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British Home Stores collapse: the case for an employee derivative claim

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ABSTRACT

British Home Stores collapsed led 11,000 employees to lose their jobs and faced substantial cuts to their pension with a £571 million pension deficit. In light of the BHS scandal, the UK Government has proposed a set of corporate governance reforms to strengthen the employee voice. Although the government's approach towards strengthening the employees' protection is well intentioned, we argue that without providing a derivative claim right for employees, these measures will likely have little impact in practice. Hence we suggest that to safeguard the employees' interest in the company and to enhance the overall protection of the company, in addition to the current proposed reforms, the standing for bringing derivative claims should be broadened to the employee's representative.

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KEYWORDS British home stores; abuse of power; employee's vulnerability; corporate governance reforms; employees derivative claim right

1. Introduction

British Home Stores, one of the iconic high street chains, collapsed in 2016, which led to the loss of 11,000 employees' jobs and 20,000 current and future pensioners facing substantial cuts to their entitlements with a £571 million pension deficit. The store collapse resulted in an awkward parliamentary inquiry and a potential criminal investigation for its owners and the House of Commons report has described the owners' misconducts as 'an insult to the company's employees and pensioners'.¹

However, the most important fact that the BHS collapse unwrapped was the weakness of UK corporate law in terms of supporting corporate employees' interests in the company. Now, in light of the BHS scandal, the UK Government has set out some reforms to strengthen the employee voice.

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¹The House of Commons Report Inquiry into BHS, HC 54, published on 25 July 2016 by authority of the House of Commons.

The Government's specific plans for improving the protection of employees have been set in form of (1) Introducing secondary legislation to require all companies of significant size to explain how their directors comply with the requirements of section 172 to have regard to employee and other stakeholders' interests; (2) inviting the FRC to consult on a specific Code provision requiring premium-listed companies to adopt, on a 'comply or explain' basis, one of three employee engagement mechanisms: a designated non-executive director; a formal employee advisory council; or a director from the workforce; and (3) encouraging the GC 100 group of the largest listed companies to prepare guidance on the practical interpretation of the directors' duty under section 172 of Companies Act 2006.² In addition to the mentioned plans, the Government has unveiled some other corporate governance reforms such as standardizing executive pay and establishing a voluntary corporate governance code for large private companies. Although the government's approach towards strengthening the employees' protection is well intentioned, we argue that these measures will likely have little impact in practice. In fact, the proposed reforms merely offer tokenism rather than a much-needed call to action.

Employees are important stakeholders in a company who play a vital role in its long-term success and sustainability. Hence, they need a tougher mandatory enforcement mechanism enabling them to protect the company and consequently their interests against wrongdoer directors and controlling shareholders who abuse their positions and put their well-being in danger. Therefore, we propose that in order to safeguard the employees' interest in the company and to enhance the overall protection of the company, in addition to the proposed reforms, the standing for bringing derivative claims should be broadened to the employee's representative.

Our argument is that tragedies like BHS might have been prevented if the company employees had had the right to bring a derivative claim. While there were no other mechanisms from outside to stop the harms to the company, the derivative claim's deterrent function could have enabled the employees to sue the BHS wrongdoers on behalf of the company for their negligence and mismanagement and might have prevented them from further misappropriation of the company's assets. Our proposal would be a threat to potential wrongdoers like Mr Green, who in turn might be more cautious about the consequences of their misconduct, and it would prevent them from easily enriching themselves on the back of the company with no concern for anyone else.

This article proceeds as follows. Section 2 discusses the reasons for giving separate consideration to employee interests in the company. Section 3 reviews employees' interest consideration in the UK, the background that

²Department for Business, Energy & Industrial Strategy, Corporate Governance Reform, The Government response to the Green Paper consultation, p 3.

formed the enlightened shareholder value principle and the current shortcomings of section 172 CA 2006. Section 4 reviews the proposed corporate governance reforms intended to strengthen the employees' voice and discuss why these actions will be insufficient in practice. Section 5 explains how employees' derivative claims could prevent tragedies like BHS and discusses the implementation of an employees' derivative claim in the UK.

2. Why corporate law should consider employee interests

Since the rise of the law and economics movement in the 1970s, corporate law and corporate governance theory has been mainly focused on agency problems arising from conflicts of interest between shareholders and managers as well as among shareholders.³ Normatively, the primacy of shareholders and the limitation residual governance rights and the ability to sue derivatively to this group has usually been justified with their position as residual risk-bearers in the firm. While other groups, including employees, have often been thought as having contractually specified obligations and rights,⁴ shareholders simply get what is left in the form of dividends or an increased share value after everyone else's demands have been satisfied.⁵ Consequently, to achieve the best possible outcome for everyone, it suffices to maximize shareholder wealth.

This 'shareholder primacy view' provides a powerful framework for the analysis for most core aspect of corporate law. It is unable to account fully for the effects of corporate law on employees, who are usually seen as a distraction and a potential coalition partner for managers in opportunism vis-à-vis shareholders. However, there are at least two reasons to consider employee interests separately, namely human capital and pension obligations that create a financial interest for workers.

2.1. Human capital

Depending on how easily transferable an employee's education, training and abilities are, that individual's human capital can be classified as general, industry-specific or firm-specific.⁶ The most problematic type is firm-specific human

³See the classical exposition of the agency problem by Michael Jensen and William Meckling, 'Theory of the Firm: Managerial Behavior, Agency Cost and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305; also Lyman Johnson, 'Corporate Law Professors as Gatekeepers' (2009) 6 *University of St. Thomas Law Journal* 447 (identifying shareholder wealth maximization as the goal of corporate law according to the majority of scholars); Frank Easterbrook and Daniel Fischel, *The Economic Structure of Corporate Law* (Harvard University Press 1991).

⁴*ibid* 11.

⁵*ibid*.

⁶Gary Becker, *Human Capital: A Theoretical and Empirical Analysis, with Special Reference to Education* (University of Chicago Press 1964) 11; See also Henry Hansmann, *The Ownership of Enterprise* (Harvard University Press 1996); James Malcomson, 'Individual Employment Contracts' in Orley Aschenfelter and

capital, which employees cannot take to another employer.⁷ Assuming that the acquisition of this type of capital is costly for the employee, investment in this type of skill will be discouraged if this investment is not protected. In principle, the solution to this problem would be a long-term contract. However, in reality, contractual protection often reaches similar limits as legal protection, simply because real-life contracts do not correspond to the 'complete contingent' model of the economic theory. Contract theory suggests that contracts are incomplete because payoff and the distribution of rents among parties cannot be stipulated for each possible future state of the world, however unlikely.⁸ The reason may be of cognitive limitations or high transaction cost.

Employers might still want employees to invest in firm-specific skills if it enables them to do their job more effectively, thus enhancing the firm's overall competitiveness.⁹ Specific human capital may include skills to perform a particular job, but also idiosyncratic combinations of skills.¹⁰ In some cases, specific human capital may be organizational knowledge and the ability to work in a particular group or organizational hierarchy or to work within a particular corporate culture.¹¹ As a popular corporate finance textbook notes, 'managers and employees of a firm are investors, too. ... If you give financial capital too much power, the human capital doesn't show up – or if it does show up, it won't be properly motivated'.¹² If employers can easily engage in opportunistic conduct harming employees (e.g. in wage renegotiations),¹³ shareholders might benefit ex post, but employees may be discouraged from human capital investment.

David Card (eds), *3 Handbook of Labor Economics* (Science Direct 1991); David Neumark, 'Productivity, Compensation, and Retirement' in Gordon Clark, Alicia Munnell and J. Michael Orszag (eds), *Oxford Handbook of Pensions and Retirement Income* (Oxford University Press 2006); Larry Fauver and Michael Fuerst, 'Does Good Corporate Governance Include Employee Representation? Evidence from German Corporate Boards' (2006) 82 *Journal of Financial Economics* 673.

⁷Hansmann (n 6); also Malcomson (n 6); Gavin Kelly and John Parkinson, 'The Conceptual Foundations of the Company: A Pluralist Approach' in John Parkinson, Andrew Gamble and Gavin Kelly (eds), *The Political Economy of the Company* (Hart Publishing 2000); David Kershaw, 'No End in Sight for the History of Corporate Law: The Case of Employee Participation in Corporate Governance' (2002) 2 *Journal of Corporate Law Studies* 34; John Armour and Simon Deakin, 'Insolvency and Employment Protection: The Mixed Effects of the Acquired Rights Directive' (2003) 22 *The International Review of Law and Economics* 443; Fauver and Fuerst (n 6); Neumark (n 6) 721–22.

⁸Alan Schwartz, 'Incomplete Contracts' in Peter Newman (ed.), *The New Palgrave Dictionary of Economics and the Law* (Palgrave Macmillan 1999) 277.

⁹E.g. Luca Enriques and others, 'The Basic Governance Structure: Minority Shareholders and Non-Shareholder Constituencies', in Reinier Kraakman and others, *The Anatomy of Corporate Law* (Oxford University Press, 3rd edn, 2017), 79, 89 (noting that profits will be harmed if employees undertake less firm-specific investments in human capital).

¹⁰Edward Lazear, *Inside the Firm* (Oxford University Press 2011) 342.

¹¹E.g. Egon Franck, Stephan Nüesch and Jan Pieper, 'Specific Human Capital as a Source of Superior Team Performance' (2011) 63 *Schmalenbach Business Review* 376; John Coffee, 'Shareholders Versus Managers: The Strain in the Corporate Web' (1986) 85 *Michigan Law Review* 1.

¹²Richard Brealey, Stewart Myers and Franklin Allen, *Principles of Corporate Finance* (8th edn, S&P Global 2006) 949.

One might argue that these benefits are hardly tangible and difficult to measure, and thus default to the shareholder primacy perspective in corporate law. After all, specific human capital of this type be present only in a few firms or certain industries. However, arguably employees are in a far more precarious position than shareholders. At least in publicly traded, widely held firms shareholders typically can sell their shares and thus cut their losses in the case at a relatively limited cost. A troubling situation in any particular firm should thus not inflict an existential crisis on a properly diversified investor. This is typically not true for larger blockholders such as controlling families that have much of their capital tied up in the firm. However, these shareholders are in a good position to look after their own interest by influencing corporate management and consequently should enjoy relatively strong control over the risk to which they are exposed. By contrast, employees typically have only one job, meaning that the risk of corporate collapse is very significant for their continued ability to earn a livelihood.¹⁴ Even if they do not have firm-specific human capital that exposes them to a particular risk, transitioning to a new job typically entails a significant cost, including relocation.

2.2. Pension wealth

Most employees expect to retire at some point in their life, and the standard of living they will have in retirement is of great importance for individual well-being once individuals are no longer able to support themselves. As a part of pension wealth, occupational pension plans are often a significant component of the funds at the disposal of an employee for her sustenance in retirement.

Different types of plan expose employees to varying types of risk. In an unfunded DB (defined benefit) plan, the employer is on the hook for paying employees when pensions are due. Employees are essentially creditors of the employer hoping that the latter is capable of fulfilling the progress after their retirement. In a funded DB plan, the employer bears the investment risk, but is still on responsible for a potential shortfall. Again, the employees are creditors, but at least they are secured to the extent as the set aside funds cannot be used by the employer for other purposes or are insured.¹⁵ They are exposed to the risk of the employer's insolvency only to the

¹³Thomas Eger, 'Opportunistic Termination of Employment Contracts and Legal Protection Against Dismissal in Germany and the USA' (2004) 23 *International Review of Law & Economics* 381.

¹⁴Kent Greenfield, 'The Place of Workers in Corporate Law' (1998) 39 *Boston College Law Review* 283.

¹⁵Barry Friedman, 'Individual Accounts and the Continuing Debate over Social Security Reform in the United States' in Martin Rein and Winfried Schmähl (eds), *Rethinking the Welfare State* (Edward Elgar 2004) (noting the risk of employer bankruptcy in a DB plan); see also Steven Sass, 'The Development of Employer Retirement Income Plans: From the Nineteenth Century to 1980' in Gordon Clark and Alicia Munnell (eds), *Oxford Handbook on Pensions and Retirement Income* (Oxford University Press 2007) ('If the employer went bust, so would the benefits of current and future pensioners'); Sandy Mackenzie, *The Decline of the Traditional Pension* (Cambridge University Press 2010) 53.

extent of a funding gap, which could open because of a decline in the stock market.¹⁶ By contrast, in a defined contribution (DC) plan, employees bear the investment risk. Employees are in the position of equity investors¹⁷ exposed to movements in the stock market.¹⁸

Pension wealth may tie employees' well-being to their employer's fate, depending on the structure of the pension plan. While a properly diversified DC plan does not create any additional dependence, workers are among the firm's shareholders in an ESOP (Employee Stock Option Plans), whose terms may even prohibit them from diversifying. This exposes employees to the risk of the employer's default, which turned out to be a significant issue for employees of Enron after its collapse in 2001.¹⁹ In a DB plan, as the one formerly provided by BHS, employees are creditors, but they are still in the unfortunate position of having both their human and financial capital tied to the fortunes of one particular firm. In BHS, According to the House of Commons report, the pension schemes had a combined surplus of £43 million when Sir Philip Green bought the company in 2000. Nonetheless, the surplus gradually diminished during the years of his ownership and finally, by the time of the company sale to RAL in 2015, the value of the schemes' assets fell short of the liabilities by almost £350 million.²⁰ BHS had declined to make the employer contributions necessary to preserve the sustainability of the pension schemes.²¹

Although some argue that the pension deficits mainly emerged because of the interest rate reduction by the Bank of England following the 2008 financial crisis,²² however, Sir Philip Green could have protected the scheme by investing in it and he did not. The House of Common report states that BHS had declined to make the employer contributions necessary to preserve the sustainability of the pension schemes.²³

In 2015, the pension fund's position became so bad that Project Thor was proposed internally to Sir Philip Green. The project included several features

¹⁶Friedman (n 15) 220.

¹⁷Alicia Munnell and Annika Sundén, *Coming Up Short; The Challenge of 401(k) Plans* (Brookings Institution Press 2004) 68.

¹⁸Andrew Samwick and Jonathan Skinner, 'How Will 401(k) Pension Plans Affect Retirement Income?' (2004) 94 *American Economic Review* 329. Regarding the effects of the financial crisis, see Edward Whitehouse, Anna D'Addio and Andrew Reilly, 'Investment Risk and Pensions: Impact on Individual Retirement Incomes and Government Budgets' [2009] OECD Social, Employment and Migration Working Papers No. 87, 47.

¹⁹David Millon, 'Enron and the Dark Side of Worker Ownership' (2002) 1 *Seattle Journal of Social Justice* 113; Munnell and Sundén (n 17); Jeffrey Gordon, 'What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections' (2002) 69 *University of Chicago Law Review* 1233.

²⁰The House of Commons inquiry to BHS report, para 19.

²¹*ibid*; also BHS pension trustee minutes, 11 June 2002, 24 November 2006, 13 February 2007, 8 May 2009, 26 August 2009.

²²Matt Hitchens, IF researcher on behalf of the intergenerational foundation, 2016, DB Pensions: Choking Hazard, How Defined benefit schemes are throttling the UK economy <http://www.if.org.uk/wp-content/uploads/2016/06/Pensions-Throttling_Final.compressed.pdf> accessed 20 May 2017

²³The House of Commons inquiry to BHS report, para 19; see also BHS pension trustee minutes, 11 June 2002, 24 November 2006, 13 February 2007, 8 May 2009, 26 August 2009.

including restructuring the pension schemes. Nevertheless, Sir Philip Green found Project Thor to be too expensive and decided to sell BHS instead. The BHS buyer was Retail Acquisitions Limited (RAL) owned by Dominic Chappell, a three-times-bankrupt ex-racing driver with little experience of retail. The House of Commons report found that the BHS sale at that time was ‘substantially detrimental’ to the pension schemes.²⁴

The new owners were aware that the pension schemes were in heavy deficit when they bought BHS. In fact, in addition to Sir Philip and the BHS managers during his ownership, the House of Commons report considers Dominic Chappell and RAL’s directors responsible for the BHS pension scheme deficiency. They accepted responsibility for the company with a ‘negligent’ and ‘careless attitude’ towards the risks and potential consequences. This negligence was paired with incompetence and a self-serving attitude throughout their tenure. The new owner failed to recruit a retail expert despite his own lack of experience. He failed to secure funding on commercial terms, failed to address BHS’s property leases in a timely way, and made many other mistakes in managing the company.

The company collapsed and went into administration in 2016. The collapse of BHS resulted in the redundancy of 11,000 employees, who were left with no retirement plan. Sir Philip has already managed to escape legal action by the Pension Protection Fund though the £363 million settlement with the Pension regulator. However, the settlement did not erase the bitter fact that he himself, and his family, benefited significantly from excessive dividends at the expense of the BHS employees, as did Dominic Chappell and all of their respective directors and advisers.²⁵

3. Background to the consideration of employee interests in the UK

As we have seen in the previous part, employee are often strongly exposed to decisions made by the board of directors; as illustrated by BHS, unlike shareholders they are typically in a bad position to protect their interests in the company and diversify their risk. It is therefore not surprising that, even prior to the UK Government’s proposed reforms for strengthening the employees’ voice, company law often played an important role for employee interests. In this part, we survey the historical background. Before the recent proposal, there were two formative periods that shaped the present law, namely (1) the debate following the Bullock report in 1977 and subsequent changes to the Companies Act, and (2) the discussion about ‘enlightened shareholder value’ that led to section 172(1) of the Companies Act 2006.

²⁴The House of Commons inquiry to BHS report, para 44.

²⁵*ibid* paragraphs 9, 11, 44, 54 and 171.

3.1. From the Bullock Report to section 309 of the Companies Act 1985

The debate about employees in UK company law first flared up in the 1970s. In light of case law binding directors closely towards following shareholder interests,²⁶ the Conservative Government's Companies Bill of 1973 first proposed to widen the discretion of directors by entitling them 'to have regard in exercising their powers include the interests of the company's employees as well as the interests of its members'.²⁷ After coming to power in 1974, the Labour Government pursued an even more radical project and commissioned the 1977 Report on Industrial Democracy developed by a commission chaired by Lord Alan Bullock.²⁸ This report recommended a form of codetermination comparable to the one in the largest German firms, with union representatives having equal representation.²⁹

'Industrial democracy' failed in Britain not primarily because of opposition from business circles, but because labour itself did not fully support it. Unions feared being drawn into management responsibilities and losing their independence from capital.³⁰ Moreover, the Labour Party depended on the Liberal Party and the support of the City of London for its economic policy.³¹ The unions did not want to jeopardize legislative projects they considered a higher priority, such as employment protection statutes.³² Following the more moderate White Paper of 1978, Labour did not pass a law³³ until the Conservatives came back into power in 1979.

Margaret Thatcher's Conservative Government introduced section 46 of Companies Act 1982 in 1979. The section stated that 'the matters to which the directors of a company are to have regard in the performance of their functions shall include the interests of the company's employees in general as well as the interests of its members'.³⁴ Even if the proposal of the Bullock report was not enacted, one might have expected it to improve the position of employees in corporate law to some extent, but in practice the provision proved to be of little consequence, not least due to the absence

²⁶*Parke v. Daily News* [1962] Ch. 927 (finding that directors could not make voluntary redundancy payments to employees without a related benefit to the company).

²⁷Lord Wedderburn of Charlton, 'Employees, Partnership and Company Law' (2002) 31 *Industrial Law Journal* 99.

²⁸Alan Bullock Baron, 'Report of the Committee of Inquiry on Industrial Democracy' (1977) 6706 HM Stationery Office.

²⁹However, the report advised against the introduction of a two-tier board. See Otto Kahn-Freund, 'Industrial Democracy' (1977) 6 *Industrial Law Journal* 65.

³⁰David Marsh and Gareth Locksley, 'Capital in Britain: Its Structural Power and Influence Over Policy' (1983) 6 *West European Politics* 36, 49–50; Herman Knudsen, *Employee Participation in Europe* (Sage Publications 2015) 54. There were a number of issues of dispute, such as the appointment process which would have been channelled through the unions in the absence of mandatory works councils in the UK. See Kahn-Freund (n 29) 67–68.

³¹Marsh and Locksley (n 30) 50.

³²Lord Wedderburn of Charleton, *The Worker and the Law* (3rd edn, Penguin Books Ltd 1986).

³³Marsh and Locksley (n 30).

³⁴Companies Act 1980, s 46.

of an enforcement mechanism.³⁵ Section 309 of the Companies Act 1985, the immediate successor of section 46 of the Companies Act 1980, inherited exactly the same features.³⁶

Without either a 'codetermined' board or an enforcement power for employees, s. 309 remained a toothless tiger.³⁷ Shareholders could hardly be expected to pursue an action in a case of shareholder-employee conflict of interests.³⁸ Commentators continued to assert that the guiding principle of UK Company Law remained shareholder primacy.³⁹

3.2. *Employees and the Companies Act 2006*

The issue of employees and corporate governance came on the table again when the Labour government initiated the Company Law Review Steering Group (CLRSG) in 1998 to reform the company object.⁴⁰ Although the Steering Group considered both 'pluralism' as well as what came to be known as 'Enlightened Shareholder Value', they ultimately selected the second option.⁴¹ The CLRSG raised a number of issues with regard to the application of the stakeholder principle in the UK corporate law.⁴² In particular, it argued that stakeholder protection should generally be pursued outside of company law, given that a reform of company law itself would require an essential change to the current framework with unpredictable and potentially damaging effects.⁴³ Most of all, the CLRSG feared that giving directors discretion to consider the interests of stakeholders' other than shareholders' would dangerously distract directors, thus reducing British firms' competitiveness.⁴⁴

³⁵D.D. Prentice, 'A Company and Its Employees: The Companies Act 1980' (1981) 10 *Industrial Law Journal* 1; Simon Deakin and Giles Slinger, 'Hostile Takeovers, Corporate Law, and the Theory of the Firm' (1997) 24 *Journal of Law and Society* 124; Christopher Bruner, *Corporate Governance in the Common-Law World: The Political Foundations of Shareholder Power* (Cambridge University Press 2013) 164.

³⁶Neither of the provisions empowered employees with an enforcement mechanism, nor were they understood, for example, to allow board to consider the effect of a takeover on employees in their obligations under the Takeover Code. John Armour, Simon Deakin and Suzanne Konzelmann, 'Shareholder Primacy and the Trajectory of UK Corporate Governance' (2003) 41 *British Journal of Industrial Relations* 537.

³⁷Simon Deakin and Giles Slinger, 'Hostile Takeovers, Corporate Law, and the Theory of the Firm' (1977) 24 *Journal of Law and Society* 135.

³⁸Prentice (n 35) 4–5; see also Len Sealy and Sarah Worthington, *Cases and Materials in Company Law* (10th edn, Oxford University Press 2013) 177; J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law* (Clarendon Press 1995).

³⁹Wedderburn of Charlton, 'Companies and Employees: Common Law or Social Dimension?' (1993) 109 *Law Quarterly Review* 220; Paul Davies, 'Shareholder Value, Company Law, and Securities Markets Law: A British View' in Klaus Hopt and Eddy Wymeersch (eds), *Capital Markets And Company Law* (Oxford University Press 2003) 261; Jonathan Rickford, 'Fundamentals, Developments and Trends in British Company Law – Some Wider Reflections' (2004) 1 *European Company and Financial Law Review* 391 (arguing for a shareholder primacy interpretation).

⁴⁰Department of Trade and Industry, *Modern Company Law for a Competitive Economy 1.1* (1998), at <<http://www.berr.gov.uk/files/file23283.pdf>> accessed 7 May 2017.

⁴¹Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: The Strategic Framework 40* (February 1999), at <<http://www.berr.gov.uk/files/file23279.pdf>> accessed 7 May 2017.

⁴²*ibid* paras 5.1.25–5.1.33.

⁴³*ibid* para 5.1.27.

⁴⁴*ibid* para 5.1.28.

The UK enlightened shareholder value is now encapsulated in section 172 of the Companies Act 2006 as a 'duty to promote the success of the company'. One of the matters that directors should have regard to, according to section 172(1), is the interests of employees. The only other group's interest section 172 refers to it explicitly is creditors.⁴⁵

Consequently, ultimately more in line with the traditional understanding of company law than the prior s 309, the new 'enlightened shareholder value' approach of s 172 sees stakeholder interests only as instrumental to long-term shareholder wealth maximization.⁴⁶ Commentators seem to agree that the requirement remains largely subjective, given that it must read in combination with the statutory requirement of 'good faith'.⁴⁷ Authors of an early handbook on the Companies Act, therefore, speculated that the enlightened shareholder value approach might well turn out not entail an actual obligation for practical purposes, but – as did its predecessor – a defence for directors against reproach.⁴⁸ Andrew Keay goes even further, arguing that 'the provision ... grants unfettered discretion to the directors to act in a way that they consider would most likely promote the success of the company for the benefit of the members'.⁴⁹

The CLRSg rejected a separate consideration of the interests of stakeholders, including employees, based on the argument that it would give directors broad discretion that would be difficult to police.⁵⁰ However, the current enlightened shareholder value principle's approach has brought the CLRSg's assertion in rejecting the pluralism into question. It has inherited exactly the same problem by giving the same wide discretion to directors without a clear wording in the Act or providing a guideline for directors regarding how and when they should consider the interests of employees. Despite recent attempts to clarify the ambiguities of section 172 as part of the ongoing corporate governance reform, the Government still has no plans to change the wording of section 172. However, it has declared that the GC 100 group of the largest listed companies will be required to prepare guidance on the practical interpretation of the directors' duty under section 172 of Companies

⁴⁵Section 172(1)(b) of the Companies Act 2006 clearly requires directors to in promoting the success of the company have regard to the interests of the company's employees. Also section (172)(3) gives a separate emphasis on the interest of creditors in certain circumstances.

⁴⁶For a detailed account of the arguments put forward in the debate, see Sarah Kiarie, 'Crossroads: Shareholder Value, Stakeholder Value and Enlightened Shareholder Value: Which Road Should the United Kingdom Take?' (2006) 17 International Company and Commercial Law Review 329; Brenda Hannigan and others, *The Companies Act 2006 – A Commentary* (LexisNexis UK 2007).

⁴⁷Andrew Keay, 'Tackling the Issue of the Corporate Objective: An Analysis of the United Kingdom's "Enlightened Shareholder Value Approach"' (2007) 29 Sydney Law Review 108; Charles Wynn-Evans, 'The Companies Act 2006 and the Interests of Employees' (2007) 36 Industrial Law Journal 188, 191; Hannigan et al. (n 46) 31.

⁴⁸Goffrey Morse and others, *Palmer's Company Law: Annotated Guide to the Companies Act 2006*, 168 (Sweet & Maxwell 2007); Keay (n 47).

⁴⁹Keay (n 47) 107; see also Daniel Attenborough, 'The Company Law Reform Bill: An Analysis of Directors' Duties and the Objective of the Company' (2006) 27 Company Lawyer 162.

⁵⁰Company Law Review, 'Modern Company Law for a Competitive Economy: Strategic Framework' (London, 1999), para 5.1.30.

Act 2006.⁵¹ As we discuss below, the practical effect of the proposed guidance is dubious.

Still, one important criticism to the Companies Act 2006 is the lack of an enforcement mechanism for employees to enable them to protect their interests in situations of director misconduct. The only group with actual enforcement possibilities remain shareholders under the statutory derivative claim and apart from situations in which employees double as shareholders, they have not been empowered by the Companies Act 2006 to enforce the compliance of their interests embodied in section 172(1). As the law ultimately only serves shareholders' interests, only shareholders are even in the position to safeguard the interests of employees against management. In practice, however, shareholders are unlikely to bring a time-consuming and an expensive derivative claim to protect the employees' interests. While the debate about short-termism in corporate governance is far from settled, shareholders may sometimes prioritize short-term profit maximisation goals and thus care mainly about investment returns in the near future. Hence, they may be reluctant to be involved in corporate governance matters and costly monitoring of their investee companies or they may not care if their companies earn profits by breaking the law or hurting employees.⁵²

The deficiencies of section 172 and the employees need for a stronger protection under the company law have become evident to the UK government, which has responded with a proposed package of reforms with the aim of strengthening the employees' voice. In the next section, we discuss that why the proposed reforms are not sufficient and why employees need a derivative claim right as a complementary mechanism.

4. The Government's new package of reforms: Would it prevent tragedies like BHS?

The House of Commons report named the BHS scandal as 'the unacceptable face of capitalism',⁵³ and the UK Prime Minister Theresa May has promised to

⁵¹Department for Business, Energy & Industrial Strategy, Corporate Governance Reform, The Government response to the Green Paper consultation, Action 8, para 2.45.

⁵²Lorraine Talbot, 'Why Shareholders Shouldn't Vote: A Marxist-Progressive Critique of Shareholder Empowerment' (2013) 76 *Modern Law Review* 791; Lynn Stout, *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public* (Berrett-Koehler Publishers 2013); Aidan O'Dwyer, 'Corporate Governance after the Financial Crisis: The Role of Shareholders in Monitoring the Activities of the Board' (2014) 5 *Aberdeen Student Law Review* 115, 112; George Hadjikyprianou, 'The Principle of "Comply-or-explain" Underpinning the UK Corporate Governance Regulation: Is There a Need for a Change?' (2015) 7 *Corporate Governance Law Journal*; Lorraine Talbot, 'Polanyi's Embeddedness and Shareholder Stewardship: A Contextual Analysis of Current Anglo-American Perspectives on Corporate Governance' (2011) 62 *Northern Ireland Legal Quarterly* 451; Leo Strine, 'One Fundamental Corporate Governance Question We Face: Can Corporations be Managed for the Long Term Unless Their Powerful Electorates also Act and Think Long Term?' (2010) 66 *Business Lawyer* 1, 17 (suggesting that institutional investors have pushed US corporations toward more short-term orientation); but see Mark Roe, 'Corporate Short-Termism – In the Boardroom and in the Courtroom' (2013) 68 *Business Lawyer* 977, 1005–1006 (suggesting that the short-termism problem in the US is insufficiently proven).

⁵³The House of Commons Report Inquiry into BHS, para 168.

stamp out irresponsible corporate behaviour through the new corporate governance framework.

In light of tragedies like BHS, the UK Government has proposed reforms in three main aspects of corporate governance. The proposed plans have three key components: Fixing executive pay; strengthening the employee, customer and supplier voice; and extending the corporate governance code to large privately held businesses.

For strengthening the employees' voice, the Government's intention is to: introduce secondary legislation and require all companies of significant size (private as well as public) to explain how their directors comply with the requirements of section 172 to have regard to employee and other interests. Also on a 'comply or explain' basis, FRC requires premium-listed companies to adopt one of three employee engagement mechanisms: a designated non-executive director; a formal employee advisory council; or a director from the workforce. Furthermore, the government intends to invite the GC100 group of the largest listed companies to complete and publish new guidance on the practical interpretation of directors' duties in section 172 of the Companies Act.

The Government's assumption is that these proposals will drive change in how big companies engage with their key stakeholders by putting higher expectations on companies especially on leading, premium-listed companies. Before discussing our proposal, this section analyses the Government's proposed reforms in order to determine if they are likely to be effective in practice. We argue that more far-reaching reforms than the ones envisioned by the government are needed, such as the derivative claim for employees that we are proposing.

4.1. 'Comply or explain' models of employee engagement

4.1.1. Designation of existing non-executive directors

Under the proposed reforms, assigning an existing non-executive director to represent the interest of employees is one of the options which premium-listed companies can adopt on the basis of the 'comply or explain' principle.⁵⁴ However, it is neither clear at this stage that how the designated non-executive director is supposed to increase the voice of employees at the board level, nor whether the designated non-executive director will act for different stakeholder groups or only for the employees in the company.

Some respondents to the Government Green Paper have suggested that there should be more than one non-executive director acting as a point of liaison for different stakeholder.⁵⁵ Other respondents have suggested that

⁵⁴Department for Business, Energy & Industrial Strategy, Corporate Governance Reform, The Government response to the Green Paper consultation, Action 7, p 34.

⁵⁵ibid para 2.10, 25.

non-executive director(s) should be able to meet management, the workforce and unions to discuss matters of concern; should have access to employee engagement survey results and other statistics; should be able to consult with key suppliers; and should be able to review customer feedback, including complaints. Regardless of the extent to which the Government would apply the proposed recommendations in defining the role of the non-executive directors for employees, it is unlikely that this option would be effective.

4.1.2. Problems with the role of the non-executive director

It is difficult to analyse the possible impacts of designating a non-executive director to increase the voice of stakeholders without knowing how the mechanism will be implemented. Respondents to the Green Paper have raised the concern that, if the non-executive director is expected to promote rather than channel the interests of particular groups, the role could potentially conflict with the joint duties of directors and compromise their independence. There are also concerns that designated non-executive directors could find themselves isolated on the board, unable to provide an effective challenge.⁵⁶ Another concern is the difficulty of reconciling diverging stakeholder interests.

We can add some general concerns about the role of non-executive directors and its efficacy, in spite of the fact that non-executive directors have long been considered a key part of the corporate governance. Although non-executive directors have broad duties to monitor the executive directors' conduct, there is a lack of clarity on how they should perform their duties and what fiduciary duties they have towards the company.⁵⁷ In addition, they may not always completely understand the complexities of the businesses they direct.⁵⁸ Moreover, they may lack incentives to effectively perform the tasks that have been assigned to them,⁵⁹ unless they are provided with strong financial incentives that likely align their interests with those of shareholders only. Further, they may be under the influence of the executive directors who have proposed them.⁶⁰

⁵⁶ibid para 2.11, 26.

⁵⁷Arad Reisberg, *Derivative Actions and Corporate Governance: Theory and Application* (Oxford University Press 2007); James Kirkbride and Steve Letza, 'Can the Non-executive Director be an Effective Gatekeeper? The Possible Development of a Legal Framework of Accountability' (2005) 13 *Corporate Governance An International Review* 542; Wolf-Georg Ringe, 'Independent Directors: After the Crisis' (2013) 14 *European Business Organization Law Review* 401; Jonathan Liu and Tomas Andersson, 'Mind the Gap: Expectations on the Role of UK Non-Executive Directors' (2014) <<http://www.regents.ac.uk/media/975652/RWPBM1402-Liu-J-Andersson-T.pdf>> accessed 23 April 2017; Simon Witney, 'Corporate Opportunities Law and the Non-Executive Director' (2016) 16 (1) *Journal of Corporate Law Studies* 145–186.

⁵⁸Christopher Pass, 'Non-executive Directors and the UK's New Combined Code on Corporate Governance' (2008) 9 *Business Strategy Series* 291–296; Reisberg (n 57).

⁵⁹Andrew Kakabadse and others, 'Role and Contribution of Non-Executive Directors' (2001) 1 *Corporate Governance: The International Journal of Business in Society* 4; Ringe (n 57) 418.

⁶⁰Sanjai Bhagat and Bernard Black, 'The Non-Correlation Between Board Independence and Long-Term Firm Performance' (2002) 27 *The Journal of Corporation Law* 231; Pass (n 58); Samuel O. Idowu and Céline Louche (eds), *Theory and Practice of Corporate Social Responsibility* (Springer 2011) 39, 51.

4.1.3. *Formal employee advisory council*

The second option under the government plan is a formal employees' advisory council. As for the previous option, it is not clear how this body is expected to strengthen the employees' voice. Also, it is not clear that how the council members would be chosen and what kind of task they would have. If works council in Germany and other Continental European jurisdictions serve as the model, would employees elect the council members themselves, or would the task be given to the directors or shareholders?

What impact would the council have on the board decisions? Would the panel have enough power to challenge the board? Would they participate in decisions about company strategy and its execution? Would they similar to the work councils in Germany have an impressive set of information, consultation and co-decision rights? ⁶¹

Respondents to the Green Paper have suggested, among other things that: the panel should be able to issue an annual public statement (potentially as part of the annual report) and commission independent investigations, in order to maintain its independent voice. The panel should ensure that board and management are clear about key risks and amplify perspectives that may be absent or weak at board level. Moreover, the panel could have a formal consultative role with the remuneration committee in reviewing executive pay policies and performance. While it is unclear whether the Government will implement any of these suggestions, it is evident that the employee advisory council as the sole mechanism would not have sufficient mandatory nature to oblige directors to consider the employees' interests in their decision-making, nor it would have strong power to prevent the directors' opportunistic behaviour.

4.1.4. *Appointment of an employees' representative to boards*

The third proposed employee's engagement mechanism is appointing a director from the workforce, which was actually one of the UK Prime Minister's campaign pledges. However, she eventually stepped back from her initial promise by substituting mandatory employees' representative with optional, but strongly encouraged workforce representation for public listed companies.

As a general concept, providing employees with the right to have a representative on board could provide some advantages both to the company and to the employees themselves. The economic rationale for employee representation is that employees may be more motivated to invest in the company specific skills if they are less exposed to threats of opportunistic wage negotiations or termination of pension plans.⁶² Also, employees' representative

⁶¹Paul Davies, 'Efficiency Arguments for the Collective Representation of Workers: A Sketch' in C. Costello, Bogg, Paul Davies and J. Prassl (eds), *The Autonomy of Labour Law* (Hart Publishing 2014).

could introduce different perspectives on the operation of the company. Some argue that employee participation may reduce information asymmetries between executives and other employees and thus decrease the costs of collective bargaining and the incidence of strikes,⁶³ given that employees' representative could have hands-on knowledge of the daily operations of the company.⁶⁴ Better-informed employees may be less likely to object to necessary restructuring.⁶⁵

Naturally, there are some potential problems. The first important point is that the employees' representative in the UK as a voluntary option based on comply and explain principle might not be effective in practice. Listed companies might not see this as an opportunity to engage with employees. Even if companies choose this option, some factors might undercut its potential benefits. It is not clear that how the proposed employee's director would be elected. Company employees might either hold an official election, or they might only be permitted to nominate a candidate for subsequent appointment by directors or election by shareholders.⁶⁶ In the latter case (which is currently practiced in the few British companies having employee representatives)⁶⁷ the powers of employees would remain notional. The purpose of employees' representatives is not merely to serve as figureheads, but to guarantee that employees' interests are represented in board deliberations. Representatives selected by the board and voted into office by shareholders will likely not be sufficiently independent from shareholders.

Moreover, the Government has not clarified the prospective role of employees directors. If the purpose is to represent the interests of employees and to contribute their concerns to board deliberations, this role could be potentially in conflict with general duties of directors. The UK Companies Act 2006 clearly indicates that the company is the only beneficiary of directors' fiduciary duties.⁶⁸ Therefore, all the fiduciary duties described in sections 171 to 177 of the Companies Act 2006, including the duty to avoid conflict of

⁶²Martin Gelter and Genevieve Helleringer, 'Constituency Directors and Corporate Fiduciary Duties' in Andrew Gold and Paul Miller (eds), *Philosophical Foundations of Fiduciary Law* (Oxford University Press 2016); Eger (n 13) 384–85; see also Martin Gelter, 'The Pension System and the Rise of Shareholder Primacy' (2013) 43 *Seton Hall Law Review* 909, 937–941.

⁶³Gelter and Helleringer (n 62) 317; Gérard Hertig, 'Codetermination as (Partial) Substitute for Mandatory Disclosure' (2006) 7 *European Business Organization Law Review* 123–130.

⁶⁴Margit Osterloh and Bruno Frey, 'Shareholders Should Welcome Knowledge Workers as Directors?' (2006) 10 *Journal of Management and Governance* 325, 330; Hertig (n 63) 128; Gelter and Helleringer (n 62).

⁶⁵Hertig (n 63) 130; Gelter and Helleringer (n 62) 317.

⁶⁶This resembles to the situation in the Netherlands, where the works council has the right to nominate candidates for the board. See Edo Groenewald, 'Corporate Governance in the Netherlands: From the Verdam Report of 1964 to the Tabaksblat Code of 2003' (2005) 5 *European Business Organization Law Review* 291, 299.

⁶⁷This is currently the practical approach in the First Group PLC which is apparently one of the few UK public companies who has an employee representative on board; <http://www.firstgroupplc.com>.

⁶⁸Companies Act, 2006, ss. 170.

interest⁶⁹ must be discharged in a similar way by employee directors and others.⁷⁰

It is far from clear how the proposed employees' representative will be positioned to promote and preserve the interests of employees without creating the conflict of interest? Also, information sharing between the employees' director and the group he is representing is a two-edged sword. Employees' directors may struggle keeping their duty of confidentiality on one hand, while reducing the asymmetry of information between employees and the board by providing the employees with reliable information on the other. Information sharing has long been a main concern in the debate about German codetermination.⁷¹ The CEO and the chairman might attempt to withhold certain information, for example a proposed downsizing, from employees' representatives because it might leak to the union, politicians, or the business press. It has thus been argued that the absence of a continued flow of information undermines the functioning of the German supervisory board.⁷² The UK Government needs to clarify the mentioned ambiguities on the role of the employees' representative. Even if her duty would be to provide perspective rather than representing particular interests, the scope of her role should be clear.

The other serious concern is that a single employees' representative will be isolated on the board and will not have an impactful voice on the board. For the Government proposal to work in practice, a critical mass of two or three directors would have to be appointed. Considering the traditional board structure of UK companies, few firms will likely choose this option.

4.2. Mandatory report on compliance with section 172

The Government's fourth option is strengthening the reporting requirements on how directors comply with the requirements of section 172 to have regard to the employees' interests. Again, the details of the proposal could hardly be less clear. Under the current plan, companies will be required to explain how they have identified and sought the views of key stakeholders, why the mechanisms adopted were appropriate, and how they influenced boardroom decision-making. In addition to the annual report, the government may require disclosures on the company website.⁷³

⁶⁹Companies Act, 2006, ss 175.

⁷⁰Gelter and Helleringer (n 62) 309.

⁷¹Mark Roe, 'German Codetermination and German Securities Markets' [1998] Columbia Business Law Review 171; Jean Du Plessis and Otto Sandrock, 'The Rise and Fall of Supervisory Board Codetermination in Germany?' (2005) 16 International Company and Commercial Law Review 67, 75–75; Felix FitzRoy and Kornelius Kraft, 'Co-determination, Efficiency and Productivity' (2005) 43 British Journal of Industrial Relations 233, 236 (at 236 citing studies suggesting that information is sometimes withheld).

⁷²Gelter and Helleringer (n 62) 317.

⁷³Department for Business, Energy & Industrial Strategy, Corporate Governance Reform, The Government response to the Green Paper consultation, para 2.36.

The new reporting requirement is expected to encourage directors to give more thought to how they engage with employees and other stakeholders.⁷⁴ However, the requirement does not provide any guidance on how directors can ensure effective engagement.⁷⁵ Nonetheless, it is not clear that how the new reporting requirement will be different from the contents of section 414C of Strategic Report and Directors' Report Regulations 2013. Section 414C of Companies Act 2006 requires directors to report to members of the company how they have performed their duty under section 172.⁷⁶ The problem with the current and the proposed report is that directors are required to report their compliance to the company members only. Unless directors are required to report to the employees or employees' representatives directly, the consideration of employee interest will not be a priority because shareholders will likely only consider the information relevant to the extent that it serves shareholder interests. As mentioned above, directors may sacrifice the long-term stability of a company in order to enhance short-term profit maximization.⁷⁷ This could be damaging for the long-term development of the company, and might ultimately harm the economy as a whole.⁷⁸ One reason is that in such situations, institutional shareholders would be indifferent to other stakeholder interest or corporate social responsibility.⁷⁹ As a result, strengthening directors' report on compliance with section 172 may not be an adequate solution to control corporate misconduct in all circumstances.

4.3. Guidance on the practical boardroom interpretation of directors' duties under section 172 CA 2006

While the Government has announced that it has no plans to amend the wording of section 172, it considers publishing a new guidance on the practical boardroom interpretation of directors' duties, for which it has invited the GC100 group of largest listed companies to prepare and publish a draft. Considering the ambiguous wording of s 172, such guidance on the performance of directors' duties is a step in the right direction. However, without knowing any details at this point, it is impossible to predict effects.

⁷⁴*ibid* para 2.39.

⁷⁵*ibid*.

⁷⁶s 414C(4)(b) CA 2006.

⁷⁷Iris, H.-V Chiu, 'Operationalizing a Stakeholder Conception in Company Law' (2016) 10 Law and Financial Markets Review 173; Caitlyn Helms, Mark Fox and Robert Kenagy, 'Corporate Short-Termism: Causes and Remedies' (2012) 23 International and Comparative Company Law Review 45.

⁷⁸*ibid*.

⁷⁹Chiu (n 77); also Emeka Duruigbo, 'Tackling Shareholder Short-Termism and Managerial Myopia' (2011–2012) 100 Kentucky Law Journal 531; David Millon, 'Shareholder Social Responsibility' (2012) 36 Seattle University Law Review 911; Marc Moore and Edward Walker-Arnott, 'A Fresh Look at Stock Market Short Termism' (2014) 41 Journal of Law and Society 416; BIS, 'The Kay Review of UK Equity Markets and Long-Term Decision Making' (Final Report, 23 July 2012) <http://www.ecgi.org/conferences/eu_actionplan2013/documents/kay_review_final_report.pdf> accessed 12 October 2017.

4.4. Strengthening the corporate governance framework in the UK's largest privately held companies

In addition to the proposed reforms for increasing the employees' voice, the Government aims to enhance the confidence of employees and other stakeholders in large private companies by providing a set of corporate governance principles. Nevertheless, adopting these principles will be voluntary, given that companies will be permitted to retain industry-level codes and guidance. At least, in order to increase transparency in private companies, large private companies with over 2000 employees will be required to disclose their corporate governance arrangements in their Directors' Report and on their websites.⁸⁰

Critics argue that these measures will not impose any meaningful obligations on wrongdoer controlling shareholders and directors to refrain from detrimental opportunistic behaviour. Even if large private companies in the UK adopted the corporate governance principles and reporting requirements, they would not serve to shield companies from harm in all circumstances. For instance, in cases such as BHS, there would be no shareholders outside the wrongdoers' team to discipline directors.

4.5. The government's governance reforms do not suffice to stop abuse to employees and other stakeholders

The UK Government has claimed that the proposed reforms 'will improve corporate governance and give workers and investors a stronger voice'.⁸¹ The UK Prime Minister has also pledged to introduce tough new laws for pension schemes to prevent a repeat of the BHS pension scandal. She has promised the Pensions Regulator will have the power to block business takeovers that could be used to raid pension funds.⁸² As we have seen, the Government reforms although are promising in rhetoric but will unlikely to have a practical impact.

All of this reveals the key problem: In proposing these reforms, the Government still assumes that shareholders are the only important group of stakeholders. Only shareholders will receive a report on executive pay, and only shareholders will have a binding vote on it. Even in terms of strengthening the employees' voice, shareholder would still have more rights than the employees themselves. Directors will still report exclusively to shareholders on how they discharge their duty to consider employee interests. Also, it is

⁸⁰Department for Business, Energy & Industrial Strategy, Corporate Governance Reform, The Government response to the Green Paper consultation, Action 11, p 42.

⁸¹ibid, Introduction from the Prime Minister.

⁸²Josephine Cumbo, 'UK Pension Scheme Protections Not Expected Before 2020' *Financial Times* (19 October 2017) <<https://www.ft.com/content/9aec9d16-b4d6-11e7-aa26-bb002965bce8>> accessed 4 January 2018.

very plausible that shareholders play a greater role in forming the proposed advisory council and choosing the employees' director than the employees. As previously discussed, shareholders may not always have a long-term orientation, and they may not object to extraordinary rewards for executives as long as they receive substantial short-term returns on their investments. They may not care when directors harm the company assets with opportunistic behaviour putting employees' jobs in jeopardy.

There is no chance that the government's proposals for large private companies will prevent scandals comparable to BHS, which was a family-run business in which controlling shareholders and directors stripped the employees' pension fund. There are many other private companies where there are no control mechanisms outside of the board of directors. Due to the lack of scrutiny by markets and regulators, the wrongdoers' abuses remain unchecked, and the transparency provided by the proposed corporate governance code would likely not affect internal management.

Employees, however, are the arm and brawn of the company, and the Government has clearly identified the need for strengthening their protection. Nevertheless, the Government has failed to adequately address this need to adopt practical solutions that preserve company stability in the long term. Therefore, in addition to the current proposals, which are theoretically constructive, directors' accountability could be strengthened at relatively low cost by implementing an additional element that would increase the accountability of directors and controlling shareholders towards the company. The right to initiate a derivative claim, which is currently restricted to shareholders, should be broadened to employees. The need for broadening the derivative claim right to other stakeholders, including the employees, has also been mentioned by respondents to the Government Green Paper.⁸³

We argue that instead of only empowering the pension regulator to prevent the scandals such BHS in future, it would be better if such enforcement right were granted to employees themselves. Employees have stronger incentives than the pension regulator to protect their own interests in the company either in form of protecting their pension schemes or protecting the company from any other negligent or opportunistic behaviour, which could harm the company and damaged their interests.

5. Establishing an employees' derivative claim

How can a derivative claim be a useful mechanism in cases like BHS? As we previously discussed, protecting the interests of employees very much depends on the stability of the company in the first instance. The derivative claim is the only direct protection available to the company, as a separate

⁸³ibid para 4.7, 44.

legal entity, to maintain its sustainability. If a violation of the law harms employees' interests, but benefits shareholders in the short run, shareholders will not necessarily have incentives to bring a derivative claim; or even in cases like BHS, there might not be a minority shareholder to protect the company. Consequently, broadening the derivative claim right to employees in such situations would benefit the firm.

The BHS tragedy might have been prevented and the company could have been saved if the company's employees had been equipped with the right to initiate a claim on behalf of the company against Sir Philipp Green and all those other company wrongdoers for their negligence, mismanagement, and for the misappropriation of the company's assets through dividends and a variety of intragroup transactions. Under the current statutory provisions, only shareholders have the right to bring a derivative claim against a wrongdoer director or another person, or both.⁸⁴ Nevertheless, in cases like BHS – which was a private company – there is no shareholder from outside the wrongdoer's team to act as a watchdog and control and stop the wrongdoers' misconduct. Even if BHS had not been a private family-run business and there were some outside shareholders with some theoretical ability to monitor the director's conduct, the employees' pension scheme might not have been any of their concern.

It is thus not clear why only shareholders should have the right to initiate derivative claims. An employee derivative claim could fill this gap. The derivative claim's function does not only serve to compensate the company financially; its deterrence role is also important. The deterrence role would increase the likelihood of a derivative lawsuit by the employees and could have a deterrent effect in preventing losses to the company and work as a threat to managers or majority shareholders like Sir Green, who under the current situation feel free to do whatever they want with the company's assets while disregarding the interests of others. Although just like shareholders, employees usually do not have the right to investigate the company's documents or get direct information on the board's conduct, they are still possibly in a better position to obtain information about the directors' wrongful conduct in the company than shareholders from outside. Therefore, if BHS employees had been equipped with the right to initiate a claim on behalf of the company, they could have challenged directors or controlling shareholders opportunistic behaviours such as excessive dividends, extraction of cash from the company or depleting the pension funds.

5.1. The proposal is not in conflict with other employee rights

It needs to be clear that our proposal is neither a substitute for other proposed reforms, such as the right to have a representative on the board nor do we

⁸⁴Companies Act 2006 section 260(3).

claim that having the derivative claim right only, would provide ironclad protection for the employees' interests. However, we argue that the derivative claim right could work as a complement to other employees' rights.

The argument is that just like shareholders who have both personal rights as well as the right to make a claim on behalf of the company, employees who are often more deeply invested in a company with their human capital, and are dependent on the company for their livelihoods and their pension benefits, should have similar right to protect their reflective interests. As Paul Davies argues, employee governance rights which operate only at sub-board or only at board level (including the advisory panel and having a representative on board) are unlikely to provide sufficient support for a fully effective cooperation arrangement, but each is arguably a necessary ingredient in a complete structure.⁸⁵ Employees' governance rights such as having a representative on board and a work council can have beneficial effects, provided that the role and function of these mechanisms have been defined clearly. The employees' derivative claim right could be the building block to complete this edifice. It is less likely that mechanisms providing representation for workers work effectively in preventing harm to the company without an enforcement mechanism to support them. What would be the advantage of employees being aware of directors' opportunistic behaviour that harms the company when they would not have the enforcement power to stop them?

One might possibly argue that employees could use other platforms such as media discussions or whistleblowing to bring wrongful conduct to the attention of the public. However, while either of these mechanisms could be helpful, they both fall short of holding directors accountable for breaching their fiduciary duties as much as a legal action. Many companies, especially private companies, are not big or sufficiently well-known to invoke the media attention or become the subject of financial analysts. The derivative claim could theoretically play an outsize role in protecting smaller publicly traded or private companies against the exploitation by majority shareholders.

Another objection could be that employees should be given stock in the company, or buy it in order to have a greater governance role. This would permit them to sue wrongdoer directors in their capacity as the shareholder. Again, this solution does not apply to all companies. Whether employees hold shares depends on the firms' capital structure, public trading status, and remuneration policies. As a large privately held firm, BHS is an example where employees could not avail themselves of a shareholder derivative claim.

⁸⁵Davies (n 61) 381.

5.2. Extending the derivative claim right to the employees' representative

Based on the arguments given, statutory provisions under the Companies Act 2006 should be broadened to include employees as the claimant for the derivative claim. In this regard, in addition to the shareholders, the proposed derivative claim would be initiated by, *a registered trade union that represents employees of the company, or another representative of employees of the company.*

The proposal resembles section 165(2) of the South African Companies Act 2008,⁸⁶ which clearly permits a registered trade union that represents employees of the company or another representative of employees of the company to initiate a derivative action. Limiting the derivative claim right to the employees' representative would reduce the amount of litigation and undercut concerns about abusive lawsuits.

One objection could be that the employees' representative, especially a trade union, might pursue its own agenda rather than serve the employees' interests. The situation is similar as in collective bargaining, where the union representative could take advantage of the situation when dealing with the company's directors. However, the situation discussed here differs crucially in that a derivative claim is brought on behalf of the company, which would receive any possible benefit or remedy. Considering the factors such as the role of the court, the derivative claim's tough procedural requirements and the costs of the litigation, it is unlikely that the derivative claim would create many opportunities for misuse. It seems doubtful that employees or their representative take the risk of initiating a time-consuming and costly litigation, which would not even benefit them personally with the aim of abusing the directors. If we are too concerned about the risk of employees' representative abusing the situation of a claim on behalf of the company, then we could find employees' representative on the board, which has already been proposed by the UK Government, equally troubling. In the end, this is a larger question to what extent unions are accountable to their constituents, and to what extent the relationship between unions and workers entails an agency problem. If such a concern would affect all union activities, unions that are properly accountable to workers should be largely immune from to this criticism.

Another objection might be that the proposed reform would cause an excessive amount of litigation against company directors and would reduce directors' business risk-taking, and consequently affect the profit growth because broadening liability risks would make directors more risk-averse. In fact, other jurisdictions have already expanded the derivative claim right to

⁸⁶South African Companies Act 2008, section 165 (2).

other corporate stakeholders, including corporate employees, without such an effect. For instance, the Canada Business Corporations Act 1985 section 238 provides that in addition to the members, some specific types of creditors, and directors, the derivative action can also be initiated by 'any other person who, in the discretion of a court, is a proper person to make an application'. Singapore has also taken the same approach to Canada.⁸⁷ The experience in these jurisdictions reveals that because of the derivative claim's procedural requirements, expanding the derivative claim right to other stakeholders would not open the floodgates to litigation against the company.

As mentioned above, our article's proposal was inspired by section 165(2) of the South African Companies Act 2008. The section gives standing to pursue a derivative action to:

a registered shareholder or a person entitled to be registered as a shareholder of the company or a related company, a director or prescribed officer of the company or a related company, *a registered trade union representing employees of the company or another employee representative*, or a person who has been granted standing by the court. (our emphasis)

In fact, the employees' representative right under the Companies Act 2008 is not limited to the right to initiate a derivative action. The employees representative could also apply to the court to restrain a company from acting in conflict with the Act⁸⁸ or to declare a director delinquent or be put on probation. The union as the employees representative could also make an application based on unconscionable abuse of the company as a separate entity.⁸⁹ The union must be given access to a company's annual financial statements to initiate a business rescue.⁹⁰ Moreover, if there is a directors' resolution to provide financial assistance to a director, the union must be given written notice of the resolution.⁹¹ In addition, a trade union could be a whistleblower and disclose irregularities or contraventions of the Act.⁹²

With regards to the derivative action, in *Lewis Group Limited v Woollam and Others*,⁹³ the High Court of South Africa held that:

[o]ne of the most obviously reformatory aspects of s165 of the 2008 Companies Act is that standing to bring derivative actions is afforded more widely than it appears to have been under the common law. Standing is afforded under s 165 also to directors, employee representatives and any other person who might obtain the court's leave to proceed derivatively.'

⁸⁷Singaporean Companies Act section 216A(1)(c), also see Andrew Keay, 'Assessing and Rethinking the Statutory Scheme for derivative Actions Under the Companies Act 2006' (2016) 16 Journal of Corporate Law Studies 39.

⁸⁸Companies Act section s 20(4).

⁸⁹ibid section 20(9).

⁹⁰ibid section 131.

⁹¹ibid section 45(2).

⁹²ibis section 159.

⁹³*Lewis Group Limited v Woollam and Others* (9900/2016) [2016] ZAWCHC 130.

The court further reasoned that,

[w]hilst the majority of shareholders might be prepared to condone loss occasioned to a company due to the negligent conduct of its directors, employees faced with resultant redundancy or wage cuts might have a different view and be able to persuade a court that objectively it would be in the company's best interests to seek redress against the negligent directors.⁹⁴

This article agrees with the court ruling that the employees should have the right to make a claim on behalf of the company and that their derivative claim right would pose a greater deterrent to wrongdoers in the company. This is true especially in private companies whose directors may otherwise feel sufficiently secure to interfere as they please with the company's assets or to run the company in a way that benefits them personally without having to consider any consequences of their conduct for others. The derivative claim right to employees would make directors and managers more cautious in their conduct. Even if they had shareholders supporting them or ignoring harm being done to the company, employees would be theoretically in the position to prevent harmful actions. Hence, the benefit of broadening the derivative claim provisions to include employees would outweigh its possible disadvantages.

As was explained above, in light of the South African experience the risk abusive litigation appears negligible. The derivative claim is a lawsuit on behalf of the company predicated on shareholders and employees' ability to show that the company's interest is harmed or is in jeopardy. The claim's limited grounds, the two-staged judicial procedure for the admission of derivative suits and the difficulty of surmounting the leave requirements should suffice to discourage problematic suits.

5.3. The structure of the current statutory provision should change

The current statutory derivative claim scheme has been established on the shareholder primacy principle. Under the statutory provisions, only shareholders have the right to initiate the claim. Consequently, the procedure requirements have been based on the shareholder right only. Therefore, in case of the broadening of the derivative claim standing to employees, the wording of the current provisions, as well as some of the procedure requirements, should be amended.

One factor is the current role of the shareholder ratification in the context of the derivative claim. The problem is that the ratification is not limited only to the ratification, which has already occurred. Under section 263(3)(c), the Act also requires the court to use its discretion to consider whether the act or

⁹⁴ibid para 33.

omission that has raised the derivative claim would be likely to be ratified or authorised by shareholders in future. Such considerations would add to the complexity of the derivative procedure and cause confusion for the courts. In practice, it would be unpredictable whether the breach of duty would be ratified or not unless the court can sustain the procedure until the company shareholders decide about whether to ratify. This would be particularly unfair to the employees as an applicant because the interest of shareholders and employees is not always in line with each other and their claim should be considered on the grounds of their own interests only.

Hence, our article's suggestion is that instead of playing a role as a substantial requirement for assessing a derivative claim under the statutory derivative claim provisions, ratification should be regarded as a factor for the court to consider with regards to the shareholders' derivative claim only and in certain circumstances, but not in cases of employee suits.

6. Conclusion

In light of the BHS scandal and some other companies' failure in protecting the employees' interest, the UK Government has set out some plans to strengthen the employees' voice.

The Government's specific plans for improving the employees protection have been set in form of a mandatory report on how directors comply with the section 172 requirements in considering the employees interest, adopting either: a designated non-executive director; a formal employees advisory council; or a director from the workforce on a 'comply or explain' basis. Moreover, the Government requires the GC 100 group of the largest listed companies to prepare guidance on the practical interpretation of the directors' duty under section 172 of Companies Act 2006. In addition, the Government has unveiled some other corporate governance reforms such as standardizing the executive pay and establishing a voluntary set of corporate governance code for large private companies. The Government proposed reforms, provided that the role and function of these mechanisms will be defined clearly, may have beneficial effects.

However, our argument is that these proposed reforms would be insufficient to protect the company and its employees. A derivative claim right for employees would help to further protect their interest in the company. In the current situation, only shareholders have the right to bring a claim on behalf of the company when directors fail to comply with their fiduciary duties. Nevertheless, they may not care when directors harm the company assets with their opportunistic behaviours and put the employees' jobs in jeopardy as long as they are benefiting from short-term developments in the company. Employees often have better incentives than shareholders to protect the company in a long run.

In this regard, the article proposed the broadening of the derivative claim provisions to a registered trade union that represents employees of the company, or another representative of employees of the company. Considering a derivative right for employees at least in theory would pose a threat to wrongdoers, especially in private companies where there is no external control on directors and controlling shareholders. If directors and other wrongdoers are aware that their misconduct can be challenged by a larger group of applicants, they will be more strongly deterred from acting without care and disloyally, and they would be less likely to run the company in a way conducive to their personal benefit, while harming the company itself and its other stakeholders.

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