, including our employees, through a simple and compelling promise. It says who we are, what we stand for and what makes us different. Here for good captures our genuine commitment to our customers and clients, our staff and the communities where we operate; our focus on consistently doing the right thing and acting responsibly; and our aim to continually lead the way across Asia, Africa and the Middle East. It has raised the bar on how we demonstrate our values through our everyday business activity.”

⁹⁵ BBC News, US and Canada, 2 July 2012.

⁹⁶ See the Ofgem's [SSE – Notice of Intention to impose a financial penalty on SSE for failure to comply with Standard Licence Conditions 23 and 25](#) at paras. 134 and 149, 3 March 2013.

been protestations of the need for new standards of conduct, a new culture, retraining and no repetition of improper behaviour.⁹⁷ But while the improper practices were taking place, there was little suggestion in the annual reports that anything was amiss. The question then arises: to what extent did the directors of the banks at the time know what was going on? If they did, they were in breach of Companies Act 2006 s.172(1); and if they did not know, the question arises of why they did not know.

Awareness of s.172(1)

It will probably never be known whether the various directors in the various companies above genuinely were unaware of unsatisfactory practices within their firms, vaguely knew what was going on, encouraged or turned a blind eye to the more disreputable practices, or even delighted in their “gaming”.⁹⁸ There may have been a culture of wilful ignorance, so that directors could plead ignorance of their employees’ misdeeds and thus escape liability, or of creative compliance.⁹⁹ While no director working at a senior level can be expected to know every dubious activity of his employees, it may be worth asking what steps directors took to ensure that any dubious activity was stamped out. All these companies had Audit and Risk committees on which directors will have sat. Those directors should have been mindful of the requirements of s.172(1), in particular the requirement to have regard to the interests of customers and to maintain a reputation for high standards of business conduct. It is most unlikely that the UK directors of the major banks above, or of GlaxoSmithKline and ESS, could have been unaware of s.172(1) and its requirements. These companies had company secretaries who would have ensured that directors had been told about the changes in the law from October 2007 to reflect s.172(1) coming into force.

However, being told about s.172(1) is one thing: paying attention to it is another. A proper adherence to s.172(1) should have ensured that certain lucrative but questionable activities,

⁹⁷ For example, the chief executive, Sir Anthony Jenkins, of Barclays Bank, in an echo of Barclays Bank’s original Quaker roots, wrote to all the bank’s employees on 16 January 2013 about his then new mantra called TRANSFORM, promoting the values of “respect, integrity, service, excellence and stewardship”. Similar assertions were made by the directors of the Royal Bank of Scotland to the Treasury Select Committee on 11 February 2013.

⁹⁸ Andrew Bailey of the FSA told the Treasury Select Committee on 16th July 2012 that Barclays had a “culture of gaming” (i.e. sailing close to the wind in its compliance with regulations) and implied that that culture came from Bob Diamond, its then CEO.

⁹⁹ Doreen McBarnet, *Corporate Social Responsibility Beyond Law, Through Law, for Law*, University of Edinburgh - School of Law, March, 27 2009, [Working Paper No. 2009/03](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1369305), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1369305.

Doreen McBarnet, *Financial Engineering or Legal Engineering? Legal Work, Legal Integrity and the Banking Crisis*, University of Edinburgh - School of Law, February 2, 2010, working paper series, 2010/02, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1546486.

such as money-laundering and mis-selling, did not take place. However, if, as described earlier, the sanction for non-adherence to s.172(1) is weak, and if there is a general culture of creative compliance with legislation anyway, a director has much to lose by adherence to s.172(1). Many of the directors, and other employees, were shareholders themselves, had generous bonus schemes and were entitled to share options which could be triggered on certain targets being achieved. It would not be in those persons' interests to query anything that in the short term might adversely affect the share price or their bonuses or their promotion prospects; and it is interesting to note that one of the remedies that is now being proposed, particularly for the banks, is that directors and other senior executives should only be able to obtain certain benefits or bonuses if the company obtains long term gain, not merely short term market share or an increase in the share price obtained by rent-seeking officials.¹⁰⁰

To put the matter succinctly, the sort of directors who would have taken account of s.172 would not need to be told to do so, and the sort of directors who ought to have been reminded of s.172(1) would not have troubled themselves about it anyway, because, it is suggested, there was no compulsion to adhere to its terms and little likelihood of any punishment for their failure to do so.¹⁰¹ It is possible to point to companies that probably did, and probably still do, all that is required under s.172(1) – The John Lewis Partnership is a good example – but they would have done so anyway because a company where the directors do take account of a wide range of stakeholder interests probably is quite a thoughtfully run company. Staff are valued, customers and suppliers treated properly, and the business is well regarded in the community. The irony of s.172(1) is that intrinsically what it expects directors to do makes a good deal of sense, but in the absence of effective sanctions, if directors wish to ignore s.172(1) for their own perceived short term advantage, or their employees' or short-term shareholders' advantage, they will do so, and the problems, when they arrive, will be for someone to sort out at some stage in the future, long after the directors and employees have cashed in their bonuses and their share options and moved elsewhere.

¹⁰⁰ BBC News 5 February 2013, at <http://www.bbc.co.uk/news/business-21333527>.

¹⁰¹ For an expanded view of the same point, see N. Okoye, *The BIS review and section 172 of the Companies Act 2006: what manner of clarity is needed?* [2012, Company Lawyer. 33\(1\), 15-16](#)

The failure of s.172(1)

It has already been explained that s.172(1)(f) of the Companies Act 2006 can work well at a small company level in ensuring redress for some shareholders being treated badly by directors in terms of s.172(1)(f). In this respect one can take some small issue with the view of Elaine Lynch¹⁰² who asserts that “s. 172 brings little or nothing to the table”. But Lynch’s view in respect of the other parts of s.172(1), namely s.172(1)(a)–(e), would appear to be correct, in that those provisions have proved in practice completely ineffective, at least as far as the large companies referred to earlier are concerned. This view is also well advanced by Professor Andrew Keay.¹⁰³ If this is correct, it suggests the requirement for directors to have regard to the various matters in s.172(1)(a)-(e) has moral suasion but no more. It is like patting a wolf on the head and asking it to be good. This does not mean that the provisions of that subsection are worthless, but rather that they are in practice sanctionless and therefore can afford to be ignored. Thus there is a return to the themes of this thesis, the second and third of which are

- The use of law to alter business and social behaviour
- The tension between intention of the legislation and the actuality

S.172(1) was designed to make directors, in effect, behave well and to be good and thoughtful people when making directorial decisions. If directors did follow the precepts of s.172, the law might well alter business and social behaviour for the better. The evidence, so far, is that while s.172(1)(f) may be effective at a small company level, and as between directors and disgruntled shareholders, the rest of s.172(1) in the past was ignored by the directors of certain larger companies, did not alter business and social behaviour and that the gap between the intention of the legislation and the actuality was indeed wide.

The redundancy of s.172(1)

¹⁰² Lynch, *Section 172: a ground-breaking reform of directors’ duties, or the emperor’s new clothes?* 2012 *Company Lawyer*, (33(9)), 196-203.

¹⁰³ Professor Keay has written extensively on this area (see <http://www.law.leeds.ac.uk/assets/files/research/events/directors-duties/keay-the-duty-to-promote-the-success.pdf> and *Moving towards stakeholderism? Constituency statutes, enlightened shareholder value, and more: much ado about little?* E.B.L. Rev. 2011, 22(1), 1-49, in particular) and his view is that s.172 has, frankly, not worked. He is not alone in this view: see D. Fisher, *The Enlightened Shareholder -- Leaving Stakeholders in the Dark: Will Section 172 (1) of the Companies Act 2006 make Directors Consider the Impact of their Decisions on Third Parties* [2009] I.C.C.L.R 10;

Notwithstanding all of the above, at the time of writing the banks are receiving such opprobrium that a cultural change is needed in order to regain customers' trust. It will be commercial common sense that will now ensure that directors take more trouble to find out what is happening within their companies. It is not the fear of shareholder litigation under s.172(1) that will cause directors to adopt the very behaviour that s.172(1) hopes to instil. It is the fact that treating customers badly, and not playing by the rules, not surprisingly, in the long run has turned out to be bad for business. If a bank mistreats its customers, as Barclays and UBS did with LIBOR, and SSE did with those to whom it supplied electricity, it may well encourage at least some customers not to use those banks and companies again once the customers have found out what was happening.¹⁰⁴ Misleading customers, or treating them with contempt, either by not genuinely given the best deal they should be getting, or deliberately confusing them, can be, in the longer run, unprofitable. The cost to SSE of the fine (£10.5 million) and the reimbursement of the customers who were mis-sold electricity is greater than the amount of money that the company made by mis-selling (estimated to be £4 million).¹⁰⁵

The first theme in this thesis was achieving the balance between creditors and debtors. A bank relies on the trust that the bank's creditors, its depositors, will not all demand their funds back at once, thus causing a run on the bank, as happened with Northern Rock. The bank has to convince its customers/creditors that its funds are in safe hands. The evidence of the scandals above suggests that the hands of the directors (as the ones ultimately responsible) were not in those cases as safe as they might have been, and that some directors have now realised that they also need to be seen over a considerable period of time to be clean and trustworthy hands.¹⁰⁶ The paradox is that it has been commercial pressure and market forces, not s.172(1), that has ensured that lessons will have been learned – those lessons, ironically, being the same as those matters in s.172(1) to which directors are adjured to “have regard”. The climate seems to be altering in favour of greater integrity in banking practice, at least as regards ordinary consumers. That it has altered is not as a result of s.172(1). It is because to continue as before is no longer commercially tenable. If this is the case, it almost suggests

¹⁰⁴ Customers are notoriously reluctant to change their banks, but even if they do not change their banks, they are much more likely to be cautious about buying its products.

¹⁰⁵ See the Ofgem's [*SSE – Notice of Intention to impose a financial penalty on SSE for failure to comply with Standard Licence Conditions 23 and 25*](#) at para. 159, 3 March 2013.

¹⁰⁶ Anthony Jenkins, current CEO of Barclays Bank, said it would take five to ten years to rebuild trust in banks (speech to Brooke House Sixth Form College, East London, 31st December 2013) reported at <http://www.independent.co.uk/news/business/news/antony-jenkins-admits-it-could-take-10-years-to-rebuild-trust-in-barclays-9031350.html>

that the provisions in s.172(1)(a)-(e) are unnecessary. The directors of a sensible company would do what s.172(1) expects, without those requirements having to be put in legislation.

Whether or not these provisions are unnecessary, s.172(1)(a)-(e) is not going to go away. Even if the statute is not effective, it is what is on the statute book and it is unlikely that Parliamentary time would be found for its amendment. Instead, at the time of writing the Parliamentary Commission on Banking Standards is considering the Treasury's proposal that directors of a bank should face criminal sanctions if found guilty of serious misconduct in the management of that bank.¹⁰⁷ This suggestion is not without its difficulties, but the active threat of imprisonment and fines, not to mention the ignominy of conviction, may concentrate directors' minds more effectively than s.172(1) appears to have done.

One may then ask why the politicians and their civil servants allowed such ineffective legislation as s.172(1) onto the statute book. There were warnings, particularly from some Conservative MPs,¹⁰⁸ that what eventually became s.172(1) would cause more difficulties than it solved. What did not appear to have been anticipated, at least in public, was that the section would be ignored. It was complied with to the extent that the board minutes could demonstrate that directors had had regard to it, but the fact that the scandals referred to above took place at all suggests that amongst the many other tasks directors have to contend with, actually paying attention to s.172(1) was a very low priority. As for the politicians, it could be said that there was an emotional and sentimental attachment to what seemed a socially desirable objective, irrespective of the practical feasibility of that objective.¹⁰⁹ By the time that the voting on the second reading of the bill was to take place, they had persuaded themselves that it was worthwhile, and as the Labour party, which was supporting the bill, was in a majority in the House of Commons at the time, there was no difficulty in getting the motion passed.¹¹⁰

Comparison with proposed legislation in Ireland

It is telling that the current company law reform bill being discussed in the Republic of Ireland has made significant changes to many areas of company law – that country's law

¹⁰⁷ See the Treasury Discussion document, 3 July 2012, "Sanctions for the directors of failed banks", available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81565/consult_sanctions_directors_banks.pdf Responses to the consultation are still being considered by the Commission and the Treasury.

¹⁰⁸ See Hansard, House of Commons, 6 June 2006, columns 204-5.

¹⁰⁹ One can compare this to another famous example of well-intentioned but completely unworkable legislation, namely the 18th Amendment to the American constitution, being the prohibition in 1920 on the production, sale and transport of alcohol. The 21st Amendment in 1933 repealed the 18th Amendment.

¹¹⁰ See Hansard House of Commons, 6 June 2006, column 219

being in many respects similar to UK law – but has expressly not introduced any attempt to draft directors’ duties in the manner shown in Companies Act 2006 s.172(1).¹¹¹ The (Irish) Companies Bill, s.229(1), at present being discussed in the Dail, is the nearest equivalent to Companies Act 2006 s.172(1), but there is no mention of the need to have regard to the various stakeholders. There is instead a requirement to:

- (a) act in good faith in what the director considers to be the interests of the company;
- (b) act honestly and responsibly in relation to the conduct of the affairs of the company;
- (c) act in accordance with the company’s constitution and exercise his or her powers only for the purposes allowed by law;
- (d) not use the company’s property, information or opportunities for his or her own or anyone else’s benefit unless—
 - (i) this is expressly permitted by the company’s constitution; or
 - (ii) the use has been approved by a resolution of the company in general meeting;

The simple but wide words “act honestly and responsibly in relation to the conduct of the affairs of the company” have much to commend them. It is evident from elsewhere in the Bill that the Irish have adopted much from the Companies Act 2006, but for good reason they did not replicate s.172(1). The words “honestly and responsibly” are particularly apt, and their lack of specificity is useful because it suggests that the directors should act honestly and responsibly not just to their companies, but to all those party to the “affairs of the company”. It does not resolve the irresolvable question of the duty to act responsibly only being owed to the company, but unlike s.172(1), as a duty it is easy for directors to understand and hard to avoid. It would be easy for a shareholder to point out that a director’s reluctance to ask, say, what its mis-selling sales representatives were doing, or why money-laundering was taking place, showed a failure to act honestly and responsibly. Were s.172(1) of the Companies Act 2006 ever to be amended, there is much to be said for adopting the wording of the Irish Companies Bill s.229(1)(b).

¹¹¹ The author is not aware of the adoption of the wording in the UK of s.172(1) in any other Commonwealth country.

Conclusion

One intention behind the Bankruptcy and Diligence etc. (Scotland) Act 2007 was that making it easier for debtors to apply for their own sequestration would be a social good in that it would relieve those who were unlikely ever to be able to pay their debts from the crushing effect of debt and allow them more easily to start afresh. It might also reduce the stigma of bankruptcy. The use of Bankruptcy Restrictions Orders and Undertakings would provide a counterbalance where the debtors had behaved unsatisfactorily either in the period leading up to their sequestration or thereafter. Greater availability of sequestration might also lead to more responsible lending. The greater availability of sequestration certainly led to a marked rise in applications to the Accountant in Bankruptcy, suggesting that there was a need that was being met, but it is not evident that the stigma of bankruptcy has been eradicated, and realistically the Scottish debt market, being only a tenth of the English and Welsh one, was probably not large enough for the greater availability of sequestration to alter lenders' profligacy in making loans. Wider commercial factors elsewhere in the loan industry, and increased regulation generally, have been more effective in that respect.

As regards diligence, the remedies available in the Bankruptcy and Diligence etc. (Scotland) Act 2007 were meant to provide a better degree of protection for debtors than before, and to ensure that creditors had to treat debtors in a kindlier manner than before. In return, creditors would have rights over almost all of a debtor's assets. The latter part of the arrangement was not brought into force, which meant that in effect it was business as normal for creditors, except that there were more hurdles for creditors to jump through, which in turn increased debtors' expenses. There was no evidence that the changes in the law made debtors quicker to pay their bills. However, in fairness, the codification of some of the common law on diligence has made the process of diligence easier to follow and to apply.

As regards company law, it is evident that while many aspects of the Companies Act 2006 were useful, s.172, which was specifically designed to try to alter directors' behaviour and to make directors act in a more thoughtful manner, was not successful. A fundamental weakness in the legislation enabled directors not to take it seriously, and the evidence is that it made very little difference to the management of companies, and that Parliament was seduced by the goodness of its own intentions into overlooking the practicalities of its implementation.

Chapter 5

Conclusion

The previous chapters, and the books that are the subject of this critical appraisal, demonstrate certain themes relating to certain areas of business law. These themes are

- Achieving the balance between the interests of debtors and creditors,
- The use of legislation to alter business and social behaviour
- The tension between the intention of the legislation and the actuality

What has also been demonstrated is that the way that politicians practise politics does not always sit easily with their attempts to regulate how business is carried out. As was particularly demonstrated in the case of s.172 of the Companies Act 2006, what may appeal to politicians' ideas, particularly at an emotional level, of how businesses ought to be run, needs to be dispassionately considered and understood by politicians with an eye to its practical effectiveness and the extent to which its ideals are accepted by those likely to be accepted by the legislation; and when this does not take place, the legislation will not achieve its intended result. By contrast, effective legislation in the field of business law is legislation, such as certain parts of the Bankruptcy and Diligence etc. (Scotland) Act 2007, that takes proper account of both the debtors' and the creditors' views, is not over-ambitious or sentimental, and does not have unrealistic expectations of the end result.

It is important to consider what lessons may be drawn from all this. This last chapter therefore provides an overview of the limitations of legislation in the context of the three themes with reference to the publications referred to throughout this thesis.

Achieving the balance between the interests of debtors and creditors

In the realm of corporate law, this thesis chose to discuss this theme in the context of recent developments in the corporate veil. The *Prest* case has very clearly indicated that the veil should be lifted in very restricted circumstances, namely the evasion of a legal responsibility or the frustration of the law. A controlling shareholder or director may then be liable, particularly if the company itself is insolvent or not worth suing. Should a company be used for similar purposes but not evidently at the instance of a controlling shareholder or director, while the victim may still have a right of relief against the company (unless it is insolvent or not worth suing) the controlling shareholder or director may escape without liability. This clearly places the creditor at a disadvantage. Creditors must do what they can to limit their risk but our law has chosen to place the risk with creditors even if that leads to “hard cases”.

As regards the law of bankruptcy, the law prior to the Bankruptcy and Diligence etc. (Scotland) Act 2007 was not entirely unfair to creditors, but the 2007 Act in a number of small but on the whole effective ways pushed the balance towards in the debtor’s favour, though there are some benefits to creditors too. Debtor applications have made the possibility of sequestration easier for debtors. Third parties contracting with debtors, unaware of the debtor’s sequestration, are now better protected than before. The law is undoubtedly more complex than it was before but it is more humane. Debtors are now only bankrupt for one year instead of three. In the past someone contracting to buy a house from a debtor at the time of the debtor’s sequestration could have paid the purchase price and ended up losing the purchase money and the house, with the only solace being a right against his solicitor if he could prove that the solicitor had been negligent. All the innocent purchaser would have wanted was to have moved into his new house – and this the legislation has achieved. It is true that overall creditors may receive less as a result, but as has been explained before, most creditors, with the exception of involuntary creditors such as delict-victims or H.M. Revenue and Customs, are in a position to bargain with the debtor, or at least can choose to deal with the debtor and to factor into their costs the likelihood of the debtor’s default – this is not so likely to be the case with an innocent purchaser of the debtor’s house.

As regards diligence, the position of the debtor is mixed. Because of the Scottish Government’s reluctance to introduce a form of land attachment, at least to date, debtors owning heritage are relatively fortunate, since few creditors will use adjudication for debt, and sequestration as a method of debt recovery is uncertain and slow. The methods of

diligence referred to shortly, although broadly beneficial to the creditor, are tempered by many opportunities for the debtor, or anyone with an interest in the debtor's property, to be relieved of the diligence where the execution of the diligence could be "unduly harsh". On the other hand, the clarification of the laws relating to arrestment, inhibition, together with arrestment and inhibition on the dependence, money attachment, and interim attachment mean that the creditor's armoury is better stacked than was the case previously.

The use of law to alter social and business behaviour

As explained earlier, this critical appraisal sought to demonstrate that the attempt by legislation, particularly s.172 of the Companies Act 2006, to make directors behave in a particular moral way, and in particular to persuade directors to have regard to their companies' reputation for high standards of business conduct and to consider the interests of customers and suppliers, fell on deaf ears. That it did so was for a variety of main reasons, the principal one of which was that there was no effective sanction in law for directors' failure to follow this vague instruction. A second reason was that it was often not in shareholders' interests to object to the directors' behaviour provided profits were good. In any case, if the shareholders did not like what the directors were doing, it was easier just to sell their shares.¹¹² A third reason was that it suited directors to ignore the interests of the creditors or long term shareholders because they were focussed on producing high short term profits which would allow payment of bonuses and cause the share price to rise, thereby triggering further benefits for directors and many other staff by way of exercising share options.

As has already been narrated, the obsession with generating profits led to a lack of attention to wider considerations, not least the long term source of those profits and their sustainability, namely the interests of customers. The failure to get the balance right as regards customers' interests ultimately has led to revisiting the concerns of those customers and to regaining their trust; paradoxically the banking crisis has had the effect that the directors of at least some companies are now actively doing what s.172 of the Companies Act 2006 would have them

¹¹² This was not always the case: for example, the directors of the holding company, Covea, sacked the entire board of its subsidiary Swinton Insurance because the board members of Swinton were putting their own interests ahead of its shareholders. But in this case, the shareholders were a holding company as opposed to a diverse body of shareholders (<http://www.insuranceage.co.uk/insurance-age/news/2132072/entire-swinton-executive-board-sacked>).

to – not because s.172 tells them to do so, but because commercially it is prudent to do so. The market, not the legislation, has been the effective motive behind compliance.

s.172 of the Companies Act 2006 did not prove effective in making directors take account of stakeholders' interests and failed to alter social and business behaviour. The market has done this, but not as result of the legislation. The lesson to be drawn from this is first that sanctionless legislation is not a good method for trying to make people behave well, and secondly that exhortatory legislation, designed to achieve certain apparently desirable social, or even moral, objectives, or promote certain values, is futile. The political attempt to make directors behave well was worthily intentioned, but in the haste of the political process, politicians, meaning for the best, and thinking that what they were doing would look good to a wider audience, fell prey to wishful thinking. The pragmatic wording of the current Irish Companies Bill would both have been less ambitious and more effective.

The Bankruptcy and Diligence etc. (Scotland) Act 2007 had originally hoped to change Scotland's culture to one of being more accepting of bankruptcy than used to be the case, and by reducing the period of bankruptcy to one year to be more encouraging of entrepreneurs. If the culture has changed, it is not evident, and the encouragement of entrepreneurs probably owes more to the availability of finance than to the period of time a debtor remains a bankrupt. These social ambitions were unrealistic, whereas the other reforms within that Act were realistic, achievable and on the whole unexceptionable.

Tension between the intention of the legislation and the actuality

Harold Wilson, whenever asked on television about some current difficulty, would light his pipe, puff out some smoke and say smoothly that he was bringing in legislation to deal with the difficulty. Whether or not it was true, it would generally quell the interviewer. The implication was that legislation always fixes problems. It is true that some legislation does resolve some problems sometimes. The Smoking, Health and Social Care (Scotland) Act 2005 may have proved difficult for public houses, but has been beneficial in many other respects, including unexpectedly reducing the incidence of childhood asthma.¹¹³ That Act's success is due to the fact that smoking was increasingly seen in the wider population as socially unacceptable, and self-evidently expensive and unhealthy. The Act was merely

¹¹³ See <http://www.ashscotland.org.uk/ash/5510>

reinforcing an existing and well-established view. There was no attempt to suggest that smoking was “bad” or immoral: it just made it difficult to smoke in certain places and it was relatively easy to establish sanctions for non-compliance. The problem with s.172 of the Companies Act 2006 was that the lack of clarity as to the sanctions for non-compliance, the general vagueness of the provision, and the disinclination of directors to take it seriously meant that its effectiveness was always going to be problematic. There was little enthusiasm outside Parliament for the proposed wording. The Government appears in retrospect to have been blinded by the benevolence of its own good intentions to the reluctance of business and the legal profession to engage with this section. Small private companies with directors who were also the shareholders were always unlikely to trouble themselves with the wording of that section, and as has been seen, larger companies, unless they were already actively engaged in such practices themselves, as a few were, merely paid lip-service to it. The attempt by Parliament to impose moral values on directors frankly failed. By contrast, The Bankruptcy and Diligence etc. (Scotland) Act 2007 was reasonably successful because, with some exceptions, it did not attempt to be too ambitious and its intentions were broadly acceptable to those affected by the Act, and made no pretensions as to imposing moral standards on anyone.

Good-enough legislation

This thesis, and the books that are the subject of this thesis, have tried to demonstrate some of the weaknesses in political attempts to effect social change in the world of business by legislation. Although it is easy to be censorious of the inadequacies of legislation, and imperfect as some of it may have been, the legislation discussed in this thesis, and in the books referred therein, taken as a whole made some difference for the better: most of it was “good enough”. It is perhaps unreasonable to expect every part of the Companies Act 2006, at its time the longest ever Act in the UK with its 1,300 sections, all to be perfect. S.172 was clearly less than perfect, and this thesis demonstrates how utterly it was ignored by those to whom it was directed. It is a good demonstration of the futility of politicians trying to impose moral values in business by legislation. In commercial matters, law that simplifies procedures, is clearly set out, has clear sanctions, and is broadly accepted by those at its receiving end probably works: laws that try to change directors’ mind-sets or impose moral guidelines may do no harm, but without sanctions or acceptance by those for whom the

legislation is intended are unlikely to work well; and in the absence of sanctions, commercial necessity is a great deal more effective than any amount of legislation, however well intended, in effecting worthwhile change for the better.

The future

As for the future, the Holyrood Parliament has introduced the Bankruptcy and Debt Advice (Scotland) Bill to make further changes towards the ease of access to sequestration and to the Debt Arrangement Scheme. It remains to be seen how achievable some of its objectives will be, in particular the implementation of financial education for former debtors, but at the time of writing there have been no major objections to the Bill overall. Quite how the education will be carried out or assessed will be interesting to observe. The Enterprise and Regulatory Reform Act 2013 has made some changes to the Companies Act 2006, for example in the field of directors' salaries,¹¹⁴ for which there is considerable support, but there are no changes being made to s.172 of the Companies Act 2006. There are no attempts in the 2013 Act to start imposing morality on directors. The experiment of s.172 failed; if it had been successful it would have been adopted in other English-speaking jurisdictions, but it has not been; perhaps the legislature has learned its lesson, and lawmakers will know for the future that legislating for people's consciences is an unrewarding activity.

¹¹⁴ At ss.79-82

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