

# Banking

## Another Day Another Culprit: Corporate Governance – Is it to Blame for the Banking Crisis?

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### Abstract

*This paper aims to explore the corporate governance of banks in economic crisis and whether poor corporate governance has led to the crisis. The aim of this paper is to demonstrate the complex world of financial regulation and that corporate governance is just one of the many possible culprits in the economic crisis. The level of financial crisis has been unprecedented and as such the regulatory response has been prolific. The researcher aims to discuss some of the reform proposals to see whether the time is right to legislate and whether these areas of reform indeed address the facets of the banking sector that need to be fixed.*

### Introduction

Since 2007, the UK, as well as many other countries in the world, has experienced what could possibly be called the worst economic crisis in history. Nearly two years into the crisis, commentators and regulators are looking towards the future of the banking industry. This nebulous glance into the future is discussed within this paper. To examine the future in great depth is always a brave and cautionary thing to do, cautionary especially when no one is sure whether the crisis is completely over, and whether the banks and financial system have hit rock bottom. However, government is paving the way by examining what can be learnt from the crisis and how to start to rebuild the economic system that created the economic boom of the last fifteen years.

This paper will therefore examine one of the many proffered failures and causes of the crisis. It will not delineate the crisis as it occurred since 2007 but will focus on a retrospective analysis of the problems that have been said to have caused the crisis. The paper will then move on to explore one area that the government is proposing to reform, namely corporate governance. The aim of the paper is to demonstrate the complex world of financial regulation and to discuss one of the many possible culprits for economic crisis. The level of financial crisis has been unprecedented and as such the regulatory response has been prolific.

### Background

Over the last eighteen months, the UK financial system has collapsed. The financial crisis has hit nearly every bank and financial institution and this is now pervading the economy as a whole. Jobs are being lost, homes repossessed, lives disrupted and the future is insecure and uncertain. 'Financial services are in

ruins'.<sup>1</sup> As *The Economist* states, 'for a quarter of a century finance basked in a golden age. The 21<sup>st</sup> century began with the enactment of the Financial Services and Markets Act 2000. This legislation was meant to be the panacea for all of the financial markets. It was the super regulator. Under this initial realm globalisation and our economy flourished. Modern finance improved countless lives'.<sup>2</sup> However things have not stayed this way. The Financial Services and Markets Act (FSMA) 2000 created the Financial Services Authority (FSA), designed to be the watchdog of the financial services sector. However, the FSMA 2000 and the FSA have not stood the test of time with the latest crisis. It was not sufficient to stop the collapse of Northern Rock<sup>3</sup> and the ensuing financial crisis that has been experienced. Today we can see that 'modern finance is under attack'.<sup>4</sup> We can see this from the plethora of media coverage and criticism levied on the banking system. *The Economist* states boldly, 'the golden age of finance collapsed under its own contradictions'.<sup>5</sup>

The starting point, certainly in the UK, was the collapse of Northern Rock in 2007. Initially the problems with Northern Rock created a small-scale banking crisis with many customers demanding their money back from the bank.

However this was to be just the beginning and since this date the banking sector in the UK has been pulled into an economic crisis unlike any for over a century.<sup>6</sup> The banking industry has been hugely influenced by the sector in the US. This was initiated after a two-year period (2004-2006) when US interest rates rose from 1% to 5.35%.<sup>7</sup> This meant homeowners struggled and more and more people defaulted on their mortgages. The sub-prime market, where lenders lent to customers with poor or no credit history, showed increased repossessions as borrowers defaulted on their mortgages.<sup>8</sup> This occurred from April 2007 up until the end of 2007. The failure of the sub-prime market impacted on the UK market and with the failure of Northern Rock and the first run on a bank in a century, the market took its first steps into a tumble of decline.<sup>9</sup>

The list of failures and crises continued into 2009. It

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<sup>1</sup> *The Economist*, 'Greed & Mash; and Fear', 22 January 2009.

<sup>2</sup> *Ibid.*

<sup>3</sup> Treasury Select Committee, 'The Run on the Rock', HC56-II 2007-08.

<sup>4</sup> *The Economist*, 'Barbarians at the Vault', 15 May 2008.

<sup>5</sup> *The Supra n.1.*

<sup>6</sup> *The Guardian*, 'A financial crisis unmatched since the Great Depression, say analysts', 18 March 2008. <http://www.guardian.co.uk/business/2008/mar/18/creditchunch.marketturmoil1>.

<sup>7</sup> BBC News, 'Credit Crunch Timeline', <http://news.bbc.co.uk/1/hi/business/7521250.stm>.

<sup>8</sup> BBC News, 'Sub Prime Crisis Sours US Dream', 5 April 2007. <http://news.bbc.co.uk/1/hi/business/6528387.stm>.

<sup>9</sup> Times Online, 'The Credit Crunch Explained', 14 August 2008. [http://www.timesonline.co.uk/tol/money/reader\\_guides/article4530072.ece](http://www.timesonline.co.uk/tol/money/reader_guides/article4530072.ece).

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also changed on a daily basis. It is not the aim of this paper to cover these in any depth but to colour the arena that future reform is based on.

The purpose therefore is to look at the failures and criticisms levied at the government, society and the banks and to determine whether the proposed method of reform is firstly appropriate and secondly whether reforming so close to the epicentre of the crisis is wise.

There have been many criticisms linked to the economic crisis. One major criticism is that 'finance is rigged to enrich bankers, rather than their customers, shareholders or the economy at large'.<sup>10</sup> Similarly it has been noted that, 'the biggest danger facing Western finance is not a fall in its earning power but a loss of faith in how it works'.<sup>11</sup> This lack of confidence and trust in the system promulgated the economic crisis that is the basis of the situation. It also prompted the government to enact radical reforms and proposes legislation in the form of the Banking Bill in 2008. The government, by further enacting this proposed piece of legislation, aimed to try and regain some of this lack of confidence and trust. However, this is intangible and very difficult to regain. *The Economist*, however, has warned that regulators should not rush to regulate.<sup>12</sup> Regulation is largely reactive to crisis, especially in finance. After each financial crisis legislation has been passed.

We can see that 'trust's slow accumulation pushes financial markets forward; its shattering betrayal batters them back'.<sup>13</sup> In the golden age of finance we saw that 'trust ... has evolved to [a] miraculous point'. Today it lays in the gutter in shreds. How can the government think that a piece of legislation that was rushed through both Houses of Parliament can go any where near restoring confidence in the market?<sup>14</sup>

Despite the enactment of the Banking Act 2009, HM Treasury published recommendations for reform that cover not only the financial world but also corporate governance.<sup>15</sup> Before a detailed examination of the HM Treasury reforms, the challenges facing bank regulation will be detailed. These challenges emanate from the failures that were fundamental to the banking crisis.

## Challenges Facing Banking Regulation

Hector Sants, Chief Executive of the FSA, outlined that, in his view, there were seven fundamental structural failures:

- a prevailing mindset of government and society promoting the benefits of credit and asset inflation, notably in housing;
- a flawed global regulatory architecture, which in particular lacked adequate macro-prudential oversight and had a series of gaps with regard to the oversight of financial institutions, particularly shadow banks, such as SIVs;
- a flawed set of prudential rules particularly for capital and liquidity. Basel II is an improvement on Basel I but still has large elements of procyclicality;
- a failure of the market to self-correct;
- a failure to recognise the overriding influence of the herd instinct;

- a pro-cyclical interaction between the accounting regime and market sentiment; and
- a lack of responsible governance by market participants, in particular bank management themselves.<sup>16</sup>

In particular what can be seen from these seven failures, and for the purpose of this paper, is that the first, sixth and seventh of these demonstrate the turning tide of acquisitions, that it was the structural and systematic failings of corporate governance that caused the banking crisis. This leads the FSA to believe that the future reform should be based in two areas of reform, namely regulatory framework and the supervisory approach.<sup>17</sup>

Conversely, the Turner Review 2009,<sup>18</sup> also published by the FSA, shows an analysis of five other factors which illustrate what went wrong. Turner himself outlines these as being:

- the rapid growth since the mid-1990s of a complex variant of the securitised credit intermediation model, with much of the risk retained on the trading books of banks and bank-like institutions, rather than truly distributed to end investors;
- the growth of leverage in institutions and embedded in products;
- the growth of a shadow banking system – investment banks, mutual funds and off-balance sheet vehicles – performing credit intermediation and maturity transformation functions but not subject to adequate capital and liquidity constraints;
- over-reliance on apparently sophisticated mathematical techniques for analysing and controlling risk; and
- a classic cycle of irrational exuberance and then reversal.<sup>19</sup>

Turner reiterates his proposition in speeches globally that there must be a return to simplistic banking where there is a need for real economic delivery of real finance.<sup>20</sup>

Sants surmises that the Banking Act 2009 and the future reform proposals that will be proposed will have a change of philosophy to ensure that these failures will not occur again. He states, 'We need to supervise to a philosophy that judges firms on the outcomes, the consequences of their action, not the com-

<sup>10</sup> *Supra n.4.*

<sup>11</sup> *Supra n.4.*

<sup>12</sup> *Supra n.4.*

<sup>13</sup> *Supra n.4.*

<sup>14</sup> Chambers, C. 'A Historical Piece of Legislation or a Relic of our Time: The Banking Act 2009', IBLT Conference Malta 2009, and in *Legal Discourse in Cyberlaw*. (ed) S. Kirkgaard.

<sup>15</sup> House of Commons Treasury Committee. 'Banking Crisis: Reforming Corporate Governance and Pay in the City'. Ninth Report of 2008-09 session, 12 May 2009.

<sup>16</sup> Sants, H. Chief Executive, FSA, Association of Corporate Treasurers, 14 May 2009. [http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0514\\_hs.shtml](http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0514_hs.shtml).

<sup>17</sup> *Ibid.*

<sup>18</sup> The Turner Review. March 2009, FSA, [http://www.fsa.gov.uk/pubs/other/turner\\_review.pdf](http://www.fsa.gov.uk/pubs/other/turner_review.pdf).

<sup>19</sup> Speech by Adair Turner, Chairman, FSA, Global Financial Forum, New York, 27 April 2009, [http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0427\\_at.shtml](http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0427_at.shtml).

<sup>20</sup> *Ibid.*

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pliance with any given individual rule ... a better description of this philosophy is outcomes-focused regulation'.<sup>21</sup> His criticism of management and governance of compliance in line with the regulatory approach is verbose. He aims to put into place a system where banks are on the receiving end of the intensive supervisory approach and outcome focus that the FSA will deliver over the coming months. Similarly, he believes that the role that non-executive directors and executive directors should play must change from the role they play now. Management in banks must plan for failure and how to manage the crisis if and when it occurs. Speedy action is required from the governance of the industry at this time.<sup>22</sup> Reforms to the corporate governance and management structure will demonstrate this new ethos.

## Improvements in Corporate Governance

Of the many reasons proffered for the failure of banks, corporate governance has come under immense scrutiny at the present time. In particular, the role of the non-executive director (NEDs) has been at the cornerstone of the criticism. Corporate governance of banks is regulated by the Combined Code on Corporate Governance. The Code states that 'every company should be headed by an effective board, which is collectively responsible for the success of the company'.<sup>23</sup> A normal board comprises NEDs, executive directors, chairmen and chief executives. It is the board's role to 'provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed.'

Part of the board's duties should be to set the company's strategic aims and ensure that resources essential to the running of the company are fulfilled. The board should also ensure that the objectives of the company are met to the agreed standard by the shareholders.

The Companies Act 2006 lays down the director's duties:

1. to act within powers;
2. to promote the success of the company;
3. to exercise independent judgment;
4. to exercise reasonable care, skill and diligence;
5. to avoid conflicts of interest;
6. not to accept benefits from third parties; and
7. to declare interests in proposed transactions or arrangements.<sup>24</sup>

The second objective listed here, to promote the success of the company, is most pertinent to the banking crisis and review of the corporate governance of those failed or failing organisations. It is for the board to ensure that the company is promoted so that it is successful. With a failed or failing bank this has not been the case. The role of the NED is criticised because HM Treasury believes that NEDs have two fundamental flaws. The first is that NEDs often do not have the necessary experience or qualifications to oversee large and complex financial institutions. Many NEDs have no formal qualifications in banking and are part of the 'cosy club'<sup>25</sup> or old boys' network in

the city. The second flaw is that NEDs often occupy more than one NED role and it is believed that they do not have the sufficient time or resources to devote to each intuition, thereby not providing the necessary checks and balances that are required by their indicative role.

Banks' boards and in particular NEDs should acknowledge their part in the economic crisis. Mr Varley (CEO Barclays Bank since 2004) stated that he 'entirely understood'<sup>26</sup> the public's anger. He admitted that the banks were the 'the single, biggest contributor' to the crisis and could reasonably be apportioned the largest share of the blame: 'If you ask me as I sit here today, is it understandable that the public sentiment is that the banks have the majority of blame? – in other words, if you think about blame attributable to any particular sector, is the largest particular sector the banks? – I think that is a perfectly understandable and reasonable conclusion.'<sup>27</sup>

Other board members of failed banks have publicly apologised for the economic crisis and the role they and their banks played in causing the catastrophic events. The following apologies are those articulated by the former chief executives and chairmen of RBS and HBOS and the former chairman of Bradford & Bingley:

*Lord Stevenson*: 'we are profoundly and, I think I would say, unreservedly sorry at the turn of events. Our shareholders, all of us, have lost a great deal of money, including of course a great number of our colleagues, and we are very sorry for that.'

*Sir Fred Goodwin*: 'I apologised in full, and am happy to do so again, at the public meeting of our shareholders back in November. I too would echo Dennis Stevenson's and Tom's comments that there is a profound and unqualified apology for all of the distress that has been caused.'

*Sir Tom McKillop*: 'In November of last year I made a full apology, unreserved apology, both personally and on behalf of the Board, and I am very happy to repeat that this morning. We were particularly concerned at the serious impact on shareholders, staff and, indeed, the anxiety it caused to customers.'

*Andy Hornby*: 'I am very sorry about what has happened at HBOS; it has affected shareholders, many of whom are colleagues; it has affected the communities in which we live and serve; it has clearly affected taxpayers; and we are extremely sorry for the turn of events that has brought it about.'

*Rod Kent*: 'absolutely the board accepts it is fully accountable for what happened ... we are massively

<sup>21</sup> Sants, H. Chief Executive, FSA, Association of Corporate Treasurers, 14 May 2009. [http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0514\\_hs.shtml](http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0514_hs.shtml) Retrieved on 18 May 2009.

<sup>22</sup> Ibid.

<sup>23</sup> The Combined Code.

<sup>24</sup> Companies Act 2006, Part 10 A Companies Directors, Chapter 2, General Duties of Directors.

<sup>25</sup> House of Commons Treasury Committee. 'Banking Crisis: Reforming Corporate Governance and Pay in the City'. Ninth Report of 2008-09 session, 12 May 2009, p. 55.

<sup>26</sup> Ibid. p. 48.

<sup>27</sup> Supra n.25. p. 48.

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disappointed and deeply sorry that this has happened.<sup>28</sup>

These apologies, although needing to be expressed to regain credibility in light of public scorn, do not go far enough to demonstrate that lessons have been learnt and that these board members are willing to change. The apologies are practised, polished and professional, yet they are lack lustre and lack a robustness that should be shown in times of economic crisis. It is questionable whether the banks are sorry for being partly to blame for the economic crisis or whether they are just sorry for it having got it so wrong and that they were 'found out'. After all, banking is all about risk and gambling on right options, if the gamble goes wrong, as it has, they are considered to be the culprit, yet if they had got it right and the economy had been booming as a result then they are rewarded. This reward culture is what the UK has seen over the past decade. The rewards have come in the form of remuneration packages and bonuses. This is yet another area that the government is proposing to reform.

## The Walker Review

In July 2009, the Walker Review, headed by Sir David Walker and sponsored by HM Treasury, reported back on the reform of corporate governance in the industry.<sup>29</sup> What is clear is that this culprit will be expounded upon for many more months and years to come. This is but the tip of the iceberg for reform. However it is an important starting point. The review took place over a five-month period and looked at the restructuring of banks boards as well as the behaviour of the executive staff on those boards. The review also looked at top executives' freedoms and remuneration, which could have promulgated a risk-taking approach and acted as a catalyst for the economic crisis. In essence there were five main themes of the review:

1. to assess whether the Combine Code remains fit for purpose;
2. to assess whether the principal deficiencies of the bank executives were behavioural rather than organisational structure;
3. to assess the nature of risk within the banking business;
4. to assess whether there is a need for more engagement in board matters from fund managers and other major shareholders; and
5. to review the remuneration procedures of top bank executives.

The Review, which aims to be finalised in November 2009, offers 39 recommendations within these five main areas. To summarise these:

1. to ensure that NEDs are suitably trained for their purpose in the organisation and that they spend a good proportion of their time conducting banking business. Also, that the FSA has greater supervision over the NEDs;
2. the function and performance of the board should be much more stringent, with the chairman devoting a good proportion of his time to the bank's business: the board should question the running of the business more; the board should have relevant

financial industry experience and training; the chairman should be elected annually, etc.;

3. the role of the institutional shareholder should be communication and engagement driven;
4. a separate risk committee should be established for each bank and should report separately on the risk activities and controls undertaken in the annual report; and
5. the remit of the remuneration committee should be extended and should be involved in the processing and signing off of top executive remuneration packages.

Of the Review, Walker stated that he would act as an independent reviewer of these recommendations and that he did not want them to be placed on a statutory footing but that they should be overseen and regulated by the voluntary Code of Conduct. This has been met with consternation by many in political opposition of the Labour Government. Vince Cable, Liberal Democrat Treasury spokesman, stated that, 'If the Walker approach is to have any value, then it has to be obligatory through the FSA and not just on a voluntary basis.'

## Conclusion

The aim of this paper was to examine whether the corporate governance of banks caused the economic crisis. Although government and regulators blame the lack of corporate governance enacted with banks and that the large-scale bonuses, created a risk-taking approach to investment, there are many diverse, multilayered and complex reasons why there has been such a prolific economic crisis. All economies suffer in an economic crisis. This is not in dispute. However the current economic climate is unprecedented. Its ripple effect has touched most of the global financial markets. The paper looks at one of the culprits that has taken centre stage: corporate governance.

The paper concludes that the corporate governance of banks should be reformed in terms of the qualifications held by NEDs and in their not taking on appointments if they cannot dedicate the appropriate amount of time to currently held positions. Commentator Wighton propounds that when a crisis occurs, critics are all too ready to pounce on areas such as corporate governance of boards and believes that reform should take into account that businesses are only as good as those people within them.<sup>30</sup> If we criticise and reform too much then it could be disastrous for an already fragile system. He states, 'This sort of thing looks too much like crony capitalism and is a gift for those who want to overturn the whole system'.<sup>31</sup>

<sup>28</sup> *Supra* n.25. p. 48.

<sup>29</sup> HM Treasury. The Walker Review. Reviewing Corporate Governance in UK banks and other Financial Services. [http://www.hm-treasury.gov.uk/d/walker\\_review\\_consultation\\_160709.pdf](http://www.hm-treasury.gov.uk/d/walker_review_consultation_160709.pdf) July 2009.

<sup>30</sup> Wighton, D. 'Corporate Governance Crises out for Reform', *The Times*. 18 March 2009. <http://business.timesonline.co.uk/tol/business/columnists/article5927876.ece>.

<sup>31</sup> *Ibid*.

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Moreover, this paper concluded that the economic crisis was caused by many different and interwoven facets. Not just the issues discussed here, albeit they are integral to the crisis. It is time to reform and to refocus. Yet it is not time to curb the procyclicality of the banks and development of economies. Aspects such as good corporate governance are common sense. What is not required is a strict regulatory approach, but one that is founded on logic and allows the banks to have the necessary freedom to undertake banking business, whilst not allowing risky strategies to be in place, culminating in traders conducting inappropriate business.

To face a brighter future, lessons need to be learnt and these can only come from dissecting the practices of the past. Banking crises will never be far from an active economy but the manner in which they occur and the effects felt can be minimised by prudent and carefully crafted regulation. To keep blaming different sectors of the banking system is a necessary evil but should be seen a fraction of the overall problem. The contributory parts of the economic boom did not equate to success but led to catastrophic failure, each cannot be blamed in isolation from one another.

## Addendum

Further to the above article the Walker Review published its final report on 26 November 2009.

At the heart of the proposed reforms is the idea that banks need to change their behaviour to ensure effective corporate governance. The Review states that “board behavioural change through clearer identification of best practice rather than more implementation of new regulations”,<sup>32</sup> would be the method of choice in reforming corporate governance in banks. Furthermore, Sir David Walker stated in the review that: “Better regulation of corporate governance will not guarantee that an economic crisis in the future will be avoided”.<sup>33</sup> Therefore it is with this in mind that a brief analysis and overview of the reform points follows.

The Review has been undertaken since February 2009 with a consultation period being beginning in July 2009. This review process has been robust and with much support but six main areas of reserve remain, these being the:

- a) overall scope of the review – wanted to encompass all financial institutions so a call for wider scope;
- b) differentiation among BOFIs – there are large differences in the nature of business and risk characteristics of major banks, life assurance companies and fund managers which were not dealt with adequately;
- c) shareholder engagement by fund managers as being the least implicit proposition;
- d) degree of prescriptiveness – some respondents wanted more guidance around “comply or explain” as this could lead to less flexibility in practice;
- e) international competitiveness – to ensure that the UK does not move out of line with other countries corporate governance obligations; and

- f) role of the Financial Services Authority (FSA) – respondents wanted a more engaged role for the FSA within the regulation of corporate governance.<sup>34</sup>

The five key themes of the July consultation were kept and these received much support. These being: first, both the UK unitary board structure and the Combined Code of the Financial Reporting Council (FRC) remain fit for purpose. Secondly principal deficiencies in bank or other financial institution (BOFI) boards related much more to patterns of behaviour than to organisation. Thirdly, given that the overriding strategic objective of a BOFI is the successful management of financial risk, board-level engagement in risk oversight should be materially increased, with particular attention to the monitoring of risk and discussion leading to decisions on the entity’s risk appetite and tolerance. Fourthly, there is need for better engagement between fund managers acting on behalf of their clients as beneficial owners, and the boards of investee companies. Finally, against a background of inadequate control, unduly narrow focus and serious excess in some instances, substantial enhancement is needed in board level oversight of remuneration policies, in particular in respect of variable pay, and in associated disclosures.<sup>35</sup>

To put this more simply, the main aspects of the review can be divided into the three areas of governance, pay and risk. The most prolifically argued point on the day of publication was the reform to make banks publish and disclose the payment of their top bankers who earn more than £1million and if the disclosure should be broken down into bands of pay. The amounts will not be attributable to any specific individual as the disclosures are anonymous and meant to act as a reference guide for shareholders. This recommendation is likely to add little benefit to the excessive risk talking that has taken place because of the anonymity and secondly it is likely to add to the bankers competing against one another. As Corrigan states: “[T]o give bankers a league table to measure themselves against is simply to feed their desire to climb the pay ladder.”<sup>36</sup>

Also within the remit of pay reform it was proffered that the remuneration committee’s role should be extended to cover the whole firm and be directly responsible for the pay of all top earners. At least half of pay or bonuses should be in the form of a long-term incentive scheme with half vesting after three years and the rest after five years. Thirdly,

<sup>32</sup> A Review of Corporate Governance in Bank and other Financial Institutions: Walker Review. Final Recommendations. 26 November 2009

<sup>33</sup> Ibid.

<sup>34</sup> *Supra*, n.1.

<sup>35</sup> *Supra*, n.1, pp 11-13.

<sup>36</sup> Corrigan, T., ‘Walker Review: Disclosure will push bankers pay up’, *The Daily Telegraph*, 26 November 2009. <http://blogs.telegraph.co.uk/finance/tracycorrigan/100002250/walker-reviews-forced-disclosure-will-push-pay-up-not-down/> accessed 30 November 2009.

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two-thirds of cash bonuses should be deferred. Remuneration committees should disclose rights of high-paid employees to receive enhanced benefits. Finally, the chair of the remuneration committee would face re-election if the report got less than 75% approval.<sup>37</sup>

The reforms suggested for governance entail the role of non-executive directors needing to be strengthened, with them taking responsibility for monitoring risk and pay. Most non-executive directors would have to spend substantially more time on the job. They would face tougher scrutiny under FSA authorisation process. Furthermore, there would be an induction process for all non-executive directors and regular training to enable them to “assess risk and ask tough questions about strategy”. Finally, institutional investors would have to play a more active role as owners of businesses, especially if they suspected weakness in governance. Active investors would have to sign up to a new independently-monitored stewardship code, with the FSA monitoring conformity to code.<sup>38</sup>

The third area of reform deals with risk. The reforms suggested are that banks should have board-level risk committees chaired by a non-executive director. The job of that risk committee would be to scrutinise and, if necessary, block big transactions. A Chief Risk Officer would have a reporting line to the risk committee. Finally that Chief Risk Officer could only be sacked with agreement of board.<sup>39</sup>

The review has had a nebulous welcome. John Cridland, CBI deputy director-general, said: “Banks play a unique role in the economy and have particular systemic risks associated with them. They therefore require different rules”.<sup>40</sup> This is similar to the HM Treasury report<sup>41</sup> in which it was stated that banks are special and therefore have special rules pertaining to them. Whether this is a desirable position to occupy is contentious. However, what these recommendations are said to ensure is that Britain is going to be the

toughest place in the world for pay policies. This, therefore, has substantial issues in relation to maintaining an effective and competitive workforce in banking in the UK.

The FRC will on, 1 December 2009, publish a draft of its 2009 Code for Consultation of the Combined Code on Corporate Governance. The draft review is expected to advocate a stronger emphasis on values and behaviours, along with more diversity and fewer cliques in boardroom nominations. Other proposals include the need for a more extensive and rigorous approach to the definition, assessment and management of risk, especially around culture, values and behaviours. This will link in with the publication of the Walker Review and allow consultation by banks on the Combined Code for Corporate Governance.

What is clear is that corporate governance, and in particular behavioural change, is in need of review but it is doubtful whether: first, regulation can have a drastic influence on bankers behavior and cultural attitudes; and secondly whether the Walker Review has gone far enough to capulate the reform of corporate governance. Perhaps with the Combined Code being reviewed at the same time, these two reviews will find a balance and put forward realistic and workable suggestions for reforming bankers corporate governance.

<sup>37</sup> *The Daily Telegraph*, ‘The Walker Review main points’, 26 November 2009. <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/6658885/Walker-review-main-points.html> accessed 30 November 2009.

<sup>38</sup> *Supra* n.6.

<sup>39</sup> *The Daily Telegraph*, ‘The Walker Review main points’, 26 November 2009. <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/6658885/Walker-review-main-points.html> accessed 30 November 2009.

<sup>40</sup> Monaghan, A., ‘CBI Warns on Walker Review’, *The Daily Telegraph*. 26 November 2009. <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/6663950/CBI-warns-on-Walker-Review.html> accessed 30 November 2009.

<sup>41</sup> HM Treasury, *Run on the Rock*, 2008.

# Dispute Resolution

## Litigants and Fair Trial: Harsh Messages in Appropriate Cases

John Corrie\*

### Summary

*This article examines the case of Cherney v. Deripaska as an example of the court using the tools available to it to find that a claimant might not receive justice in the natural forum.*

### Introduction

The Court of Appeal has upheld a finding by the High Court that a trial should be held in England rather than Russia because of concerns about the fairness of Russian judicial process. *Michael Cherney v. Oleg Deripaska* ([2009] EWCA Civ 849) concerned an application by Michael Cherney to serve proceedings out of the jurisdiction on the well-known Russian business tycoon Oleg Deripaska in connection with a long-running commercial dispute.

The High Court held that although the defendant had shown Russia to be the natural forum for trial of the action, the claimant had demonstrated a risk that he would not receive a fair trial there because of the defendant's close links to and ability to influence instruments of the Russian State, coupled with the approach of the Russian Arbitrazh courts to matters of strategic importance to Russia. The Court of Appeal held that the first instance judge was entitled to make such a finding.

The case demonstrates that the English courts will, in appropriate cases, not shy away from delivering judgments apparently critical of foreign judicial process in considering the appropriate forum for resolving a dispute. It also underlines the factual nature of that assessment and the limited role of the appellate courts in the process.

### Facts

The dispute related to ownership of Russian Aluminium ('Rusal'), the world's largest aluminium producer.

Mr Cherney alleged that during March 2001 he met Mr Deripaska in London and entered into an agreement under which Mr Deripaska agreed (inter alia) (i) to hold 20% of the shares in Rusal on trust for Mr Cherney, (ii) to sell them; and (iii) to account to Mr Cherney for the proceeds.

Rusal merged with two other companies in 2007 to form United Company Rusal ('UCR'). The effect of the merger was that the former shareholders of Rusal held 66% of UCR. Mr Cherney therefore alleged that Mr Deripaska held 20% of 66% (13.2%) of UCR on trust for him, worth approximately USD 4.35 billion.

### First Instance Decision

Mr Cherney sought to establish English jurisdiction on

various grounds, including that the agreement upon which he based his claim was made in England.

In a detailed and carefully reasoned judgment ([2008] EWHC 1530 (Comm)), Christopher Clarke J found that the court had a basis for exercising its discretion to take jurisdiction since it was common ground that, if the relevant agreement was made, it was made in England.

However, in considering whether the English court was the proper place for the proceedings to be brought, the 'natural forum' was Russia. In other words, the dispute was most closely associated with Russia and the Russian courts.

In deciding on the appropriate forum, the court applies the two-stage test from *The Spiliada* [1987] AC 460, namely it:

- (i) identifies the natural forum, i.e. that with which the case is most closely connected; and
- (ii) asks whether there are any considerations of justice which should prevent the court from declining jurisdiction in favour of the natural forum, in this case, Russia.

On the second part of the test, following a detailed assessment of a large amount of evidence, the judge found that if the English courts did not take jurisdiction, Mr Cherney would never take the matter to trial in Russia as a result of a well-founded fear for his own safety. There was also a significant likelihood of Mr Cherney being prosecuted if he returned to Russia, with a real possibility that this would be as a result of Mr Deripaska using his influence to encourage the authorities to prosecute, and a 'distinct possibility that the charges would be trumped up'.

As regards the question whether Mr Cherney would receive a fair trial in Russia, the judge referred to the need for 'positive and cogent evidence'. With that in mind he noted that it was common ground between the experts that, in certain cases, the Arbitrazh courts in Russia cannot necessarily be expected to perform their task fairly and impartially, such as where 'the outcome will affect the direct and material strategic interest of the Russian state'.

The judge then found that the affairs of Rusal and Mr Deripaska's group of companies were of considerable and strategic importance to the Russian State, and there was a close link between the Russian State and Mr Deripaska. Thus there was 'a significant risk of improper government interference if Mr Cherney were to bring the present claims in Russia'.

Notably, the judge made clear that he was not finding that a fair trial could never take place in Russia; simply that there were inherent risks in the current proceedings.

The English court therefore took jurisdiction. The judge recognised that 'the parties are not strangers to England' and that neither would suffer prejudice if the matter were heard in England.

The judge granted leave to appeal because he considered there was an arguable point concerning the second stage in *The Spiliada* test.

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# Dispute Resolution

## The Court of Appeal

Mr Deripaska's appeal rested on three questions, two of which are relevant:

1. If a judge has concluded in a service-out application that the natural forum is somewhere other than England, can he still find England to be the appropriate forum for the trial?
2. If the answer to that first question is yes, in what circumstances can he so conclude; and did the judge (a) direct himself appropriately and (b) if so, did he have evidence, or evidence of sufficient cogency, on which he could reach the conclusion he did?

On the first question, the Court of Appeal considered the distinction in *The Spiliada* between the 'natural' forum (with which the dispute is most closely connected) and the 'proper' forum (for the interests of all parties and the ends of justice). That distinction, held the Court of Appeal, highlighted that the answer to the first ground of appeal must be affirmative.

On the second question, the Court of Appeal noted that in displacing the natural forum, there is no requirement for 'cogent evidence' or any particular kind of evidence to establish all other factors which may lead the court to be persuaded that, despite somewhere else being the natural forum, England is the forum where it is in the interests of all parties and the ends of justice for the case to be tried. The requirement is that the plaintiff ... should 'clearly establish' that England is the appropriate forum in that sense.

The requirement for 'cogent evidence' related only to allegations that the claimant would not receive a fair trial abroad.

The Court of Appeal then reviewed each of Christopher Clarke J's key findings of fact and concluded 'it seems ... to be an impossible contention that the judge did not have evidence or indeed "cogent evidence".'

The Court noted that 'in conducting that exercise the Court of Appeal should be slow to interfere with the judge's assessment of the affidavit evidence' as 'It is not the function of the Court of Appeal to go through the whole exercise again unless it can be shown that the judge has misdirected himself in some way.'

The judgment also usefully clarified that the first instance judge need not be satisfied that the threatened injustice in the natural forum would *in fact* occur; only that the judge should weigh up the likelihood of it occurring.

## Comment

Whilst the appeal is a blow for Anglo-Russian judicial comity, it is an example of the court using the tools available to it to find that a claimant might not receive justice in the natural forum. Whereas a lack of litigation funding in the natural forum has previously provided the court with a reason to displace it in favour of England (see *Connelly v. RTZ* [1997] UKHL 30) it is more unusual that allegations concerning the integrity of the system of judicial administration in a friendly foreign State will make it to the fore.

Recognising the possible implications of the decision, the Court of Appeal repeated observations from *The Abidin Daver* that 'allegations of a kind that impugn the integrity of a foreign state should neither be made nor entertained lightly, but must be distinctly alleged and supported by positive and cogent evidence' but that 'I do not think that the court is precluded on the grounds of comity from considering them in a proper case' (per Moore-Bick LJ).

Interestingly, in *Pacific International Sports Clubs Ltd v. Soccer Marketing International Ltd and others* [2009] EWHC 1839 (Ch), decided in the wake of *Cherney*, the Court was faced with allegations of judicial corruption and political influence in the Ukraine. Although the case was decided on other grounds, Blackburne J 'not without considerable hesitation' doubted that the evidence in question 'quite crosses the threshold of cogency that the jurisprudence required' in *forum conveniens* cases. As well as the case having almost no connection with England and raising novel questions of Ukrainian law, the party making the allegations as to corruption seemed content to litigate in the Ukraine when it suited him.

Although *Cherney* was an extreme case, it shows that the court will not shy away from harsh messages in appropriate cases and that the doctrine of *forum conveniens* is alive and well for use where the European Judgments Regulation does not apply.



# Current Comment

## Intellectual Property

### Are Software Patents Dead after *Bilski*?

David Flint\*

This month, I am looking at one of the seminal cases of US patent law in the last few years; timely because having granted certiorari<sup>1</sup> on 1 June 2009, oral argument was heard by the US Supreme Court on 9 November 2009.<sup>2</sup>

The case dealt with a patent application for a method of hedging risks in commodity trading; such patent claims are often referred to as business method claims.

From the perspective of a UK practitioner, the notion of business method patents is a somewhat alien concept, given that the standard requirements of the Patents Act 1977 tend to exclude most business method claims as they fail the industrial application test; not so in the United States where this test is not part of the statute.

The details of the patent application are not really relevant to the legal discussion but they related to a method for providing a fixed-bill energy contract to consumers. The patent examiner rejected all 11 claims of the patent on the basis that “the invention is not implemented on a specific apparatus and merely manipulates [an] abstract idea and solves a purely mathematical problem without any limitation to a practical application, therefore, the invention is not directed to the technological arts”.<sup>3</sup>

The applicants appealed to the Board of Patent Appeals and interferences which affirmed the rejection, although on different grounds. It was held that the examiner erred by applying a “technological arts” test when the case law did not support such a test. Further the Board held that the requirement for a specific apparatus was erroneous because a claim that did not cite a specific apparatus might still be directed to patent-eligible subject matter “if there is a transformation of physical subject matter from one state to another”. The Board held that the necessary transformation did not exist here and indeed that the wide claim (which the Board thought “pre-empted any and every possible way of performing the steps of the [claimed process], by human or by any kind of machine or by any combination thereof,” only claimed an abstract idea ineligible for patent protection. Finally the Board held that the applicants’ process as claimed did not produce a “useful, concrete and tangible result” and for this reason also was not drawn to patent-eligible subject matter.

The Applicants appealed to the Federal Circuit, which was argued before a panel of the court in October 2007 and, *sua sponte*, before an *en banc* court on 8 May 2008.

On 30 October 2008, the *en banc* Federal Circuit court upheld the rejection by the Board by a 9-3 majority. The majority decision was given by Chief

Judge Paul Redmond Michel who characterised the issue as whether the claimed method is a patent-eligible “process” under the patent statute (35 U.S.C. § 101) – “Whether a claim is drawn to patent-eligible subject matter under § 101 is a threshold inquiry, and any claim of an application failing the requirements of § 101 must be rejected even if it meets all of the other legal requirements of patentability.” Patent-eligible processes do not include “laws of nature, natural phenomena though just discovered, mental processes, and abstract ideas.”<sup>4</sup>

The court thought that a determination of these prohibited areas of patentability were not helped by the three Supreme Court decisions cited above although a legal test could be distilled from them:

“A claimed process is surely patent-eligible under § 101 if: (1) it is tied to a particular machine or apparatus, or (2) it transforms a particular article into a different state or thing. See *Benson*, 409 U.S. at 70 (“Transformation and reduction of an article “to a different state or thing”” is the clue to the patentability of a process claim that does not include particular machines.”)

“A claimed process involving a fundamental principle that uses a particular machine or apparatus would not pre-empt uses of the principle that do not also use the specified machine or apparatus in the manner claimed. And a claimed process that transforms a particular article to a specified different state or thing by applying a fundamental principle would not pre-empt the use of the principle to transform any other article, to transform the same article but in a manner not covered by the claim, or to do anything other than transform the specified article”.

“A claimed process involving a fundamental principle that uses a particular machine or apparatus would not pre-empt uses of the principle that do not also use the specified machine or apparatus in the manner claimed. And a claimed process that transforms a particular article to a specified different state or thing by applying a fundamental principle would not pre-empt the use of the principle to transform any other article, to transform the same article but in a manner not covered by the claim, or to do anything other than transform the specified article.”

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<sup>1</sup> <http://www.supremecourtus.gov/orders/courtorders/060109zor.pdf>.

<sup>2</sup> [http://www.supremecourtus.gov/oral\\_arguments/argument\\_transcripts/08-964.pdf](http://www.supremecourtus.gov/oral_arguments/argument_transcripts/08-964.pdf).

<sup>3</sup> <http://www.uspto.gov/web/offices/dcom/bpai/its/fd022257.pdf>.

<sup>4</sup> See *Gottschalk v. Benson*, 409 U.S. 63 (1972); *Parker v. Flook*, 437 U.S. 584 (1978); and *Diamond v. Diehr*, 450 U.S. 175 (1981).

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## Current Comment

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The Federal Circuit observed that as far as the transformation-machine test was concerned there were two qualifications; that a field of use limitation was insufficient to avoid the prohibition against pre-emption; and that conventional or obvious “insignificant extra- solution activity” did not make what is otherwise a claim to a principle patent eligible. The court added that pre-solution activity was equally ineffective.

The Court then turned to what several of the amicus briefs had argued; – the “technological arts” test – that a patent eligible advance must be “technological” in nature and rejected this on several grounds:

“the contours of such a test, however, would be unclear because the meanings of the terms “technological arts” and “technology” are both ambiguous and ever-changing. And no such test has ever been explicitly adopted by the Supreme Court, this court, or our predecessor court, as the Board correctly observed here. Therefore, we decline to do so and continue to rely on the machine-or-transformation test as articulated by the Supreme Court.”

Turning to *Bilski*’s method, the Federal Circuit held it to be patent-ineligible because it did not “transform any article into a different state or thing”.

“Purported transformations or manipulations simply of public or private legal obligations or relationships, business risks, or other such abstractions cannot meet the test because they are not physical objects or substances, and they are not representative of physical objects or substances. Applicants’ process at most incorporates only such ineligible transformations.”

Accordingly *Bilski*’s claim entirely failed the transformation-machine test and the Federal Circuit upheld the earlier rejections of the Application.

*Bilski* appealed to the Supreme Court who heard oral argument on 9 November 2009.

### The Supreme Court

It is unlikely to be until July 2010 that the decision of the Supreme Court will be known, but from the reports of the argument stage, it appears that the proponents of business method patents and by analogy software patents may be about to see the tide turn against them. It appears that several of the court contrasted unfavourably patents for financial strategies, risk management or teaching methods (one patent quoted in the case had been for a method of teaching janitors how to dust!), as against patents for inventions such as the telephone or morse code that an inventor might invent in a laboratory.

A report in the Wall Street Journal even went so far as to suggest that rather than reconsidering whether the *Bilski* method should be patented, the question was whether the Federal Circuit had gone far enough in blocking inappropriate patents. “‘If we don’t limit it to inventions or technology’ or tie patent protection ‘to the sciences, to the useful arts, then why not patent the art of speed dating?’ asked Justice Sonia Sotomayor.”

It is unclear which way the Supreme Court will go. Over 70 amicus briefs were filed, many warning of dire consequences if the other side were to prevail. On the other hand, patents on doing business have soared in recent years with patents for such unlikely subjects as the Amazon.com one-click online shopping to methods for writing novels and making sandwiches. Whatever the ruling, it is to be hoped that there will be some greater clarity over what can (and cannot) be protected. In a global world the existence of wide ranging and controversial patents is an impediment to global commerce and benefits no one.