IOSR Journal Of Humanities And Social Science (IOSR-JHSS)
Volume 28, Issue 3, Series 2 (March, 2023) 01-06
e-ISSN: 2279-0837, p-ISSN: 2279-0845.
www.iosrjournals.org

An analysis of the 2007-8 banking crisis and the balance of power between Shareholders and Directors generally in Corporate Governance

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Date of Submission: 24-02-2023 Date of Acceptance: 05-03-2023

I. Introduction

The issue of what started the global financial crisis in 2007 and 2008 is disputed among policymakers and academic experts[1]. Poor risk management by directors has been blamed for the financial catastrophe[2]. According to other scholars, the crisis was the result of the management. Director turnover is thought to be more critical to the immediate profitability of the company than long-term profitability. Long-term risk implications of credit expansions were overlooked because monetary policies were unduly permissive in this situation[3]. The focus of this study is to analyse directors' and shareholders' responsibilities and their interplay before and after the financial crisis to determine whether they helped bring about the global financial tragedy. The director-shareholder balance of power must also be looked at in its entirety.

II. The Director's Roles Prior to the 2007-2008 Financial Crisis

In our business, a director acts as the business's alter ego[4]. Decision-making and evaluation, as well as management performance monitoring, are a part of their duties. The board of directors is held accountable for the company's overall success under the 2008 Combined Code of Corporate Governance guidelines, which specifies that the board of directors is accountable for the company's success[5]. Because this is usually how good directors operate, it is to be expected that good directors will take steps to avoid excessive business risk-taking, which significantly impacts the company's success or failure during the economic downturn. As part of the duties of the board of directors, the board owes the firm and its shareholders an obligation of care and skill, as well as the duty to act in the best interests of the company and shareholders[6]. There is a presumption that the board follows the norm of best business judgment unless and until it is proven otherwise. When business decisions are made, there is a presumption that the directors took care, had good faith, and made the best decision with an honest belief that it was in the company's best interests. The court also concluded that the presumption applies "when fraud, bad faith, or self-dealing is not present in the ordinary sense of personal benefit or advancement." Defendant accused the directors of issuing debentures and warrants to consolidate their

[1]Erkens, H. D., Hung, M. and Matos, P. (2012), ‘Corporate governance in the 2007–2008 financial crisis: Evidence from financial institutions worldwide’ (Journal of Corporate Finance, Vol. 18, Iss. 2, pp 389-411, 2012)
[2]Lehuede, H. J., Kirkpatrick, G. and Teichmann, D. (2012), ‘Corporate Governance Lessons from the Financial Crisis’ (SSRN Electronic Journal, 2012). accessed 25 August 2021
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[5]Molano-Leon, R., ‘The Roles of the Board of Directors: The Unresolved Riddle’ (2011) (122 Vniversitas, 541-602, 2011)
[6] Ferrero-Ferrero, I., Fernandez-Izquierdo, M. A., and Munoz-Torres, M. J. (2012), ‘The impact of the board of directors characteristics on corporate performance and risk taking before and during the global financial crisis’ (Review of Managerial Science, Vol 6, pp 207-226, 2012)

positions, claiming a breach of fiduciary duty in the case of Gearhart Industries, Inc. v. Smith Intern[7]., Inc. Since the board showed adequate skill and care in choosing and managing financial experts and legal counsel, the court found that no evidence of a violation of fiduciary responsibility existed. In this instance, Cede & Co. sued the directors of Technicolor, accusing them of fraud, violation of a fiduciary obligation, and unjust enrichment[8]. Another requirement for directors is to reveal any earnings they may have made in secret and abstain from accepting advantages that might lead to a conflict of interest. Prior to the financial crisis, this responsibility was abandoned to give directors greater latitude in allowing them to explore riskier investment strategies to earn higher profits.

III. Institutional Shareholders' Roles Prior to the Financial Crisis

The administration and direction of a corporation's activities is a statutory duty of the board of directors that must be carried out in the best interests of the corporation and its shareholders. Given that directors exercise direct control and management over the business's affairs, what happens if they commit fraud or any other irregularity against the firm or its shareholders? As a result, prior to the financial crisis, institutional shareholders had supervisory duties and capabilities. Attempts to give some tasks to shareholders for them to be able to check the directors' activities began in 1991 with the establishment of 'Responsibility of Institutional Shareholders' in the United Kingdom by the Institutional Shareholders Committee (ISC). In 1992[9], the Adrian Cadbury Committee on the Financial Aspects of Business Governance suggested that shareholders have the power to review corporate investments through their votes to strengthen corporate governance[10]. Additional efforts to empower shareholders to monitor directors' compensation were made in multiple committee recommendations prior to the consolidation of the different existing committees' findings into the Combined Code of Corporate Governance (1998). The Combined Code underwent several revisions but was still insufficient to push shareholders to take proactive measures due to the Code's non-binding nature. This condition persisted until 2006, when the Companies Act allowed shareholders to vote, convene meetings, request information from directors, approve long-term service contracts, and remove disqualified directors.

Additionally, shareholders were empowered to bring a minority action against directors who behaved illegally or against the best interests of shareholders. This is the widely accepted guideline for minority protection. The minority protection rule is an exception to the Foss v Harbottle proper plaintiff rule[11]. The minority action empowers shareholders to examine and challenge the board of directors' actions, as necessary, on their behalf or behalf of the firm under the following circumstances:

i. Where the company's leaders committed illegal or extra vires acts
ii. When an ordinary resolution is used to carry out an act that an ordinary resolution should not carry out
iii. Where the directors committed an act that adversely affected the shareholders' individual rights
iv. Where fraud was committed against the company or minority shareholders and the directors failed to act
v. Where the company meeting cannot be convened promptly to correct the wrong done to the company or minority shareholders
vi. Where directors profit from their wrongdoing or failure to perform their duties, When one of the circumstances mentioned above occurs, either member may take direct action, which may include bringing a personal or representative action on behalf of the shareholder(s), or bringing a derivative action on behalf of the company. Regardless of the various roles and powers assigned to shareholders under corporate governance regulation, corporate governance failure contributed to the global financial crisis of 2007–2008, partly attributed to shareholders' failure to monitor directors effectively.

IV. Relationships between Directors and Shareholders Throughout the period of the Global Financial Crisis

Prior to the global financial crisis of 2007–2008, there was an economic bubble, and in an attempt to capitalise on the opportunity, the directors began securitising credit facilities without further recourse to the shareholders. This created the inherent conflict of interest inherent in the agency-principal relationship. According to David H. Erkens, Mingyi Hung and Pedro Matos, "independent directors and institutional shareholders encouraged managers to increase shareholder returns through greater risk-taking before the

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[7] US Court of Appeals, 5th Circuit, 741 F.2d 70, (1984).
[8] Grobow v. Perot, Delaware Supreme Court, (1988) 539 A.2d 280, 187
[9] Institutional Shareholders' Committee code,(1991)
[10] Ruth V. Aguilera, Cynthia A. Williams, John M. Conley, Deborah E. Rupp. "Corporate Governance and Social Responsibility: a comparative analysis of the UK and the US*", Corporate Governance: An International Review, 2006
[11] Foss v Harbottle (1843) 67 ER 189 Gearhart Industries, Inc, v. Smith Intern., Inc., US Court of Appeals, 5th Circuit, 741 F.2d 70, (1984)

crisis"[12]. Additionally, it has been noted that financial institutions with high institutional ownership incurred greater credit risk prior to the crisis. This could be attributed to the argument that the shareholder's inability to monitor the directors' activities led to excessive risk-taking, culminating in the crisis[13].

V. Are Directors to Be Blamed for the Global Financial Crisis of 2007-2008?

One of the fundamental causes of the global financial crisis has been acknowledged to be a market failure due to excessive credit risk-taking. The financial markets saw a tremendous overreliance on the securitisation of the market due to the introduction of new market technologies. A home loan collateralised by a mortgage held by the financial institution is the mechanism that financial institutions use to issue mortgage-backed securities. Also, they followed up by including the Credit Default Swap (CDS), which was developed to guarantee bondholders who had pledged their bonds as collateral against default, by pledging to pay the buyer of the CDS to put in place an entire value contract on the debt that had issued the CDS contract. The overall development of bonds and subprime mortgages backed by securities was instead viewed to diversify risks. When the financial institutions started collapsing in 2007, the risks that had been diversified came under additional scrutiny. The global financial crisis of 2007-2008 brought corporate governance questions to the forefront; is it possible that the directors and executives have a responsibility to oversee business decision making? As a result of the crisis, shareholders in many bankrupt financial institutions believe that the board and management are solely responsible. In the Citigroup Inc. derivative shareholder litigation, the shareholders sued current and former directors for the risky subprime mortgage lending that Citigroup was involved in. Forget the long-term success of the business, the shareholders wanted a quick buck and believed that the directors were guilty of breaching their fiduciary duties by neglecting to oversee and manage the associated risk of the subprime lending, as well as the lack of proper disclosure of the risk the company was facing. the court rejected the shareholders' claim, finding that the board was acting in the best interest of the company at the time and "Plaintiffs failed to allege sufficient particulars that would have supported a claim that the Board should have "taken concrete action when presented with 'red flags' to prevent impropriety." King County, Washington, et al. v. Ikb Deutsche Industriebank Ag, et al. was a case in which a consortium of Rating Agencies, with the assistance of the Defendant's executives, helped Defendant increase its ratings[14]. This case highlights that the management and board members, who were parties to the 2007-2008 global financial crisis, were all culpable. Some commentators argue that the 2007-2008 financial crisis is due to management's obsession with shareholder value rather than a more altruistic goal of institutional success. Based on research by Justin Fox and Jay W. Lorsch, they stated that when investors pay attention to what they say they want, things will usually worsen for them. New data, such as Rosabeth Moss Kanter's article "How Great Companies Think Differently" (November 2011 issue of HBR), supports the theory that those organisations that maximise shareholder value most often tend to have loftier long-term aims than merely making more money[15].The agency theory guides corporate governance processes to maximise shareholder returns. The 2007/08 global financial crisis demonstrated its inadequacy. Effective corporate governance serves the interests of all stakeholders, not just shareholders. To make hazardous and irresponsible decisions, managers were incentivised by the corporate governance structure. Managers who did not follow the crowd risked losing their jobs. Achieving short-term profitability and a high stock price was rewarded while prudential mechanisms that ensured long-term company and market stability and health were penalised. These three factors fuelled excessive risk-taking. First, the compensation structure, among other things, encouraged managers to take risks and insufficiently rewarded them for doing so. Second, the quest for survival justified riskier lending. Managers had to take risks to display present earnings to shareholders who cared little about the firm's long-term health and the whole financial system. Third, Inadequate board oversight, insufficient disclosure and accounting rules, and the credit rating procedure enabled executives to act. The credit crisis highlighted a lack of board oversight of risk management and CEO compensation policies that incentivised excessive risk-taking[16].

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[12]Erkens, H. D., Hung, M. and Matos, P. (2012), 'Corporate governance in the 2007–2008 financial crisis: Evidence from financial institutions worldwide' (Journal of Corporate Finance, Vol. 18, Iss. 2, pp 389-411, 2012)

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[14] King County, Washington, et al., v. Ikb Deutsche Industriebank Ag, et al, United States District Court, S.D. New York, 708 F.Supp.2d 334 (2010)

[15] Fox, J. and Lorsch, J. W. (2012), 'What Good Are Shareholders?' (Harvard Business Review, The Magazine, July-August 2012). Available at accessed 25 August 2021

[16] Thomsen, S., (M. Pinedo et al (eds.)) 'Corporate Governance and the Financial Crisis (2013) (Global Asset Management, pp. 235-246,)

"Excessive risk-taking by the directors was not the single cause of the financial catastrophe," claims Grant Kirkpatrick[17]. In addition to those elements, other issues such as compensation, accounting standards, and regulatory frameworks influenced the propensity for high-risk behaviour among the directors. In the lead-up to the crisis, the audit committee's independence was not fully realised, as its members were not immune to the board's influence. The 2007 global financial crisis events demonstrated that corporate governance failure was the root cause of the crisis, as the directors' activities dominated all other operations. In this article, the writers believe that the film's directors are not solely to blame for the economic catastrophe that occurred in 2007.

On the other hand, though, they bear the primary responsibility for the problem. The claim that directors are responsible for the financial crisis because they agreed to massive pay for themselves but refused to hand shareholders a voice in pay packages is supported by Nell Minow, who says that the directors bear the blame for the crisis because it was the board who approved substantial compensation packages for themselves without any ability for shareholders to offer or propose pay packages. The explanation that "remuneration policies, risk management processes, weak board supervision, and shareholder passivism" led to the banking crisis was summarised by authors Lehuede, Kirkpatrick, and Teichmann (2012) to be that "corporate governance deficiencies caused it[18]." The Organization for Economic Cooperation and Development (OECD) in 2008 put forth reforms aimed at rebalancing the power between directors and shareholders by improving company remuneration, risk management, board of directors' practices, and shareholder rights[19].

VI. The Political, Technological, Philosophical and Economic Implications of the Debate Over Balance of Power Between the Directors and the Shareholders.

With all the talk about the balance of power, political, technological, philosophical, and economic ramifications must be considered. To deal with this, we must divide the Directors and shareholders. It is assumed that shareholders' and directors' interests are better served by a balance of power between the two groups. Additionally, the global financial crisis of 2007-2008 could have been avoided had the directors avoided excessive risk-taking and disclosure of non-full information. Because of this, it may slow down decision-making in organisations, as all directors' decisions will be put under the microscope by shareholders, who may not have the relevant experience and knowledge of a specific business choice. In addition, other stakeholders, like employees, creditors, suppliers, customers, and the like, may see themselves to be unappreciated and not put out their best efforts for the company, which makes the corporation look to serve shareholders' interests. In this way, finances suffer. Corporations, like every other organisation, are run on various levels of politics. When the board's power is reduced to follow shareholders, it may result in directors having little incentive to make decisions that will benefit the company.

This issue could also impact political policies addressing firm ownership, especially in developing nations, as well as corporate governance rules. Although there are still those who support the balance of powers as the cornerstone of government, the discussion about the balance of powers provides the foundation for the growing use of technology in the workplace, resulting in greater efficiency and communication[20]. Libraries, especially digital libraries, support communication platforms and other technical tools such as accessibility, participation, accountability, efficient information dissemination, and service delivery. By employing applications, simplifying processes such as generation, processing, storing, tracking, and exchanging vital records is possible, which is particularly useful for decisions made by both parties. A stakeholder like an employee, creditor, investor, consumer, or community member may not feel like they belong in the organisational structure if only shareholders and directors are prioritised[21]. That will be the case for most of them; they will lose drive and interest and cease investing and patronising the company.

VII. Conclusion

The concluding statement is: Directors were not the only actors responsible for the global financial crisis of 2007-2008, and the discussion around this topic remains relevant. This is because there are many corporate governance participants. Most authors believe that the financial crisis can be ascribed to directors failing to do their due diligence when assessing risk and seeking payment. However, some point to governance

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flaws, such as poor risk management, inadequate monitoring by shareholders, and faulty statutory corporate regulations as factors causing the crisis. While the other stakeholders, like shareholders, employees, managers, and the legal environment, may also share the blame, the paper holds that the directors alone are not solely responsible for the crisis, as they must work within the framework established by other stakeholders, such as shareholders, employees, and the legal environment. Even nevertheless, most of the blame has fallen on the shoulders of the management for risk management issues that appear to be front and centre in the financial crisis. In addition, it factors in a wide range of other economic, political, technological, and psychological influences that are connected to the argument.

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Julius Ibrahim Kalilu Foday Esq. "An analysis of the 2007-8 banking crisis and the balance of power between Shareholders and Directors generally in Corporate Governance." *IOSR Journal of Humanities and Social Science (IOSR-JHSS),* 28(3), 2023, pp. 01-06.