

RECONCEPTUALISING CORPORATE COMPLIANCE

Anna Donovan

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I, Anna Helen Louise Pope Donovan, confirm that the work presented in this thesis is my own. Where information has been derived from other sources, I confirm that this has been indicated in the thesis.

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Anna Donovan

ABSTRACT

Corporate compliance practices have, once again, become the subject of significant debate, and, more recently, regulatory reform. However, whilst recent tax practices have, for now, aligned public opinion on the question of corporate spirited compliance it nevertheless remains a subject of great conceptual difficulty. The seemingly innocuous question of whether corporations should comply with the spirit, rather than simply the letter, of the law concerns a diverse range of disciplines from political philosophy to corporate theory and (when seeking to instrumentalise this change) behavioural psychology. However, this conceptual challenge is not simply one of academic interest. A corporation's narrow understanding of their relationship with, and obligations for, compliance pervades all areas of corporate activity whilst also having an often-overlooked impact on those individuals acting on its behalf. Without reframing this understanding, meaningful and sustainable reform will remain elusive. This thesis seeks to address these difficulties by establishing a robust normative case for spirited compliance whilst challenging the powerful perception that creative compliance is a legitimate corporate strategy within a capitalist market economy. In doing so it offers a revised framework in which to define 'compliance,' providing legitimacy for recent attempts at regulatory reform in this area.

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ABBREVIATIONS

BA 2010	Bribery Act 2010
BEPS	Base Erosion and Profit Shifting
ECJ	European Court of Justice
EPS	Earnings Per Share
FCPA	Foreign Corrupt Practices Act 1977
GAAR	General Anti-Abuse Rule
HMRC	HM Revenue and Customs
OECD	Organisation for Economic Co-operation and Development
SOX	Sarbanes-Oxley Act 2002
SPV or SPVs	Special Purpose Vehicle(s)
VAT	Value Added Tax

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- Borland's Trustee v Steel Brothers & Co Limited* [1901] 1 Ch 279
- Broderip v Salomon* [1895] 2 Ch 323
- Buckeridge v Ingram* (1795) 2 Ves. Jun 652
- Canadian Eagle Oil Co. Ltd v R.* [1946] AC 119
- Cape Brandy Syndicate v I. R. C.* [1921] 1 KB 64
- Carlen v Drury* (1812) 1 Ves & B 154
- Dodge v Ford Motor Co* 170 NW 668
- Dovey and the Metropolitan Bank (of England and Wales) v John Cory* [1901] AC 477
- Ex parte Belchier* (1754) 27 ER 144
- Furniss (Inspector of Taxes) v Dawson* [1984] AC 474
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THESIS INTRODUCTION

‘The diagnosis of some asserted social ill and the prescription of the remedy are undertaken offhand by the first comer, and without reflecting that the diagnosis of a social disease is many times harder than that of a disease in an individual, and that to prescribe for a society is to prescribe for an organism which is immortal. To err in prescribing for a man is at worst to kill him; to err in prescribing for a society is to set in operation injurious forces which extend, ramify, and multiply their effects in ever new combinations throughout an indefinite future.’¹

INTRODUCTION

Should corporations comply with the spirit or simply the letter of the law?² In light of recent corporate scandals,³ we are once again faced with this seemingly straightforward question that has, nevertheless, persisted throughout the development of the modern corporation.⁴ Whilst creative compliance is not a uniquely company law problem, defining corporate compliance standards (in contrast to those of natural citizens) raises a number of particularly interesting and challenging conflicts to resolve. Corporate law and theory have consistently maintained that corporate citizens are, like their natural counterparts, free to pursue a purely instrumental approach to compliance, even where

¹ William Graham Sumner, 'Sociology' in Robert C. Bannister (ed) *On Liberty, Society and Politics The Essential Essays of William Graham Sumner*, (Liberty Fund Inc 1992), 186.

² This thesis accepts the proposition that there is an obligation to obey the law (itself a significant normative enquiry that is outside of the scope of this work) and is instead concerned with the question as to the extent of that obligation. That is, does it require ‘technical’ compliance only or should it extend to ‘spirited’ compliance. The literature concerning legal obedience more generally is vast. For arguments against a general obligation see: Joseph Raz, *The Authority of Law*, (2nd edn, Oxford University Press, 2009), 233; and M. B. E. Smith, 'Is There a Prima Facie Obligation to Obey the Law?' (1972-3) 82 *Yale Law Journal* 950. For literature in support see: John Rawls, 'Legal Obligation and the Duty of Fair Play,' in Sidney Hook (ed), *Law and Philosophy* (New York University Press, 1968), 3.

³ For example, the tax structures implemented by Google, Amazon and Starbucks, which were highlighted in the Public Accounts Committee - Nineteenth Report, '*HM Revenue and Customs: Annual Report and Accounts*,' 3 December 2012 <<http://www.publications.parliament.uk/pa/cm201213/cmselect/cmpublicacc/716/71602.htm>> accessed 31 March 2016. However, whilst these three organisations are currently dominating headlines, creative tax strategies are nothing new. See for example the discussion of Lehman's 'Repo 105' in D. Kershaw and R. Moorhead, 'Consequential Responsibility for Client Wrongs: Lehman Brothers and the Regulation of the Legal Profession,' (2013) 76(1) *Modern Law Review* 26; and Vodafone's highly publicised 2010 settlement in Richard Murphy, 'Vodafone's Tax Case Leaves A Sour Taste,' *The Guardian* 22 October 2010.

⁴ See: *Salomon v Salomon & Co Ltd* [1897] AC 22 (the use of nominee shareholders); *W. T. Ramsay Ltd v Inland Revenue Commissioners*, *Eilbeck (Inspector of Taxes) v Rawling* [1982] AC 300 and *Inland Revenue Commissioners v Burmah Oil Co. Ltd* (1982) SC (HL) 114 (the use of artificial structures to manufacture losses).

this is contrary to the clear intention of regulation.⁵ However, against this ostensible conceptual certainty, this creative approach to compliance⁶ has now generated both public and political concern, resulting in widespread demands that corporations adopt more responsible compliance standards.⁷

As laudable as these demands for reform may be, they present a number of challenging questions, both normative and positive, which have yet to be answered. For example, why should corporations adopt spirited compliance standards?⁸ On what basis, if any, can we restrain lawful, yet nevertheless undesirable, conduct?⁹ How can we justify holding corporations to a different standard of account to their natural counterparts?¹⁰ Can calls for reform find theoretical support within traditional paradigms of corporate law?¹¹ If so, why is it that corporations creatively comply and how do we address these motivations moving forward?¹² Importantly, these enquiries are of both academic and practical value. Public pressure has resulted in a bold regulatory response to the most recent examples of creative compliance in the field of tax avoidance, namely the United Kingdom's introduction of the General Anti-Abuse Rule ('GAAR').¹³ However, such regulatory intervention must be grounded in robust normative and theoretical support or risk lacking the *ex ante* legitimacy that is crucial for its success.¹⁴

⁵ Encapsulated in the view that managers '...do not have an ethical duty to obey economic regulatory laws...' See: Frank H. Easterbrook and Daniel R. Fischel, 'Antitrust Suits by Targets of Tender Offers,' (1982) 80 Michigan Law Review 1155, 1177 at their (n 57).

⁶ References to 'compliance' are to corporate compliance unless otherwise stated.

⁷ Most notably in response to the investigation of the Public Accounts Committee, chaired by the Rt Hon Margaret Hodge MP, the report of which is set out at (n 3).

⁸ This question is considered in chapter two.

⁹ This question is considered in chapter three.

¹⁰ This question is considered in chapter three.

¹¹ This question is considered in chapter four.

¹² This question is considered in chapters four and five.

¹³ Discussed further in chapter one.

¹⁴ Chapter one considers the limited success (and unintended consequences) of earlier regulatory intervention, including the Sarbanes-Oxley Act 2002. The UK tax legislation is a pertinent example of the development of highly complex, piecemeal and substantial tax codes developed in response to each new avoidance scheme, from manufactured dividends to transfer pricing. This limited success in controlling such behaviour extends to common law decisions such as *W. T. Ramsay Ltd v Inland Revenue Commissioners*, *Eilbeck (Inspector of Taxes) v Rawling* [1982] AC 300 and *Inland Revenue Commissioners v Burma Oil Co. Ltd* (1982) SC (HL) 114 (together

The critical issue with such *ad hoc* reactionary regulation is that it seeks to treat the symptom of creative compliance (often in a discrete area of practice), rather than address its underlying cause. In particular, it fails to change how corporations define ‘compliance’ and their corresponding obligations. ‘Compliance’ is not a term of art but a complex social construct¹⁵ and creative compliance is, in part, a manifestation of the norms that are inherent within the wider corporate environment.¹⁶ It is these norms that lead corporations to adopt a narrow and reductive interpretation of ‘compliance,’ one that reflects a legal, normative and economic environment that endorses a similarly narrow understanding of a corporation’s position within, and responsibility to, society and its institutions (including the legal system itself). Without addressing these environmental factors, specific regulatory initiatives are likely to be of limited success, as compliance with their terms will continue to be construed in accordance with current norms.¹⁷ Therefore, without more fundamental change, regulation intending to mitigate creative compliance risks, paradoxically, being subject to the same creative compliance practices that it is seeking to resolve.¹⁸

known as the ‘Ramsay principle’). The scope of the Ramsay principle is considered in chapter one, part one. However, at this juncture it is pertinent to note that even after this judicial attempt to curtail abusive tax structures, aggressive (and, arguably, artificial) tax planning continued. The rejection of tax avoidance as an end to a transaction in itself is also reflected in American jurisprudence (see *Helvering v Gregory* 293 U.S. 465 (1935), concerning the dividend in *specie* of corporate assets being redefined as a ‘reorganisation’). As with the Ramsay principle, this decision did not nevertheless stop aggressive tax structuring in the United States.

¹⁵ On which see: Christine Parker and Vibeke Lehmann Nielsen, ‘Introduction’ in Christine Parker and Vibeke Lehmann Nielsen (eds) *Explaining Compliance Business Responses to Regulation* (Edward Elgar 2011), 6-7.

¹⁶ Edelman *et al* describe compliance as a ‘social and political process that evolves over time’ influenced by the political climate that a subject operates within and their interpretation of the law. In this regard, a corporation’s interpretation of compliance is subject to both ‘internal and environmental normative pressures.’ See: Lauren Edelman, Stephen Petterson, Elizabeth Chambliss and Howard Erlanger, ‘Legal Ambiguity and the Politics of Compliance: Affirmative Action Officers’ Dilemma,’ (1991) 13(1) *Law and Policy* 73, 74. As to the relevance of the socio-political environment, see: Bridget M. Hutter, ‘Negotiating Social, Economic and Political Environments: Compliance with Regulation within and beyond the State,’ in Christine Parker and Vibeke Lehmann Nielsen (eds) *Explaining Compliance Business Responses to Regulation* (Edward Elgar 2011), 305.

¹⁷ These norms are considered further in chapter four.

¹⁸ This is particularly the case as this regulation relies on new governance techniques, which necessarily imposes ambiguous obligations. For example, an obligation to avoid ‘abusive’ structures (section 206(1), Finance Act 2013). Whilst unavoidable (as by its very nature creative

A significant barrier to establishing a spirited standard of corporate compliance is that it is an enquiry that is traditionally considered (by both sides of the argument) from the starting point of our understanding of the nature of the corporation as a legal subject. On the one hand, it could be argued that the corporation, as a significant economic and social actor, has responsibilities to its wider constituents (or stakeholders). Further, that it is unfair that corporate citizens can creatively comply in a way that their natural¹⁹ counterparts cannot.²⁰ In contrast, and on the other hand, it could be argued that the corporation is a private actor, one that does not (and should not) have a responsibility beyond that of non-corporate citizens to act beyond the strict requirements of the law.²¹ In doing so, this latter perspective encompasses a formalistic²² perspective of the law, which prioritises strict equality before the law (namely between natural and corporate citizens), without exception,²³ over wider notions of fairness. The difficulty with this subject centred approach to the question of corporate compliance is that it gives rise to both polarised and largely unassailable perspectives (helping to explain why this is a question that continues to endure). In particular, both perspectives rely on, *inter alia*, the need to maintain equality before the law (which is, of course, a fundamental

compliance 'thrives' on bright line, command and control style, rules) this ambiguity can lead to organisation's implementing 'symbolic structures' that do not meaningfully address the regulation's mischief. As such, broader cultural change is needed to redefine compliance rather than seeking to introduce specific regulation to address individual transgressions. As to the relationship between creative compliance and command and control style legislation see: Doreen McBarnet, 'Financial Engineering or Legal Engineering? Legal Work, Legal Integrity and the Banking Crisis,' in Iain MacNeil and Justin O'Brien (eds.) *The Future of Financial Regulation* (Hart Publishing 2010), 79; as to the relationship between ambiguity, compliance and symbolic structures see: Lauren Edelman, 'Legal Ambiguity and Symbolic Structures: Organizational Mediation of Civil Rights Law, (1992) 97(6) American Journal of Sociology 1531.

¹⁹ This thesis adopts the term 'natural' counterpart to denote non-corporate subjects (primarily individuals).

²⁰ This notion of 'unfairness' is, in fact, grounded in concepts of equality, a perspective that is considered further in chapter three.

²¹ A perspective that is the product of the dominant shareholder wealth maximising norm, which is discussed in chapter four.

²² The view that only 'the letter of the law and not its spirit is binding.' See: William H. Simon, 'After Confidentiality: Rethinking the Professional Responsibilities of the Business Lawyer,' (2006) 75(3) Fordham Law Review 1453, 1454.

²³ Chapter three discusses the importance of an exception to this strict interpretation of equality, which facilitates claims to constrain creative compliance.

principle of the rule of law) to provide persuasive support for their claims, the critical difference being the distinction between strict and relative equality. As a consequence, reform proposals lack the legitimacy that is fundamental to their ongoing success.²⁴

This thesis addresses these issues by reframing how we approach the question of compliance.²⁵ It explores the hypothesis that corporations should comply with the spirit of the law and, in doing so, it has two aims. First, the thesis seeks to identify a legitimate normative basis for constraining creative compliance. It does so by suggesting that creative compliance causes instrumental harm to the particular order necessary for a complex society to function and that this harm provides normative support to calls for reform. In making this claim, the thesis also challenges the commonly held view that creative compliance aligns with (and is legitimised by) the ethos of a liberal market economy. Secondly, and having sought to establish this first aim, it then demonstrates how corporate regulation and architecture currently operate to both facilitate creative compliance and present important barriers to reform. That is, that corporate pathology, including the norms inherent within company law, impedes the objectives of regulation such as the GAAR. As a consequence, this secondary aim contributes to our understanding both of the internal workings of the organisation and the ancillary measures that may be necessary to implement reform proposals.

In pursuing these objectives, the thesis approaches the underlying question of corporate compliance not from the starting point of the corporate subject, but by considering the functional role of compliance itself. The central claim of this work is that spirited compliance (and the trust that it generates) is integral to the proper function of the social

²⁴ For a broader discussion on the relationship between legitimacy and compliance see chapter one, part two.

²⁵ The way a question is asked/interpreted is critical. For example 'can I smoke whilst I pray / can I pray whilst I smoke' Leo Katz, *Ill-Gotten Gains Evasion, Blackmail, Fraud and Kindred Puzzles of the Law*, (University of Chicago Press 1987), 106. Indeed, characterisation and categorisation is critical to properly understanding an issue, its moral standing and the consequences thereof.

orders that are fundamental to civil society, examining the market order as a paradigm case. In making this claim, the thesis offers a legitimate basis on which to hold *all* corporations to a spirited standard of account. One of the challenges with recent enforcement attempts is that they are seen to concentrate on a small number of large corporations adopting specific structures.²⁶ In this way, it can be difficult to identify a clear (and sustainable) rationale for such action. Moreover, this conduct is unlikely to generate the normative change that is needed to embed meaningful change across the corporate community. Indeed, it risks entrenching the opposite approach as corporations react to what is perceived to be arbitrary action.

By understanding the role of compliance in this way, namely by looking at the instrumental role of compliance first (rather than the status of the corporation as a legal actor), the thesis is able to offer a conceptual framework in which to examine some of the more challenging questions that the debate gives rise to. In particular, this approach enables us to address concerns as to equality (between corporate and natural citizens) and to establish the *ex ante* legitimacy of demands that corporations adopt broad compliance strategies, even when this is not the most wealth-maximising strategy to pursue.

SCOPE OF THE RESEARCH

The question of corporate compliance could be considered from one of many perspectives. For example, examining the question of legal (or political) obligation more generally. That is, should corporations obey the law at all? An alternative perspective would be a detailed analysis of regulatory design and the impact of

²⁶ For example, Google, Starbucks and Amazon (see n 3).

enforcement strategies.²⁷ This thesis adopts a different approach, positing itself within company law literature to examine the question of corporate compliance standards. It adopts the basic premise that there is or, that corporations accept that there is, a fundamental obligation to obey the law, in a strict or technical sense. Rather, what it is concerned with is the scope of that obligation and the factors that influence the corporation in making its own determination as to what the extent of that obligation may be. It is submitted that it is only once we establish this understanding that we can fully identify how to implement reform and how to ensure that corporations see legislation not as a tool to exploit but as the requisite ‘rules of the game’ to adhere to, both in letter and in spirit.

In considering these questions, the thesis looks primarily at creative compliance with tax regulation and the regulatory response to these recent scandals. However, it should be made clear from the outset that whilst this thesis does, in part, focus on compliance within the sphere of taxation, the intention of this work is not that its findings are limited to this field. A corporation’s compliance strategy has a significant impact on both its culture and the individuals that act on its behalf (discussed in chapter five). It is an issue that goes to the essence of a corporation’s relationship with, and obligations to, civil society (as examined in chapters two and three). It will be seen that the normative basis for reform put forward by this thesis is predicated on the broad concepts of integrity (including trust, or more accurately, distrust), equality and social order, values that are, of course, relevant to all areas of practice. Rather, the focus (where necessary) on tax arises, as it is a useful case study for several reasons.

First, this is a recent area of regulatory reform that demonstrates how governments are attempting to address the problem of creative compliance, facilitating an analysis of

²⁷ These matters are considered briefly in this work but are not the primary framework within which the hypothesis is explored.

how, whilst welcome, even these sophisticated regulatory responses are still subject to important limitations without wider normative change. Secondly, it is an area that engages with the often cited claim that the financial gains derived from aggressive tax structures align with a director's duty to his or her shareholders (the suggestion being that spirited compliance does not). Therefore, it allows an analysis of the interplay between compliance and our understanding of the perennial question of the scope of a director's duty under section 172 Companies Act 2006. Finally, the use of tax as a case study helps to distil the functional role of compliance (and the normative value of spirited compliance) with a subject matter that is not viewed, ethically, in universally accepted terms. This is in contrast to, for example, bribery where most people intuitively feel that to 'bribe,' even if technically permissible,²⁸ is a moral wrong that can legitimately be constrained, potentially obscuring an objective discussion of compliance standards more generally.

Two final points on scope are necessary at this juncture. First, the research is concerned with the compliance practices of public limited corporations. As chapter three explains in more detail, the corporation (both public and private) is uniquely, functionally, positioned to be able to adopt the tax structures that typify the creative compliance that this thesis considers. However, unlike (most) private and closely held organisations, the public company is more likely to be subject to the economic (as well as legal) separation of ownership and control, which is discussed in chapter five. It is this separation that further facilitates the decision to creatively comply due to the lack of, *inter alia*, personal responsibility that is felt within the organisation for the consequences of creative compliance. It is this complete emancipation that also serves to minimise the normative sanctions (considered in chapter four) that may otherwise

²⁸ For example, a facilitation payment where the conduct is governed by the Foreign Corrupt Practices Act 1977 (note that such a payment would be unlawful under the more stringent Bribery Act 2010).

arise as a consequence of implementing abusive tax structures.²⁹ In light of this focus, references to the ‘corporation’ throughout this thesis are references to ‘public companies.’

Secondly, it should be made clear from the outset that the problem of creative compliance is not an exclusively corporate concern (notionally individuals can and arguably do creatively comply). However, as discussed further throughout this work, it is a manifestly more complicated enquiry within the corporate arena and there are a number of factors inherent within the corporate form that exacerbate (and facilitate) both the practice of creative compliance and the ability to rationalise it as a legitimate course of conduct. For the corporate citizen, compliance strategies and standards sit at the apex of a number of conflicting theoretical positions and ideologies, including political philosophy, corporate theory and behavioural psychology. Navigating these conceptual concerns is made more challenging as compliance strategies engage multiple actors, operating within multiple systems or environments. For example, the question of whether to implement a tax avoidance scheme concerns the norms (and, where applicable, moral values) of each of the market, the corporation and the individual acting on behalf of the corporation. At any given time, these norms may conflict, reinforce or, as a minimum, influence each other, mandating an understanding of each of these spheres of operation to effectively understand and address the challenges that arise when seeking to reform corporate compliance practices. To be clear, this research

²⁹ There are, of course, some exceptions to this claim. For example, some listed corporations retain an entrepreneurial, rather than managerial, model. In these organisations the company is clearly identified with an individual. For example, Apple and Steve Jobs. However, even in these corporations the threat of personal reputational damage only arises once a breach has occurred and, as discussed in chapter three, one problem with creative compliance is the difficulty with detection. Moreover, even after an allegation has been made, such individuals can still rely on the corporate norms that are discussed in this thesis to seek to justify (to themselves if not others) their behavior. For example, the Executive Chairman of Alphabet Inc (Google) Eric Schmidt claimed in respect of their tax planning ‘it’s called capitalism’ (see chapter two, part one) or Sports Direct International plc’s major shareholder Mike Ashley’s claim that he is ‘not Father Christmas.’ See: Editorial, ‘The Guardian view on Mike Ashley: the unacceptable face of modern capitalism,’ *The Guardian* (7 June 2006) available at <<https://www.theguardian.com/commentisfree/2016/jun/07/the-guardian-view-on-mike-ashley-unacceptable-face-of-modern-capitalism>> accessed 10 September 2016.

does not suggest that corporations are consciously aware of these conflicting norms and their theoretical underpinnings. Rather, as considered in more detail in chapter four, these norms coalesce to create the ‘reality’ in which corporations make decisions, including whether or not to adopt abusive tax structures.

ARGUMENTS AGAINST CONSTRAINING CREATIVE COMPLIANCE

To successfully establish a claim for spirited compliance, this thesis is faced with a number of seemingly indubitable yet conflicting normative positions. As outlined above, on the one hand, corporations are significant economic and social actors who arguably 'ought' to be restricted from compliance practices that can give rise to substantial externalities. On the other, companies are private organisations that arguably 'should' be able to manage their affairs in any way that is not expressly prohibited by law.³⁰ Crucially, both assertions rely on persuasive political, legal and theoretical arguments in support, meaning that a sustainable resolution remains elusive. This part introduces the three broad themes that these arguments fall within. These are discussed in more detail throughout the thesis but are outlined here to provide context to the early chapters of this work.

The first theme concerns the proper scope of a corporation’s political obligation. That is, what is the extent of a corporation’s moral duty to obey the spirit of the law? Modern society is premised on a capitalist market economy, predicated on classical liberal ideals. This political school of thought promotes individualism, the supremacy of the market and is ostensibly associated with advocates of deregulation. If the regulation itself lacks authority then on what basis can we legitimately demand broader compliance with its terms? Chapter two considers whether there is a basis to maintain a

³⁰ As to the private nature of the firm see: Marc Moore, *Private Ordering and Public Policy: the Paradoxical Foundations of Contractarianism* (2014) 34 *Oxford Journal of Legal Studies* 693.

claim for spirited compliance within this paradigm of limited government intervention and the pursuit of self-interest.

Secondly, our legal system rests on a foundation of the rule of law, enshrining the principle of equality before the law. One of the critical arguments against creative compliance, discussed further in chapters two and three, is that it fundamentally undermines this principle of equality. However, arguably the same charge can be made against proposals to hold corporations to a higher standard of compliance than their natural counterparts. If this is the case, on what basis could such a claim be justified? Put another way, can we legitimately respond to concerns of inequality with a solution that itself seems to undermine the principle of equality before the law?

The final criticism concerns the seeming conflict between spirited compliance and orthodox corporate ideology. As discussed in chapter four, the dominant norm within the Companies Act 2006 is that the sole objective of the firm is shareholder wealth maximisation. Within this paradigm, actions that maximise shareholder wealth are considered legitimate whereas those that reduce it, when determined by the discretion of the board, are perceived to be an illegitimate tax³¹ on shareholder funds. Moreover, it is trite law that a corporation has separate legal personality³² and that, absent *mala fides*, the courts will not interfere with the decision making of the board.³³ Given the technical legality of creative compliance, is it possible to align calls for spirited compliance (even where these are normatively justified) with these paradigms of company law?

³¹ Milton Friedman, 'The Social Responsibility of Business is to Increase its Profits,' New York Times Magazine (13 September 1970), 2.

³² *Salomon v Salomon & Co Ltd* [1897] AC 22.

³³ *Carlen v Drury* (1812) 1 Ves & B 154.

This brief overview of the key challenges to reform helps to explain why the problem of creative compliance persists. On the one hand, creative compliance enables corporations to avoid (moral) obligations, undermine the rule of law and damage the market order that corporations themselves depend upon. However, juxtaposed with this is the argument that corporations are private actors who are primarily profit maximising entities. Within this latter paradigm, the ultimate responsibility of the corporation is deemed to be profit maximisation. We are thus left with an apparent paradox between a claim to the rule of law and the dominant company law norm of wealth maximisation, giving rise to a ‘gap between the conduct that justice and the rule of law requires and what people perceive to be in their interest to do.’³⁴

THESIS STRUCTURE AND OVERVIEW

In considering the hypothesis that corporations should comply with the spirit of the law, and to achieve the two aims set out above (namely, establishing a normative foundation to constrain creative compliance and demonstrating that the current corporate environment is a powerful barrier to reform), the thesis proceeds as follows.

Chapter one provides context to the remainder of the thesis by defining creative compliance and how it has manifested both historically and, more recently, with the proliferation of aggressive tax planning. In doing so, the chapter starts to distil some of the challenges in responding to creative compliance, including judicial treatment of tax transactions. The chapter examines the structure of the GAAR and suggests that, in line with historic attempts to change corporate compliance behaviour, it is subject to both structural and situational difficulties that are highly likely to impede meaningful behavioural change in accordance with its objectives. This first chapter then introduces

³⁴ Randy Barnett, *The Structure of Liberty, Justice and the Rule of Law* (2nd edn, Oxford University Press 2014), 193.

an important theme of this work, namely the relationship between legitimacy and compliance. In doing so, it outlines the ‘compliance degeneration cycle,’ which demonstrates how the manifest belief in the legitimacy of creative compliance, combined with its impact on the unequal application, and therefore legitimacy, of regulation contributes to a cycle of creative compliance behaviour across the corporate sector.

Chapter two explores the classical liberal ideology that the market economy is premised on. The chapter starts by challenging the misconception that classical liberal thinking tacitly, if not expressly, supports creative compliance. Thereafter, and drawing on the work of Friedrich Hayek, the chapter examines the argument that society depends upon the development of 'spontaneous' (in contrast to planned) orders as the only mechanisms that are capable of ordering complex social systems. In particular, it looks at the market as a paradigm case of a spontaneous order and demonstrates the symbiotic relationship between market order and spirited compliance. By analysing the function of social systems in this way, the chapter introduces the critical importance of the maintenance of the rule of law and, most crucially, equality before the law if such order is to be achieved. In doing so, it offers normative support for constraints on creative compliance, which is a practice that fundamentally undermines the rule of law thereby damaging both the legitimacy and operation of such vital social orders.

The principle of the rule of law and, in particular, equality before the law is critical to the thesis. However, it also reflects two of its biggest challenges. First, how can we legitimately sanction behaviour that whilst undesirable is nevertheless legal? Secondly, if we reject the legitimacy of creative compliance on the basis that, *inter alia*, it undermines the principle of equality before the law how can we then argue that corporations should be held to a higher (unequal) standard of compliance? Chapter three responds to this issue by first exploring what we mean by 'equality before the law'

and demonstrating how creative compliance undermines this principle. It explores the Hayekian notion of the rule of law as a meta-rule and explains (by reference to modern scholarship on 'cheating') why it is the breach of this meta-rule that provides justification for controlling apparently lawful behaviour. The chapter then examines arguments that support a claim that corporations, as a legal subject, have an obligation to maintain the rule of law. It concludes by examining the role of legal privilege as the only justification for derogating from the strict application of equality before the law (by holding corporations to a different compliance standard than non-corporate citizens).

Chapter four analyses the norms inherent within the corporate environment that inform (and legitimise) the current, narrow, interpretation of what 'compliance' means for the corporate community. In doing so, the chapter identifies the vital role that these norms play in shaping corporate conduct and, moreover, how this current normative framework acts as an impediment to reform. The chapter argues that the homogeneity of the profit-maximising norm that traditionally pervades all aspects of corporate regulation, governance and theory adopts a position of authority and legitimacy (premised on, *inter alia*, the expressive function of law). As a consequence, it is not only the norm *per se* that is legitimised but those acts, omissions and regulatory provisions that support it. Conversely, this wealth maximising norm operates to undermine the legitimacy of those proposals, such as the GAAR, that adopt a contrary view.³⁵ This norm is further entrenched by the provision of legal advice, which is not immune from the norms of the corporate environment, and that can serve to further endorse a narrow interpretation of section 172 of the Companies Act 2006.³⁶

³⁵ Chapter four explains in more detail how norms motivate behaviour.

³⁶ Section 172, Companies Act 2006.

One challenge to the claim that corporations are driven by a regulatory imbued homogenous norm of profit maximisation that leads to 'unethical' compliance decisions is the fact that the corporation necessarily acts through individual actors who are constrained by notions of right and wrong. Chapter five responds to this charge by exploring how the structural characteristics of the firm create a powerful psychological impact on the decision making of those within it (in doing so it provides important insight into the challenges of instrumentalising behavioural change in corporations). Within the corporation, decision-making is distributed across a hierarchy of employees resting ultimately with the board of directors. In this regard, the corporation is premised on an edifice of fiduciary obligations towards others. Internally, these obligations are built on a command structure: junior employees to senior management, senior management to directors and directors to shareholders. Thus an internal 'fiduciary ladder' exists which enables each stratum of employees to outsource their ethical decision to the rung above it, on the premise that to do so is in accordance with their fiduciary undertaking. However, the reality of the modern corporation is that shareholders are now supplanted by a faceless 'market,' leading to a system of ownerless capitalism. There is no identifiable human presence to attribute moral responsibility to and the homogenised norm of shareholder wealth maximisation considered in chapter four is accepted as a proxy for shareholder interests. By understanding corporate structure in this way we can understand the absence of the non-legal behavioural constraints (such as personal ethics, religious views or a fear of personal reputational damage) that restrict individual behaviour. Furthermore, we can appreciate how the operation of the fiduciary ladder insulates corporate decision makers from public (and private) ethical scrutiny. This reputational impunity enables directors to pursue pure profit maximising objectives even where these transcend what is typically regarded as ethical conduct.

Chapter six concludes the substantive chapters of the thesis. Drawing on the earlier chapters of the thesis, it starts by explaining why looking to corporate gatekeepers (an often cited solution to the problem of creative compliance) is not a legitimate answer to this problem. Rather, that the primary obligation must be on the corporation itself, which is then a constraint on the advice that gatekeepers can provide (who are bound to apply the requisite law). Thereafter it proposes the introduction of an overarching compliance objective within the Companies Act 2006 itself. By including this reform in the Act, rather than as a discrete piece of legislation, the overarching objective adopts stronger expressive force acting as a constraint on (rather than being perceived as being subordinate to) the shareholder wealth maximising norm that is inherent throughout the Companies Act 2006. Importantly, the proposed structure of the reform is such that it facilitates enforcement by the Secretary of State, not simply shareholders, acting as both a powerful deterrent whilst addressing the inevitable collective action problems that would arise if the proposal was included in, for example, the company's Articles of Association.

CHAPTER ONE

THE PROBLEM OF CREATIVE COMPLIANCE

*'[rules] can be seized on as an easier option than the diligent pursuit of corporate governance objectives. It would then not be difficult for lazy or unscrupulous directors – or shareholders – to arrange matters so that the letter of every governance rule was complied with but not the substance. It might even be possible for the next disaster to emerge in a company with, on paper, a 100% record of compliance.'*¹

INTRODUCTION

Creative compliance is not a new phenomenon.² In January 1998, in what transpired to be a striking prophecy of the impending Enron collapse, the Hampel Committee recognised that the next corporate scandal could involve a corporation that, technically, had an impeccable compliance record.³ Notwithstanding the devastating impact of Enron's collapse, creative compliance has not merely continued as a corporate practice but proliferated to become (within industry at least) an accepted component of corporate strategy,⁴ particularly as part of an organisation's tax structuring policy. Most recently, this creative approach to corporate tax planning has received widespread public and political criticism as a consequence of artificial intra-group structures that, *inter alia*, both reduce a corporation's tax base and relocate it to a low tax jurisdiction.⁵ This public concern has resulted in a significant regulatory and global response with the United Kingdom introducing a General Anti-Abuse Rule ('GAAR')⁶ whilst the Organisation for Economic Co-operation and Development ('OECD') is leading

¹ Committee on Corporate Governance, *Final Report* (January 1998), para 1.14 <http://www.ecgi.org/codes/documents/hampel_index.htm> accessed 10 September 2016 (the 'Hampel Report').

² Creative compliance is defined in part one but, broadly, refers to compliance with the letter of the law in defeat of its spirit.

³ Hampel Report (n 1), para 1.14.

⁴ On this see the respondents to Doreen McBarnet's empirical work in this field, who saw the law as a 'hurdle' to overcome, or as something that 'inconveniently' got in the way and was to be 'creatively dealt with.' See: Doreen McBarnet, 'Financial Engineering or Legal Engineering? Legal Work, Legal Integrity and the Banking Crisis,' in Iain MacNeil and Justin O'Brien (eds) *The Future of Financial Regulation* (Hart Publishing 2010), 69.

⁵ Discussed further in part one, section two.

⁶ Finance Act 2013, Part 5. This and other responses are discussed further in part one.

international initiatives that seek to constrain this practice.⁷

The introduction of the GAAR, and the concomitant change in, or strengthening of, public opinion, is an important (and promising) first step to achieving reform in this area.⁸ However, as history has shown, such discrete regulatory intervention is unlikely, in isolation, to achieve meaningful behavioural change.⁹ A corporation's construction of 'compliance' is influenced by a wide array of factors, from corporate norms and theory to behavioural psychology.¹⁰ However, a powerful and overarching determinant of a corporation's definition of their compliance obligation is legitimacy. That is, corporations are likely to continue to adopt creative compliance strategies whilst they consider both creative compliance to be legitimate and, moreover, the attempted constraint of creative compliance to be an illegitimate intrusion on their individual freedom.¹¹ It is a central claim of this thesis that without this *ex ante* legitimacy, the GAAR is unlikely to achieve its objectives in full. This is particularly the case as the scope of the legislation is itself very narrow (arguably unavoidably so), leaving a significant range of transactions outside of its remit.¹² As a consequence, there are inevitably 'gaps' (or, put another way, loopholes) in the legislation that are left to be interpreted (or manipulated) by corporate subjects. Within the current corporate construction of 'compliance' these gaps are likely to be utilised in self-interested ways that risk undermining the objectives of the regulation. Rather, what is required is a broader change in the way that a corporation defines compliance and its concomitant relationship with, and obligation to, the wider regulatory system and those operating

⁷ Including the OECD Base Erosion and Profit Shifting ('BEPS') initiative.

⁸ Public criticism of creative compliance is important not simply as a mechanism for making some (albeit potentially slight) change to a corporation's normative framework but, primarily, because it changes the potential reputational cost of implementing these strategies.

⁹ See part one, section (three).

¹⁰ These are considered in chapters four and five respectively.

¹¹ This latter perspective is embedded within common (mis)conceptions of the classical liberal ideology of the market, which is considered (and challenged) chapter two.

¹² In particular, cross-border transactions that constitute a large proportion of the structures in question.

within it.

This chapter explores the practice of creative compliance and some of the factors that make an examination of corporate creative compliance particularly challenging. In doing so, it provides a foundation for subsequent chapters that examine the scope of a corporation's political obligation in more detail. To this end, the chapter proceeds as follows. Part one briefly defines creative compliance and its presence throughout the development of modern company law, before exploring its most recent manifestation within the sphere of tax planning and structuring. To provide context to the current regulatory landscape, and distil the difficulties that remain, this first part concludes by examining the likely success of the GAAR as an effort to constrain creative compliance.

Part two draws on, *inter alia*, Tom Tyler's work to explore the broad factors that influence compliance decision making. In particular, it examines the relationship between compliance and legitimacy and how this contributes to creative compliance.¹³ Having established the general premise that legitimacy is an influential determinant of compliance, it considers the powerful behavioural mechanisms that operate to legitimise creative, rather than spirited, compliance (and inure corporations from allegations of illegitimacy). In doing so, this part provides a broad theoretical foundation as to the importance of, and interplay between, compliance and legitimacy, with subsequent chapters examining the specific elements of corporate regulation and architecture that engender the perspective that creative compliance is indeed a legitimate strategy to pursue.¹⁴ Thereafter, part three introduces the concept of the 'compliance degeneration cycle.' Developing the concepts outlined in part two, it demonstrates why, without meaningfully changing a corporation's relationship with, and understanding of, their compliance obligations reactionary, *ad hoc*, regulation such as the GAAR is unlikely to

¹³ Most notably his seminal work: Tom R. Tyler, *Why People Obey the Law* (Princeton University Press 2006).

¹⁴ See chapters four and five.

disrupt the current narrow and formalistic concept of compliance adopted by most corporate entities.

In concluding the substantive parts of the chapter, part four suggests that what is required to achieve sustainable reform is a new legal integrity. Part four utilises Erhard, Jensen and Zaffron's definition of 'integrity',¹⁵ namely the need for both 'completeness' and 'trust' in the regulatory and corporate systems. In this way, part four frames the discussion that ensues in chapter two, which examines how creative compliance fundamentally undermines both of these principles (that is, of completeness and trust), which are essential to the proper function of the social systems that society depends upon, providing normative support for reform.

PART ONE: CREATIVE COMPLIANCE IN PRACTICE

In its most common manifestation, creative compliance is the practice of complying with the letter of the law in defeat of its spirit,¹⁶ and doing so with 'impunity.'¹⁷ Regardless of the specific structure that it adopts, it reflects the use of legal devices and mechanisms to enable the form of a transaction to fall 'on the right side of the boundary between lawfulness and illegality'¹⁸ notwithstanding its substantive effect. As Doreen McBarnet explains, these structures enable an organisation to 'accomplish the same

¹⁵ See: Werner Erhard, Michael C. Jensen and Steve Zaffron, 'Integrity: A Positive Model that Incorporates the Normative Phenomena of Morality, Ethics and Legality,' (March 23, 2009). Harvard Business School NOM Working Paper No. 06-11; Barbados Group Working Paper No. 06-03; Simon School Working Paper No. FR 08-05.

¹⁶ For a broader discussion of creative compliance see Doreen McBarnet's work in this area, including: D. McBarnet, 'After Enron Will "Whiter Than White Collar Crime" Still Wash?' (2006) 46(6) *British Journal of Criminology* 1091; Doreen McBarnet, 'After Enron: Corporate Governance, Creative Compliance and the Uses of Corporate Social Responsibility,' in Justin O'Brien (ed) *Governing the Corporation: Regulation and Corporate Governance in an Age of Scandal and Global Markets* (John Wiley & Sons 2005) 205-222; and D. McBarnet and C. Whelan, 'The Elusive Spirit of the Law: Formalism and the Struggle for Legal Control' (1991) 54 *Modern Law Review* 849.

¹⁷ McBarnet, *After Enron will Whiter than White Collar Crime* (n 16), 1091.

¹⁸ *Ibid.*

ends as criminal action,¹⁹ as they are able to evade regulatory control but, crucially, can do so whilst ‘ensuring immunity from the stigma and sanctions normally associated with out and out white-collar crime.’²⁰ Nevertheless, as this part outlines, creative compliance has been a persistent feature of modern company law, which (with a few exceptions), has traditionally upheld a formalistic interpretation of corporate compliance standards.

(i) *The rise and rise of creative compliance*

Whilst creative compliance is now synonymous with the sophisticated and complex legal structures considered in section two, it is not a novel practice. Indeed, modern company law is predicated on a decision that endorsed such an approach to compliance and, in doing so, started to shape the corporate compliance landscape.²¹ As is well known, the seminal decision of *Salomon v Salomon & Co Ltd*,²² concerned the use of six nominee shareholders to comply with the requirement of section 6 of the Companies Act 1862, which specified that a company needed to have seven shareholders to incorporate. The question before the court was whether these shareholders needed to have a real or substantial interest in the company or whether the use of nominees (as was the case here) would satisfy the Act’s requirements. Although the Act was silent on the need for materiality, it is widely considered that the Act envisaged the presence of shareholders of substance, reflecting both the development of the corporation from economically significant partnerships²³ and also broader concerns as to the abuse of the

¹⁹ Ibid 1092.

²⁰ Ibid 1091.

²¹ As Edelman recognises, compliance is defined by industry norms that become institutionalised and reflect a citizen’s understanding of ‘legality, morality and rationality.’ Judicial decision-making plays an important role in that construction, both endorsing industry norms and shaping our understanding of legality. See: Lauren B. Edelman and Shauhin A. Talesh, ‘To Comply or Not to Comply – That isn’t the Question: How Organizations Construct the Meaning of Compliance,’ in Christine Parker and Vibeke Lehmann Nielsen (eds) *Explaining Compliance Business Responses to Regulation* (Edward Elgar 2011), 103.

²² [1897] AC 22.

²³ Outlined in more detail in chapter five, part one.

corporate form.²⁴ Nevertheless, overruling the decisions of the lower courts, the House of Lords accepted that strict compliance with the Act was sufficient and the court could not (and should not) read a materiality requirement into its terms. In doing so, the court endorsed a formalistic and, arguably, reductive approach to compliance that would align with economic theories of the firm to be promulgated over fifty years later.

This early approach by the House of Lords to creative compliance was repeated in 1936 in the seminal decision of *The Commissioners of Inland Revenue v His Grace the Duke of Westminster*.²⁵ Whilst not a company law case, as will be seen in the next section, the *Duke of Westminster* decision was highly influential in establishing the normative environment in which corporate compliance standards are determined. In this case, the House of Lords had to consider whether to uphold the Duke of Westminster's claim that he had paid his gardener a tax-deductible annuity, rather than a salary. In sustaining this classification, Lord Tomlin observed that 'every man is entitled *if he can* [emphasis added] to order his affairs so as the tax attaching under the appropriate Acts is less than it otherwise would be'²⁶ regardless of how 'unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity.'²⁷ Indeed Lord Russell, in concurring with Lord Tomlin, explained that 'if the Crown ... cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be.'²⁸

²⁴ *Broderip v Salomon* [1895] 2 Ch 323, *per* Lindley L.J [337] 'There can be no doubt that in this case an attempt has been made to use the machinery of the Companies Act, 1862, for a purpose for which it was never intended ... Although in the present case there were, and are, seven members, yet it is manifest that six of them are members simply in order to enable the seventh himself to carry on business with limited liability. The object of the whole arrangement is to do the very thing which the legislature intended not to be done.' For a more detailed discussion as to the mischief and intentions of the 1862 Act, see: Paddy Ireland, 'The Rise of the Limited Liability Company,' (1984) *International Journal of the Sociology of Law* 12, 15-17.

²⁵ [1936] AC 1.

²⁶ *The Commissioners of Inland Revenue v His Grace the Duke of Westminster* [1936] AC 1, 19.

²⁷ *Ibid.*

²⁸ *Ibid.*, 25.

The *Duke of Westminster* judgment not only rejects claims to constrain creative compliance, a principle that was not disrupted (and even then only notionally) until the *Ramsay* decision some fifty years later,²⁹ but encapsulates three pertinent aspects of the corporate compliance debate. First, is the tacit acknowledgment that not every citizen is able to order his or her affairs to avoid tax. This inequality of opportunity is central to the legitimacy of holding corporations to a higher compliance standard than other legal subjects and is considered further in the context of legal privilege in chapters two and three. It is also fundamental to the wider legitimacy debate that contributes to the compliance degeneration cycle that is introduced in part three. Secondly, Lord Tomlin's reference to the 'ingenuity' of the structure reflects the view that, on one level at least, creative compliance is something that is to be revered. To the extent that this reference was not entirely earnest, it is nevertheless a reflection of industry's current view of the practice, a view that was apparent from McBarnet's empirical work in this field. In a testament to the cultural environment that corporations operate within, creative compliance was not a practice that McBarnet's interviewees felt needed to be hidden; rather it was seen as something 'clever'³⁰ and to be admired. Finally, and in light of this perspective, it is perhaps not surprising that McBarnet's interviewees, like Lord Russell, placed responsibility for controlling technical compliance practices firmly on the regulators: 'if they can't make regulations legal-engineering proof ... it is fair game to exploit that situation. Ideas such as responsibility, the public good, morality, ethics or integrity do not enter into the equation.'³¹ However, it is a trite observation that it is simply not possible for regulation to achieve this threshold by addressing every iteration of undesirable behaviour.

The significant direct and indirect consequences of creative compliance became clear

²⁹ Discussed in section two.

³⁰ Doreen McBarnet, 'Compliance, Ethics and Responsibility: Emergent Governance Strategies in the US and UK,' in Justin O'Brien (ed.), *Private Equity, Corporate Governance and the Dynamics of Capital Market Regulation* (Imperial College Press 2007), 214.

³¹ McBarnet, *Financial Engineering* (n 4), 80.

following the accounting scandals of 2001, which resulted in the spectacular failures of Enron, WorldCom and Parmalat. In particular, and as is now well known, Enron incorporated a substantial number of special purpose vehicles ('SPVs'),³² typically Limited Partnerships, designed to protect Enron's credit rating by, *inter alia*, keeping substantial debts off the Enron group's balance sheet.³³ These SPVs would acquire debt to finance new business ventures and utilise Enron stock as collateral for the relevant loan (Enron being rated as 'investment grade'³⁴ stock at the time). As newly incorporated entities, these partnerships had the appearance of being reliable borrowers. From Enron's perspective, and where the creative compliance arose, is that the relevant accounting regulations stipulated that provided 3% of the issued equity in the SPV was owned by a non-Enron entity then Enron did not need to include the debts incurred by these vehicles on its consolidated financial reports (thereby concealing considerable liabilities from the market). Whilst Enron had, technically, complied with this requirement, the general partners of the SPVs were largely controlled by Enron officers, primarily its Chief Financial Officer, Andy Fastow, or members of his family.³⁵

The repercussions of Enron's failure (and the associated scandals of that time) were global and acute. In addition to the collapse of Enron and WorldCom's auditor, Arthur Andersen, there was widespread consternation that corporations could mislead the market in this way. Of particular concern was the fact that a large part of the deception

³² As to the scale of Enron's creative accounting, of note is that for the year ending 31 December 2000 (that immediately preceding the year in which Enron filed for chapter 11 bankruptcy protection) its' annual 10-k filing listed over 2,000 subsidiaries: <<http://www.secinfo.com/dv8Cu.4f895.a.htm#1stPage>> accessed 10 September 2016.

³³ Steven L. Schwarz, 'Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures,' (2002) 70 University of Cincinnati Law Review 1309, 1310.

³⁴ Claire A. Hill, 'Why did Rating Agencies do Such a Bad Job Rating Subprime Securities?' (2010) 71 University of Pittsburgh Law Review 1, 14.

³⁵ For a high-level summary of these partnerships see: William C. Powers, Raymond S. Trough and Herbert S. Winokur Jr. *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp* (1 February 2002), 2-5 <[http://picker.uchicago.edu/Enron/PowersReport\(2-2-02\).pdf](http://picker.uchicago.edu/Enron/PowersReport(2-2-02).pdf)> accessed 10 September 2016.

was ‘perfectly legal.’³⁶ It was also against this wave of corporate failures that we started to see significant regulatory reactions to corporate compliance failures. In particular, it was in response to the 2001 accounting scandals that the United States introduced the Sarbanes-Oxley Act 2002 (‘SOX’) requiring, *inter alia*, stringent internal control disclosures and written confirmation by management as to its responsibility for such controls.³⁷ The consequences of SOX, both intended and otherwise, are familiar. The Act attracted considerable industry criticism and resulted in a number of firms delisting from the New York Stock Exchange.³⁸ Critics of SOX cite, *inter alia*, the substantial compliance costs that it imposes on firms that remain subject to its remit,³⁹ together with the indirect costs of ‘managing in the shadow of SOX.’⁴⁰ In contrast, its advocates point to a reduced cost of capital,⁴¹ improved auditing⁴² and the (perhaps surprising) appreciation of some management teams at the mandatory strengthening of their corporation’s internal control environment.⁴³ There is, of course, the wider social benefit of seeking to reduce corporate fraud.

Notwithstanding the differing views as to the merits of SOX, what is striking is that following its introduction (supported by global condemnation of the behaviour of Enron

³⁶ Hearing Before the Committee on Governmental Affairs United States Senate, Hearing 107-376, ‘*The Fall of Enron: How Could it Have Happened?*’ (24 January 2002) *per* Senator Thomson, 17 < <https://www.gpo.gov/fdsys/pkg/CHRG-107shrg78614/pdf/CHRG-107shrg78614.pdf>> accessed 10 September 2016.

³⁷ §302, 404 and 906, Sarbanes-Oxley Act 2002.

³⁸ In particular, as a result of the impact of the cost of complying with its onerous internal control requirements (see n 37). For commentary as to the relationship between Sarbanes-Oxley 2002 and the decision to de-list see: Benjamin Norris and Mark Fox, ‘Reducing Sarbanes-Oxley Compliance Costs for Smaller Companies,’ (2008) *Journal of International Banking Law and Regulation* 28, 32.

³⁹ Outlined in: Stephen Bainbridge, *The Complete Guide to Sarbanes-Oxley*, (Adams Media 2007), 4-5.

⁴⁰ These include, managerial distraction, risk-aversion and potential internal inefficiencies in decision making. On this see: Henry Butler and Larry Ribstein, *The Sarbanes-Oxley Debacle, What We’ve Learned and How to Fix It* (AEI Press 2006), 43-50.

⁴¹ Sheryl-Ann K. Stephen and Pieter J. de Jong, ‘The Impact of the Sarbanes-Oxley Act (SOX) on the Cost of Equity Capital of S&P Firms’ (2012) 13(2) *Journal of Business and Economics* 102.

⁴² John C. Coates IV, ‘The Goals and Promise of the Sarbanes-Oxley Act,’ (2007) 21(1) *Journal of Economic Perspectives* 91, 92.

⁴³ Stephen Wagner and Lee Dittmar, ‘The Unexpected Benefits of Sarbanes-Oxley,’ (April 2006) *Harvard Business Review* 1, 2.

and its counterparts) the practice of creative compliance was not materially reduced.⁴⁴ Rather, despite these highly publicised failures and, as shall be seen in the next section, judicial attempts to introduce broader compliance standards, we saw a proliferation in creative compliance, particularly with regard to tax planning (or avoidance). The question considered in section (iii) is whether the GAAR is suitably structured and situated to achieve a more successful outcome than SOX in terms of changing corporate culture and decision making.

(ii) *Creative compliance and tax avoidance*

Tax avoidance is a paradigm case of creative compliance. It is a practice that involves the implementation of technically legal transactions that are designed primarily, if not exclusively, to reduce tax liabilities, contrary to the intention of the relevant legislation.⁴⁵ Notwithstanding the recognition that such structures undermine regulatory intent, the orthodoxy of the courts when interpreting tax statutes (as enshrined in the *Duke of Westminster* doctrine) has been to base their decision on looking solely at ‘what is clearly said. There is no room for any intendment.’⁴⁶ These decisions are premised on, and endorse, the principle that technical compliance with tax regulation is a legitimate standard to apply ‘however apparently within the spirit of the law the case might otherwise appear to be’⁴⁷ and that citizens ‘incur no legal penalties and, strictly

⁴⁴ For a discussion as to why this rule-based approach might not have been successful see: M. L. Michael, ‘Business Ethics: The Law of Rules,’ (2006) Corporate Social Responsibility Initiative Working Paper No. 19. Michael’s reasoning includes not only creative compliance but also the potentially negative impact of ‘external’ motivations such as rules on individual ‘ethical’ behaviour. Section three considers more broadly, in the context of the UK GAAR, why regulatory responses alone (regardless of design) are insufficient without wider normative change.

⁴⁵ G Wheatcroft, ‘The Attitude of the Legislature and the Courts to Tax Avoidance, (1955) 18(3) Modern Law Review 209, 209.

⁴⁶ *Cape Brandy Syndicate v I.R.C.* [1921] 1 KB 64, at 71 and approved in *Canadian Eagle Oil Co. Ltd v R.* [1946] AC 119, per Lord Simon at 140.

⁴⁷ *Partington v Attorney General* (1869) LR 4 HL 100, per Lord Cairns at 122. This approach was subsequently endorsed in *I.R.C. v Barclays Bank* [1951] AC 421, 439.

speaking no moral censure⁴⁸ if they adopt a technical, rather than spirited approach to compliance.

Notwithstanding this early endorsement of technical compliance, a line of judicial decisions started to develop in the mid-twentieth century that expressed an increased awareness that such strict compliance with tax regulation (in defeat of its spirit) should not be regarded as the ‘discharge of the duties of good citizenship.’⁴⁹ This criticism of creative compliance was commonly grounded in notions of manifest unfairness, that those who could creatively comply were conferring a disproportionate burden to their fellow citizens.⁵⁰ We thus start to see a recognition of the relationship between civic responsibility (if not duty) and compliance. Nevertheless, despite this dissatisfaction with such technical approaches to compliance, the judiciary ultimately remained bound by express statutory wording, in respect of which there was limited discretion.⁵¹

A (seemingly) significant incursion into, and departure from, the strict application of the *Duke of Westminster* decision came with the development of the ‘*Ramsay* principle.’ This principle was derived from, *inter alia*,⁵² the House of Lords’ decision in *W. T. Ramsay Ltd v Inland Revenue Commissioners*⁵³ which concerned the manufacture, by Ramsay, of a deductible loss so as to counteract a genuine chargeable gain that it had realised through the sale of its freehold farmland. The House of Lords held that the creation of the loss arose simply as a consequence of a complex ‘capital loss scheme’

⁴⁸ *Levene v I.R.C.* [1928] AC 217, *per* Lord Sumner at 227.

⁴⁹ *Latilla v I.R.C.* [1943] AC 377, *per* Lord Simon at 381.

⁵⁰ See for example: *Lord Howard de Walden v I.R.C.* [1942] 1 KB 389, *per* Lord Greene MR at 397.

⁵¹ Wheatcroft (n 45), 218.

⁵² The principle also reflects the House of Lords decision of the same year in *I.R.C. v Burmah Oil Co Ltd.* [1982] S.C. (H.L.) 114. It was subsequently extended a few years later by the House of Lords in *Furniss (Inspector of Taxes) v Dawson* [1984] A.C. 474, which held that the Ramsay principle applied to all transactions with pre-ordained steps that serve no commercial purpose, not simply those involving self-cancelling steps (which had been one interpretation of *Ramsay*). Where a series of transactions fall within this definition then tax should be calculated on the effect of the structure as a whole.

⁵³ [1982] A.C. 300.

that had no commercial justification and the sole purpose of which was to offset the chargeable gain that had been made following the sale of the farm. Crucially, the House of Lords accepted that, taken in isolation, each stage of the scheme was genuine and would have to be accepted under the *Duke of Westminster* doctrine.⁵⁴ However, when taking the scheme as a whole, a deductible loss did not arise. Looked at in this way (that is, in aggregate) the scheme was, in fact, a financial nullity with neither a gain nor a loss arising. In effect, the Lords held that when considering an otherwise lawful transaction, with individual pre-determined steps that were intended to be carried out as a whole, they were not obliged to consider each step individually but could look at the transaction in its consolidated form.

Importantly, the Lords came to this decision whilst affirming the principle that a tax payer is entitled to ‘arrange his affairs so as to reduce his liability to tax ... that [the mere fact that] the motive for a transaction may be to avoid tax does not invalidate it unless a particular enactment so provides.’⁵⁵ Moreover, they did not overrule the principle in the *Duke of Westminster*, rather they held that it did not need to be applied ‘in blinkers, isolated from any context to which it properly belongs.’⁵⁶ In fact, the Lords expressly stated that the decision was not preferring substance to form, rather that it was acknowledging that if a transaction is part of a series of transactions then it is that series in aggregate, not any one of its individual steps, that should be considered. In doing so, the Lords did not disrupt the legitimacy of creative compliance as established in earlier decisions *per se* (the importance of which is considered in part two). Rather it was saying that these earlier principles should be applied having regard to the reality of the

⁵⁴ [1982] A.C. 300, at 325, 337-340.

⁵⁵ [1982] A.C. 300, at 323.

⁵⁶ [1982] A.C. 300, at 323. In this way, the ‘*Ramsay* principle subsisted alongside, and did not overrule, the *Duke of Westminster* principle,’ see: Judith Freedman, ‘Defining Taxpayer Responsibility: in Support of a General Anti Avoidance Principle,’ (2004) 4 British Tax Review 332, 350.

transaction (or series of transactions) before it.⁵⁷

It is against this backdrop that certain corporate tax structuring strategies came to public attention,⁵⁸ operating as the catalyst for regulatory reform.⁵⁹ In particular, attention focussed on the use of two structures. First, the use of ‘inversions’ and, secondly, the colloquially entitled ‘Double Irish,’ which often also incorporated a ‘Dutch Sandwich.’ The basis of consternation with these tax avoidance mechanisms becomes immediately clear when looking at how they operate in practice. An inversion typically involves the acquisition of a new parent company by an existing corporate group. Crucially, this new entity is situated in a tax haven⁶⁰ or other such lower tax jurisdiction, whilst the former parent company (now a subsidiary of the new parent) remains in its original jurisdiction of operation, for example the United States. Following the inversion, the group seeks to, artificially, ‘shift’ as much of its profits to the lower tax territory, regardless of where the activity giving rise to the profit actually occurred. The consequence of the inversion is that the group’s operations continue largely as before (often with the management team remaining *in situ*) but the taxable gains (if any) are relocated to a low-tax jurisdiction, denying tax to the jurisdiction in which the gain was made.

The so-called Double Irish scheme involved the implementation of a complex and

⁵⁷ There have, of course, been a number of tax cases following Ramsay. However, scope does not permit a detailed analysis of these decisions within this research. Rather, it focuses on Ramsay as the seminal decision that both sought to reduce the type of structures that the GAAR is now targeting, whilst nevertheless failing to make a meaningful incursion into either the normative standing of tax avoidance or corporations’ implementation of abusive structures.

⁵⁸ Although these structures have been utilised for many years. For a summary of such activity, including the relocation of UK group Shire plc, see: Johannes Voget, ‘Relocation of Headquarters and International Taxation,’ (2011) 95 Journal of Public Economics 1067.

⁵⁹ Namely, the GAAR which is discussed in section three.

⁶⁰ The OECD sets out four characteristics of a tax haven: (i) low or nominal taxes; (ii) a lack of transparency; (iii) the existence of laws or practices that hinder the exchange of information with other jurisdictions for tax purposes; and (iv) the absence of a requirement for activity to be substantial in that jurisdiction <https://web.archive.org/web/20120512074208/http://www.oecd.org/document/63/0,3343,en_2649_37427_30575447_1_1_1_37427,00.html> accessed 20 September 2016.

artificial⁶¹ corporate structure that utilised both the low tax rate in Ireland together with the fact that Irish tax law stipulated that a corporation is resident for tax purposes in the jurisdiction that it is ‘managed and controlled,’ not where it is incorporated.⁶² In brief,⁶³ two companies are incorporated in Ireland, although one is managed and controlled (and therefore taxed, if at all) in a tax haven. This offshore entity holds the legal title to the groups’ intellectual property rights that it then licenses (for significant consideration) to the second company, which is tax resident in Ireland. The taxable income that the Irish resident entity generates from the use of the intellectual property is reduced by the tax-deductible consideration that it pays to the offshore entity, with any remaining profit being taxed at the lower rate of Irish corporation tax (lower in comparison to that levied in its ‘true’ jurisdiction of operation). The fiscal impact of the Double Irish scheme can then be further increased (namely, tax further reduced) by the insertion of a ‘Dutch Sandwich.’ That is, the group incorporates a Dutch entity that is used to take advantage of Ireland’s Double Taxation Treaty with the Netherlands, which means that the Irish company does not pay tax on payments made to its Dutch counterpart.⁶⁴ As such, when the tax resident Irish company generates a profit, it then pays this (by way of a royalty, supported by the requisite legal and ownership structure) to a Dutch company within the organisation. This Dutch shell company then relies on favourable Dutch tax laws to pass on the royalty to the ‘offshore’ Irish company, where it pays little or no tax on the funds transferred.⁶⁵

⁶¹ Artificial in the sense that the structure did not have a genuine commercial purpose outside of tax avoidance.

⁶² In response to international pressure, and with effect from 1 January 2015 (subject to a transition period for existing corporations until 2020), Ireland’s Finance Act 2014 has now introduced reform that requires all Irish incorporated companies to be tax resident in Ireland.

⁶³ For a more detailed analysis of the mechanics of the ‘Double Irish Dutch Sandwich’ structure, see: Alexandre Quiquerez, ‘Intellectual Property Holding Companies: an International Perspective,’ (2013) 4 *Intellectual Property Quarterly* 303, 331-337.

⁶⁴ Double tax treaties are designed to avoid an international transaction being taxed in every jurisdiction that it engages with.

⁶⁵ An analysis of the financial and policy repercussions of these structures, drawing specifically on those adopted by Google, Amazon and Starbucks, is set out in Part 1 of the Public Accounts Committee - Nineteenth Report, *‘HM Revenue and Customs: Annual Report and Accounts,’* 3 December 2012
<<http://www.publications.parliament.uk/pa/cm201213/cmselect/cmpubacc/716/71602.htm>>

Both the use of inversions and the Double Irish Dutch Sandwich involved technically compliant, and legally effective, transactions. What resulted in public (and parliamentary)⁶⁶ censure was the manifest unfairness of large corporations being able to so clearly undermine the intention (or spirit) of the legislation in this way. By implementing these artificial structures, large corporate groups were able to gain the benefit of the resources, know-how and institutions of a particular jurisdiction whilst avoiding the concomitant (moral) obligation to pay taxes within that jurisdiction. Furthermore, it started to become clear that the adoption of creative compliance in this way resulted in significant indirect consequences, beyond the fiscal losses that they caused.⁶⁷ In particular, these structures increased distrust in the corporate system, exposed the inequality of the broader regulatory environment that all citizens (corporate and natural) operate within and, in doing so, undermined the integrity of the system as a whole.⁶⁸ Moreover, it demonstrated in stark and uncompromising terms that the modern corporation understood its compliance obligation to be one of mere legality, nothing more, regardless of the broader consequences. Indeed, when faced with challenges to the ethicality of Google's tax structures, its Chief Executive Officer declared that he was 'very proud'⁶⁹ of Google's tax structure, postulating that 'what we are doing is

accessed 10 September 2016. Note in paragraph 10 of Part 1 that Google maintained that 'it minimised tax within the letter of the law.'

⁶⁶ Ibid.

⁶⁷ The fiscal impact of these structures is, of course, significant. The UK 'tax gap,' namely the difference between the tax due and that collected for the year 2013-14 (the latest for which we have figures), that was attributable to 'avoidance' was £2.7 billion, to 'evasion' £4.4 billion and to 'legal interpretation' £4.9 billion. See: HM Revenue & Customs, *Measuring Tax Gaps 2015 Edition, Tax Gap Estimates for 2013-14* (22 October 2015) <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/470540/HMRC-measuring-tax-gaps-2015-1.pdf> accessed 10 September 2016.

⁶⁸ Kimberly A. Clausing, 'The Effect of Profit Shifting on the Corporate Tax Base in the United States and Beyond,' (June 2016) National Tax Journal (forthcoming) available at SSRN: <http://ssrn.com/abstract=2685442>.

⁶⁹ The Telegraph, 12 December 2012, Google's Tax Avoidance is Called Capitalism, Says Chairman Eric Schmidt,' *The Telegraph* (12 December 2012) <<http://www.telegraph.co.uk/technology/google/9739039/Googles-tax-avoidance-is-called-capitalism-says-chairman-Eric-Schmidt.html>> accessed 10 September 2016.

legal,⁷⁰ whilst claiming a fiduciary responsibility to shareholders to act in this way.⁷¹

(iii) *The General Anti-Abuse Rule and ongoing challenges*

In response to the highly publicised creative tax structures outlined in the previous section, the United Kingdom introduced the GAAR.⁷² The GAAR is designed to have a preventative effect, namely to discourage ‘abusive tax arrangements’ being implemented, by counteracting (effectively nullifying) the tax benefit that they would otherwise confer.⁷³ That is, the repercussion of breaching the GAAR is simply to remove the artificial tax gain that the structure sought to achieve; it does not include a punitive element. The GAAR defines a ‘tax arrangement’ as an arrangement in respect of which it would be ‘reasonable to conclude that the obtaining of a tax advantage was the main purpose, or one of the main purposes’ of the structure concerned.⁷⁴ Such an arrangement is ‘abusive’ if it ‘cannot reasonably be regarded as a reasonable course of action’⁷⁵ (the so-called ‘double reasonableness’ test) having regard to, *inter alia*, the underlying policy objectives of the relevant regulatory provision.⁷⁶ Thus, the GAAR seeks to change traditional standards of compliance, as enshrined in the *Duke of Westminster*, by replacing them with a broader, more spirited construction that prohibits both illegal and abusive structures.

⁷⁰ Gwyn Topham, ‘Google’s Eric Schmidt: Change British Law and we’d Pay More Tax,’ *The Guardian* (27 May 2013) <<https://www.theguardian.com/technology/2013/may/27/google-eric-schmidt-change-law-tax>> accessed 10 September 2016.

⁷¹ A perspective that is disputed in chapter five.

⁷² The GAAR was introduced pursuant to Part 5, Finance Act 2013, whilst its procedural requirements are set out in Schedule 43, Finance Act 2013. The Aaronson Report, which sets out the findings of the study group set up to consider the introduction of a GAAR in the UK, is instructive as to the benefits and potential concerns of implementing a GAAR. See: Graham Aaronson QC, ‘GAAR Study, A Study to Consider Whether a General Anti-Avoidance Rule Should be Introduced into the UK Tax System,’ 11 November 2011 (the ‘**Aaronson Report**’). Of note is that prior to the recent tax scandals referred to in section two, the UK had previously resisted GAAR. On this see: Judith Freedman, ‘General Anti-Avoidance Rules (GAARs) – a Key Element of Tax Systems in the Post-BEPS Tax World?’ (2016) University of Oxford Legal Research Paper Series 1, 7.

⁷³ Section 206, Finance Act 2013.

⁷⁴ Section 207(1) Finance Act 2013.

⁷⁵ Section 207(2) Finance Act 2013.

⁷⁶ Section 207(2)(a) Finance Act 2013.

The GAAR is still in its infancy and, as such, we have yet to see whether it will be successful in meeting its objectives. However, history suggests that this type of single-issue regulation, passed without substantial change to the wider context that corporations operate within, is unlikely to have the impact needed to address the complex issue of corporate compliance.⁷⁷ Drawing on Edelman's work, which recognises compliance as a social construct, a corporation's interpretation of compliance is informed by a range of environmental factors (industry, market and cultural norms for example), not simply an isolated legislative demand. If we fail to address the normative environment in which corporations define compliance then discrete regulatory intervention of this nature is unlikely to achieve meaningful behavioural (or cultural) change. Indeed, without this wider conceptual reform, we risk the GAAR itself being susceptible to technical compliance practices. Whilst this scepticism is borne, in part, from previous experience with legislation such as SOX, this is not the only basis for cynicism. Rather, when looking at the structure of the GAAR itself we see three potential, although arguably unavoidable, limitations to its success.⁷⁸

First, notwithstanding the apparent breadth of the GAAR's application to 'abusive tax arrangements,' on closer analysis it does not necessarily apply to the intra-group, international schemes that gave rise to its introduction. In its own guidance on the GAAR, HMRC acknowledges that the mere fact that a transaction benefits from a double tax treaty does not mean it constitutes 'abusive' conduct. To fall within the remit of the GAAR, the transaction would need to exploit particular provisions of the tax treaty, or its interaction with UK tax law, in a way that 'could not have been

⁷⁷ Notwithstanding the significant provisions introduced by SOX, subsequent corporate actions (such as those outlined in part one, section two) indicate that it failed to achieve the wholesale behavioural change that was necessary to curtail such corporate practices moving forward.

⁷⁸ For a wider discussion as to the challenges of anti-abuse rules see: David Weisbach, 'Ten Truths About Tax Shelters,' (2002) 55(2) Tax Law Review 215, 247-251.

intended⁷⁹ by the UK and its counterparty. This is a seemingly reasonable approach to adopt on the face of the regulation. However, it will be recalled that this is the very type of activity that the Double Irish Dutch Sandwich structure engaged, such that the HMRC's own guidance on the GAAR acknowledges, perhaps surprisingly, that 'many cases of the sort which generated a great deal of media and Parliamentary debate in the months leading up to the enactment of the GAAR cannot be dealt with by the GAAR.'⁸⁰ This, combined with the double-reasonableness test, which is expressly stated to act as a taxpayer safeguard, is likely to operate to reduce the number of large corporate structures that are caught by the GAAR and goes some way to explaining the lack of enforcement action to date.⁸¹

This limitation, combined with the lack of punitive sanction for breaching the GAAR, gives rise to the second difficulty inherent within the text of the regulation. That is, the GAAR fails to make a sufficiently unequivocal admonishment of creative tax structures. As shall be seen in chapter four, and outlined in part one, attempts to reconceptualise corporate compliance standards are operating against powerful norms that favour (and legitimise) narrow compliance definitions. One important element in changing this perception (although by no means the only one) is harnessing the expressive (or symbolic) function of law to make a clear statement as to the normative wrong of creative compliance.⁸² If the GAAR had engaged a more robust prohibition on corporate structures, and included a punitive element,⁸³ this would have gone further in

⁷⁹ HM Revenue & Customs, *General Anti Abuse Rule (GAAR) Guidance* (30 January 2015), paragraph D12 ('**GAAR Guidance**')

<https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/399270/2_HM_RC_GAAR_Guidance_Parts_A-C_with_effect_from_30_January_2015_AD_V6.pdf> accessed 10 September 2016.

⁸⁰ GAAR Guidance (n 79), paragraph B5.2.

⁸¹ As to the intentions of the double reasonableness test, see: GAAR Guidance (n 79), paragraph B12 and C5.10.3.

⁸² On the expressive function of law more generally see: Cass Sunstein, *On the Expressive Function of Law*, (1996) 144 *University of Pennsylvania Law Review* 2021.

⁸³ In August 2016 the government released a consultation seeking to impose a significant punitive sanction on professionals that advise upon such abusive tax structures, see: HM Revenue & Customs, *Strengthening Tax Avoidance Sanctions and Deterrents: A Discussion*

changing the social meaning of acceptable compliance and therefore the standing against which abusive structures would be judged.⁸⁴ One recent example of the success of such an approach is the UK Bribery Act 2010. The Bribery Act 2010 received significant (and global) early success in changing corporate attitudes to anti-corruption initiatives by adopting a zero tolerance approach to bribery (combined with significant penalties for breach).⁸⁵ It is clear that bribery is, normatively, viewed as a different category of behaviour to tax avoidance, which it could be argued is the actual reason for such widespread engagement with the Bribery Act 2010. However, it must be noted that bribery has always been illegal in the United Kingdom and never considered to be ‘ethical’ conduct (even before the 2010 Act).⁸⁶ Nevertheless, the Bribery Act 2010 made a significant impact on corporate practice. In this way, it appears that the unequivocal stance of the Bribery Act, its breadth of application and consequences for breach (all of which are lacking from or, at best, not as significant within, the GAAR) has generated a swift and significant behavioural response.⁸⁷ In contrast to the Bribery Act, the GAAR has failed to instil, in the mind of corporations at least, the view that tax avoidance is a normative wrong that *should* be prevented.

Document, Consultation Document (17 August 2016), paras 2.15 and 2.16. This is a welcome development that should limit certain incidents of aggressive tax planning. However, as discussed in chapter six, a sanction on advisers, rather than the corporation as the subject of legal duty itself, is likely to be treated as a further obstacle to overcome, rather than generating meaningful change to the normative standing of tax avoidance.

⁸⁴ Sunstein, *Expressive Function* (n 82), 2022. Note that in this context, the existence of a punitive sanction is valuable in harnessing the expressive function of the regulation. As discussed in part two, the mere existence of a severe punishment is not in itself sufficient to engender material changes to compliance behaviour.

⁸⁵ Sections 7 and 11, Bribery Act 2010. When considering the Bribery Act 2010 it is prudent to note the importance of enforcement decisions when examining the expressive function of law. The early success of the Bribery Act 2010 is starting to be potentially undermined by the relative lack of enforcement decisions taken to date and the introduction of Deferred Prosecution Agreements (pursuant to Schedule 17, Crime and Courts Act 2013).

⁸⁶ Anti-corruption legislation included: the Sale of Offices Act 1551; the Sale of Offices Act 1809; the Public Bodies Corrupt Practices Act 1889; the Prevention of Corruption Act 1906; the Prevention of Corruption Act 1916; Honours (Prevention of Abuses) Act 1925; Licensing Act 1964, s 178; Criminal Law Act 1967, s 5; Local Government Act 1972, s 117(2); Customs and Excise Management Act 1979, s 15; Representation of the People Act 1983, ss 107, 109 and 111-115; and, more recently, the Anti-Terrorism, Crime and Security Act 2001 (ss 108-110).

⁸⁷ The importance of a significant sanction to this thesis is its impact on the normative perception of breach. However, the GAARs lack of punitive sanction means that it is also unlikely to be effective in the current normative environment, which views compliance as a mere pricing exercise. On which see: Cynthia Williams, ‘Corporate Compliance with the Law in the Era of Efficiency,’ (1997) 76 North Carolina Law Review 1265, 1286-1287.

The final structural challenge with meeting the GAAR's objective is the perennial problem of regulatory design. In this regard, the GAAR eschews 'command and control'⁸⁸ style regulation and instead adopts a 'New Governance'⁸⁹ technique of principles-based regulation. That is, it prohibits 'abusive arrangements' rather than engaging in a prescriptive rules-based approach.⁹⁰ This use of this regulatory technique is not surprising. Principles-based regulation aligns with the rhetoric of the current compliance debate and, in particular, the need for more responsible corporate behaviour.⁹¹ More than this, it is the optimum regulatory design to 'minimize the scope for creative compliance,'⁹² which (as outlined in part one) is a practice that manipulates bright line rules to undermine the spirit of regulation (Enron's use of the 3% rule being a case in point).⁹³ However, whilst principles-based regulation may be the correct

⁸⁸ Command and control style regulation being the use of 'detailed rules backed by criminal sanctions overseen by a government agency,' see: Julia Black, 'Paradoxes and Failures: "New Governance" Techniques and the Financial Crisis' (2012) 75 *Modern Law Review* 1037, 1041.

⁸⁹ There is no single agreed definition of 'new-governance.' However, it is generally accepted that it embraces regulatory design that has moved away from traditional command and control style regulation to a more nuanced approach that often engages both private and public actors to achieve regulatory objectives, see: Robert Weber, 'New Governance, Financial Regulation, and Challenges to Legitimacy: The Example of the Internal Models Approach to Capital Adequacy Regulation' (2010) 62 *Administrative Law Review* 783, 836. In this way it seeks to 'offer a third way vision between unregulated markets and top-down government controls,' see: Orly Lobel, 'New Governance as Regulatory Governance, (2012) San Diego Legal Studies Paper No 12-101, 3. Examples of new governance techniques include principles-based regulation and meta-regulation (where regulators require corporations to develop their own systems for compliance). On this see: Julia Black, *Paradoxes and Failures* (n 88).

⁹⁰ Kaplow explains the distinction between a rule and a principle (or standard) as follows: 'a rule may entail an advance determination of what is permissible, leaving only factual issues for the adjudicator ... A standard may entail leaving both specification of what conduct is permissible and factual issues for the adjudicator.' See: Louis Kaplow, 'Rules Versus Standards: an Economic Analysis' (1992) 42(3) *Duke Law Journal* 557, 560. In offering this definition, Kaplow provides the example of the difference between a rule that requires a driver to keep within a speed limit of 55 miles per hour and a principle that prohibits 'excessive' speed.

⁹¹ For a broader discussion of the rhetoric of principles-based regulation see: Julia Black, 'Forms and Paradoxes of Principles Based Regulation,' (2008) 3(4) *Capital Markets Law Journal* 425, 430 – 432.

⁹² Black, *Forms and Paradoxes* (n 91), 438.

⁹³ Lord Justice Diplock observed that not only are tax transactions that come before the courts not envisaged by the relevant regulation but that they were indeed 'devised as a result of it,' see: Lord Justice Diplock, 'The Courts as Legislators,' Presidential Address to the Holdsworth Club, University of Birmingham 1965, 6 <<http://www.kessler.co.uk/wp-content/uploads/2012/05/CourtsAsLegislators.pdf>> accessed 10 September 2016.

regulatory design to adopt,⁹⁴ there nevertheless remains a significant and, perhaps unavoidable, challenge to the efficacy of this design strategy in the long term. Pending judicial or other relevant determination, principles-based regulation can be seen (by those subject to it) to lack legitimacy on the basis of its uncertainty.⁹⁵ In due course, this certainty is achieved as the broad principles are interpreted either by the courts, advising counsel or enforcement agencies and it is here that we see the long-term difficulty with this type of regulatory design. That is, over time the principle eventually becomes narrowed to ‘congeal around a particular meaning.’⁹⁶ This gives rise to the paradox of interpretation recognised by Julia Black, namely that broad principles, designed to give flexibility, are nevertheless capable of detailed interpretation.⁹⁷ In effect, this congruence of rules and principles, means that after a while the principle exists only ‘at the formal level’⁹⁸ whilst in practice the regulation is effectively comprised of clear rules that remain susceptible to the creative compliance processes that they were designed to avoid.⁹⁹

Against these inevitable challenges faced by principles-based regulation (indeed, as with any other approach) the importance of trust in the regulatory system starts to emerge. Julia Black observes that a successful principles-based regime is dependent on a ‘high level of trust between all the participants in the regulatory regime.’¹⁰⁰ Specifically, for principles-based regulation to work ‘firms need to be concerned to go

⁹⁴ Although note that it is unlikely that a regulatory system will rely upon a single approach to design. See; Cristie L. Ford, ‘New Governance, Compliance and Principles-Based Securities Regulation,’ (2008) 45(1) *American Business Law Journal* 1, 8.

⁹⁵ Julia Black, ‘Forms and Paradoxes of Principles-Based Regulation,’ (2008) 3(4) *Capital Markets Law Journal* 425, 426.

⁹⁶ Ford (n 94), 9. As to this convergence of rules and principles more generally, see: Frederick Schauer, ‘The Convergence of Rules and Standards,’ (2003) *New Zealand Law Review* 303.

⁹⁷ Black, *Forms and Paradoxes* (n 95), 446.

⁹⁸ Black, *Forms and Paradoxes* (n 95), 447.

⁹⁹ Indeed, this could be seen in practice with the response to the *Ramsay* decision. Initially feared to prohibit any transaction without a genuine commercial purpose, the ‘big four’ accounting firms quickly established structures that circumvented and survived the decision’s seemingly broad application.

¹⁰⁰ Black *Forms and Paradoxes* (n 95), 456.

beyond minimal compliance'¹⁰¹ and that without this trust, the regulation 'will never be operationalised.'¹⁰² The difficulty facing the GAAR is that one of the significant consequences of creative compliance (discussed in chapter two) is that it undermines both trust between the regulator and regulatee, as well as between regulatees *inter se*.

Nevertheless, notwithstanding these difficulties, it is important to appreciate that principles-based regulation has one significant benefit. That is, it facilitates the continued revaluation by a corporation of their 'understanding of compliance'¹⁰³ making it susceptible to changing social norms. Harnessed in the right way, this gives the GAAR the potential to reduce creative compliance practices, provided such social norms are supportive of spirited compliance. Therefore, to utilise this potential of principles-based regulation what is crucial, and reflecting the central claim of this thesis, is that we establish the requisite norms and supporting framework to encourage a broad definition of compliance and legitimise the constraint of creative compliance. Thus whilst Hector Sants (acting in his former capacity as the Chief Executive Office of the then Financial Services Authority) was arguably being somewhat facetious when he said that a 'principles-based approach does not work with people who have no principles,'¹⁰⁴ there is some merit to this observation. We need to change the frame of reference that corporations both operate, and define compliance, within for the GAAR to be a success.¹⁰⁵ That is, to move ethical compliance from being rule (or principle) governed to norm governed.¹⁰⁶

¹⁰¹ Black, *Forms and Paradoxes* (n 95), 427.

¹⁰² Black, *Forms and Paradoxes* (n 95), 456.

¹⁰³ Ford (n 94), 28.

¹⁰⁴ Hector Sants, 'Delivering Intensive Supervision and Credible Deterrence,' (Reuters Newsmakers Event, London, 12 March 2009) <http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0312_hs.shtml> accessed 10 September 2016.

¹⁰⁵ Edelman, *To Comply or Not to Comply* (n 21), 105.

¹⁰⁶ Michael (n 44), 8.

PART TWO: MOTIVATING TAX COMPLIANCE: FROM DETERRENCE TO LEGITIMACY

The fundamental challenge that has yet to be addressed by the GAAR is how to stimulate broad and voluntary compliance standards within corporations. Part one demonstrated the inherent limitations faced by most regulatory approaches. Therefore, to achieve sustainable change, what is needed is for legal actors to develop an intrinsic motivation or, put another way, sense of obligation to adopt spirited compliance policies that would mitigate (or even act as a panacea for) the current shortcomings that the GAAR faces.¹⁰⁷ Traditionally, this motivation was thought to be derived from purely extrinsic factors, namely a deterrence-based approach to regulation. However, whilst such economic considerations certainly play an important role in corporate compliance decisions, they are not the only influence.¹⁰⁸ In particular, this part explores how the legitimacy of both the authority to constrain creative compliance, and the demand for spirited compliance itself, is instrumental in shaping compliance strategies, a legitimacy that the GAAR has yet to establish.¹⁰⁹

¹⁰⁷ These difficulties were outlined in part one. For a discussion of intrinsic and extrinsic motivations for tax compliance see: Nadja Dwenger, Henrik Kleven, Imran Rasul and Johannes Rincke, 'Extrinsic and Intrinsic Motivations for Tax Compliance: Evidence from a Field Experiment in Germany,' (2016) 8(3) *American Economic Journal: Economic Policy* 203.

¹⁰⁸ A successful policy towards spirited corporate compliance is likely to incorporate a combination of deterrence and legitimacy-based approaches (the latter incorporating the importance of social norms towards compliance).

¹⁰⁹ Other studies have focused on the relationship between legitimacy and compliance for individuals. This research seeks to extend this research and apply it to corporations, not simply by identifying the norms of the corporate environment (and their impact on legitimacy) but also to understand more deeply how corporate pathology positively hinders reform. As to studies into individual norms, see: James Alm, Isabel Sanchez and Ana de Juan, 'Economic and Non-economic Factors in Tax Compliance,' (1995) 48(1) *KYKLOS* 1; Benno Torgler, *Tax Morale and Compliance, Review of Evidence and Case Studies for Europe* (2011) The World Bank Policy Research Working Paper 5922. Recent work has started to apply a non-economic analysis of corporate compliance although this does not extend to an examination of the impact that the corporate regulatory environment has on such decision making. See: Alexis Downs and Beth Stetson, 'Economic Versus Non-Economic Factors: An Analysis of Corporate Tax Compliance,' (2011) *American Accounting Association Annual Meeting – Tax Concurrent Sessions*, available at SSRN: <http://ssrn.com/abstract=1905075>.

(i) *The orthodox model of tax compliance*

An individual's tax compliance is traditionally explained by reference to an economic (essentially deterrence-based) model. This view, initially put forward by Allingham and Sandmo¹¹⁰ (who applied Becker's 'economics of crime' approach),¹¹¹ suggests that an individual will comply with tax regulation where it is utility maximising to do so. That is, when faced with a tax compliance decision a rational individual will simply factor the risk of detection against the benefit of an abusive structure.¹¹² Within this model, compliance is premised on (or motivated by) a cost-benefit analysis, which simply factors the economic consequences of breach against the risk of sanction.¹¹³ A low risk of detection, enforcement or penalty all weigh against a decision to comply. The policy implications of this model are clear; to deter abusive tax arrangements all that is required is to focus on enforcement and punishment rather than the wider normative environment.¹¹⁴

The difficulty with this orthodox view is that, if it is correct, then one would expect there to be more instances of avoidance.¹¹⁵ This seeming paradox was increasingly recognised in the late 1990's in the context of individual taxpayer behaviour. The literature at this time acknowledged that the chance of detection for tax evasion and avoidance was, in fact, quite low whilst the sanction for breach was not particularly

¹¹⁰ Michael G. Allingham and Agnar Sandmo, 'Income Tax Evasion: A Theoretical Analysis (1972) 1 *Journal of Public Economics* 323.

¹¹¹ This approach offered 'economic analysis to develop optimal public and private policies to combat illegal behavior,' see: Gary Becker, 'Crime and Punishment an Economic Approach,' in *Essays in the Economics of Crime and Punishment* Gary Becker and William Landes (eds) (National Bureau of Economic Research 1974), 43. Becker's model incorporates, *inter alia*, the view that 'an increase in a person's probability of conviction or punishment ... would generally decrease ... the number of offenses he commits' and that a 'person commits an offense if the expected utility to him exceeds the utility he could get by using his time and other resources at other activities' (Becker (n 111), 9).

¹¹² Allingham and Sandmo's work is discussed in more detail in: Torgler *Tax Morale* (n 109).

¹¹³ Torgler (n 109), 3.

¹¹⁴ *Ibid.*

¹¹⁵ See: Alm et al (n 109), 2; Torgler (n 109).

onerous.¹¹⁶ As such, if a pure deterrence-based model of compliance was accurate, then fewer people should be paying taxes in full (as it was not utility maximising or rational to do so). Nevertheless, the rates of compliance were in fact surprisingly high. For example, in their empirical study looking at the legal obligation to pay Church taxes in Germany, Dwenger *et al*, found a significant proportion of individuals complied with the obligation to pay. This was particularly striking given the zero deterrence baseline that existed, as it was widely known that the Church would not enforce its claim in the event of avoidance or evasion.¹¹⁷ In this environment, if the decision to comply were premised solely on an economic calculation absent any concerns (conscious or otherwise) as to social norms, judgment or shame, a decision to avoid (or evade) tax would be entirely rational. However, the high levels of compliance suggested the existence of other factors that were constraining such opportunistic (or rational) behaviour.

It was the incongruence between the purely economic model of tax paying behaviour and the emerging empirical data that contributed to the development of new theories of compliance. In particular, there was an increased focus on the influence of social (collective) and personal (individual) norms as a constraint on avoidance strategies. Recognising the potential impact of the ‘morality’ of tax compliance, focus moved to understanding the impact of intrinsic motivations as determinants of compliance, rather than simply the risk of sanction.¹¹⁸ For example, norms as to the ethics of tax evasion, the guilt of not paying one’s fair share and the attendant shame of being judged against

¹¹⁶ Alm *et al* (n 109), 1.

¹¹⁷ Dwenger *et al* (n 107), 3. Of note is that many of the relevant taxpayers did not actively attend the Church, mitigating a sense of religious obligation to pay. That said, whilst 20% of these taxpayers complied in full, the remaining 80% avoiding the tax to some degree. Thus, we see that intrinsic motivation is a persuasive factor in tax compliance but, also, that such motivations are not absolute and can differ amongst the tax-paying cohort (with a concomitant impact on tax paying behaviour). The importance of this is that, as discussed in chapter four, when considering corporate citizens the intrinsic motivations are more homogenous, creating a greater consistency of avoidance.

¹¹⁸ Alm *et al* (n 109), 1; Torgler (n 109), 6.

the relevant social or personal norms were identified as powerful restraints on otherwise economically 'rational' behaviour.¹¹⁹ Indeed, the power of these norms should not be underestimated. Much like individuals refrain from a wide range of behaviours because they are deemed to be morally wrong (not because they are unlawful), it is the existence of these social and personal norms that can naturally inhibit creative tax compliance, whilst also 'filling' gaps in the regulation, rendering deterrence 'superfluous.'¹²⁰

This broader, social, understanding as to the motivations of compliance behaviour may be persuasive when looking at natural citizens. However, one could argue that they have little bearing on corporate decision-making. That is, that to apply anything other than a deterrence theory to a juridical entity that famously has 'no soul to damn'¹²¹ is, at best, naïve. It is indisputable that corporate decision-making is influenced by economic rationales (indeed, this is discussed in detail in chapter four). However, there are two points against the argument that deterrence is the only determinant of corporate compliance decisions and that, as a consequence, a norm-based approach to corporate compliance is irrelevant. First, the predominance of economic motivations is not evidence against the influence of social norms on corporate compliance. Rather, they indicate the prevalence of profit maximising norms within the corporate environment and that to change compliance standards we need to address the content of these norms, rather than deny their existence and influence. Secondly, that the corporation, as a collective, nevertheless acts by individuals who are themselves influenced by personal, as well as organisational, norms. Thus, to understand corporate compliance behaviour we need to understand the consequences of any conflict that potentially arises when individual and corporate norms interact. As discussed in section three, it is this conflict

¹¹⁹ Brian Erard and Jonathan Feinstein, 'The Role of Moral Sentiments and Audit Perceptions in Tax Compliance,' (1994) 49 *Public Finance* 70, 74-75.

¹²⁰ M. Wenzel, 'The Social Side of Sanctions: Personal and Social Norms as Moderators of Deterrence,' (2004) 28(5) *Law and Human Behaviour* 547, 549.

¹²¹ Edward, First Baron Thurlow 1731-1806 as cited in John C. Coffee Jr, "'No Soul to Damn: no Body to Kick.'" An Unscandalized Inquiry into the Problem of Corporate Punishment,' (1981) *Michigan Law Review* 79(3) 386, 386.

that can, ironically, exacerbate and entrench the legitimacy of creative compliance (as individuals seek to alleviate the tension that they may otherwise feel when acting in accordance with corporate norms that are nevertheless contrary to their own).

The norms that influence corporate compliance decisions are considered in chapter four. However, at their core, their relevance goes to the fundamental question of legitimacy. That is, whether a particular compliance strategy is considered to be legitimate and whether regulation seeking to constrain such strategies is similarly premised on a legitimate basis (and exercised in a fair manner). The next section explores the instrumental relationship between legitimacy and compliance more generally. However, legitimacy plays a particularly powerful role in tax regulation and compliance. The very foundation of the fiscal relationship between state and citizen is predicated on notions of legitimacy. Tax is an inherent part of the social contract, pursuant to which a citizen recognises the authority to demand and collect tax as part of the broader consideration for living in a civil society. It is therefore a payment predicated on notions of consensual bargain, and a trust between government and citizen.¹²² Where trust in the fiscal system is lost, due to the manner in which tax is enforced, collected or spent, then that cornerstone of legitimacy is similarly destroyed.

(ii) *The relationship between legitimacy and compliance*

In his seminal work exploring why people obey the law,¹²³ Tom Tyler identified that it was a citizen's perception of the legitimacy of the law, rather than the threat of sanction, that was a critical determinant of their 'law-related behaviour.'¹²⁴ That is, when a citizen considers regulatory intervention, and the authority that it derives from, to be

¹²² Torgler (n 109), 12.

¹²³ Tyler (n 13).

¹²⁴ Tom Tyler and Jonathan Jackson, 'Future Challenges in the Study of Legitimacy and Criminal Justice,' in S. Simpson and D. Weisburd (eds.) *The Criminology of White-Collar Crime* (Springer 2009), 83.

legitimate they are more likely to comply with its direction. The importance of Tyler's work at the time was significant. It challenged the then 'ubiquitous'¹²⁵ view (outlined above) that, as rational actors, citizens are most likely to respond to a deterrence-based approach to regulation. In contrast, Tyler suggested that to achieve greater regulatory compliance (and, in subsequent work, legal deference)¹²⁶ it was necessary to enhance trust in, and the legitimacy of, the law rather than simply increase legal penalties.¹²⁷ From a corporate perspective, particularly regarding tax compliance, this legitimacy-based understanding moves us away from a purely (although, in part, still relevant) economic analysis of a rational actor model.¹²⁸ Rather, compliance (or non-compliance) is not simply a question of opportunity but a 'willingness to comply or evade.'¹²⁹

Importantly, the definition of legitimacy in this context includes not only an individual's perception of the overall legitimacy of the law,¹³⁰ but extends to procedural fairness, including the rational and fair exercise of authority.¹³¹ When regulation is applied unequally, dictated simply by a subject's ability to 'manipulate'¹³² the law this legitimacy is lost with profound consequences for future compliance as it reduces a subject's 'everyday rule-following behaviour.'¹³³ Put another way, it is manifest fairness that 'enhances voluntary compliance.'¹³⁴ Understood in this way, Tyler identified a

¹²⁵ Tyler (n 13), 269.

¹²⁶ Ibid, 273.

¹²⁷ This discussion of penalties is different to that considering the expressive function of the law discussed in part one. Here, Tyler is looking at sanctions simply as a driver of compliance based on a fear of punishment, not their capacity as a normative statement of moral wrong.

¹²⁸ Benno Torgler, 'Speaking to Theorists and Searching for Facts: Tax Morale and Tax Compliance in Experiments, (2002) 16(5) Journal of Economic Surveys 657, 657.

¹²⁹ Ibid, 658.

¹³⁰ Tyler (n 13), 273.

¹³¹ Historically, the perceived 'unfairness' or 'illegitimacy' of legislation was cited as a justification for tax avoidance, which could 'make fair what legislators have made unfair.' This, Sears argued, justified taking advantage of regulatory loopholes. See: John H Sears, *Effective and Lawful Avoidance of Taxes*, (1921) 8(2) Virginia Law Review 77, 79. See also: Tom Tyler and Yuen Huo, *Trust in the Law, Encouraging Public Cooperation with the Police and Courts* (Russell Sage Foundation 2002), 104.

¹³² Mc Barnet and Whelan, *The Elusive Spirit of the Law* (n 16), 848.

¹³³ Tyler (n 13) 274.

¹³⁴ Leo Martinez, *Taxes, Morals, and Legitimacy*, (1994) Brigham Young University Law Review 521, 548, 550.

symbiotic relationship between regulatory legitimacy (including equality) and compliance responsibility. The importance of this insight in changing corporate compliance standards is critical. A fundamental characteristic of creative compliance, explored further in chapter three is that it effectively allows certain corporate citizens (who have the requisite legal and financial resources to do so) to choose how the law applies to them. As a consequence, regulation does not apply equally to all citizens, reducing the perceived legitimacy of that regulation and, as a consequence, ‘general feelings of obligation and responsibility to obey.’¹³⁵

The value of legitimacy-based compliance is that it generates more sustainable compliance practices. Our perception of the legitimacy of the law (broadly defined to include legal institutions) concerns a citizen’s fundamental ‘beliefs about the right to power and influence.’¹³⁶ That is, does the citizen consider either the coercive entity or instrument to have the due authority to demand obedience and, as a consequence, does that citizen feel a moral duty to obey their direction? When an authority is seen to be legitimate, ‘people defer to, and cooperate with’¹³⁷ its objectives and goals, taking personal ‘responsibility for rule following.’¹³⁸ In this way, compliance is achieved in a meaningful, self-regulatory¹³⁹ and robust way over the long-term, not merely in response to an imminent risk of enforcement by a central authority.¹⁴⁰ That is, citizens follow the law because they think they should, not because they fear detection.¹⁴¹ In this way, legitimacy based compliance is more sustainable as it is norm driven and less

¹³⁵ Tom Tyler and Yuen Huo, *Trust in the Law, Encouraging Public Cooperation with the Police and Courts* (Russell Sage Foundation 2002), 26.

¹³⁶ Tom Tyler and Jonathan Jackson, ‘Future Challenges in the Study of Legitimacy and Criminal Justice,’ in S. Simpson and D Weisburd (eds.) *The Criminology of White-Collar Crime* (Springer 2009), 87.

¹³⁷ *Ibid*, 89.

¹³⁸ Tyler (n 13), 271. Interestingly, this analysis applies equally to rules within a corporation as well as to those imposed by government (Tyler (n 13), 272).

¹³⁹ *Ibid*, 269.

¹⁴⁰ Tyler and Huo (n 135), xiii.

¹⁴¹ *Ibid*.

likely to fluctuate as the fear of detection and sanction dissipates (a risk associated with deterrence-based compliance).¹⁴²

Tyler's findings offered a crucial insight into how best to engage legal institutions (including regulation and enforcement bodies) to achieve behavioural change. However, they are also incredibly salient when looking at a corporation's relationship with, and response to, regulation. For the corporation, the question of legitimacy operates both at the collective level (for example, the practices of other corporations together with industry and market norms) but also at the individual level, namely whether the individual employee implementing these structures considers (or is able to consider) their conduct to be legitimate.¹⁴³ By understanding Tyler's work, and how it applies to both the corporation and the individuals acting on its behalf, we are better able to understand how to instrumentalise the GAAR's objectives. Specifically, it becomes clear that for the GAAR to be effective both the corporation and the individual actor must view the GAAR as legitimate (or the relevant tax structure as illegitimate). Chapters four and five consider both the barriers to this approach and, as a corollary, how this may be achieved. However, at this juncture, the following section considers how legitimacy plays one further, although perhaps surprising, role in corporate compliance standards.

(iii) Legitimising creative compliance: dissonance reduction and over-rationalisation

One barrier to achieving legitimacy-based (spirited) compliance is the engagement of powerful behavioural mechanisms that operate to further legitimise creative compliance,

¹⁴² Tyler (n 13), 269.

¹⁴³ Tyler (n 13), 272.

once the relevant tax structure has been implemented.¹⁴⁴ These mechanisms serve to satisfy the needs of individuals to view their conduct as legitimate, that is, to avoid the sense of unease that arises when we feel that what we have done is illegitimate. In exploring this phenomenon, Leon Festinger recognised that once a decision to act has been made, individuals seek ‘internal ... consistency,’¹⁴⁵ namely a need for such action to be aligned with social and personal norms. Where that alignment is missing, an individual will experience cognitive dissonance (namely the stress that arises when one acts, *inter alia*, contrary to such norms) together with a concomitant desire to reduce the psychological tension that they feel as a result.¹⁴⁶ The risk of such tension arising is particularly high in a corporation, as the dissonance may come not from an internal tension within the individual but from a conflict between the individual’s value system and that promulgated by the corporation.¹⁴⁷ Thus, when an individual has responded to the corporate drivers that encourage the implementation of a creative compliance structure (discussed in chapter four), they will then seek to legitimise that decision, to achieve synergy with their own personal values. For example, they will want to rationalise an aggressive tax structure so that they may continue to identify themselves as an ethical person or as someone who would ‘do the right thing’ in a challenging situation.

Understanding this desire to reduce cognitive dissonance is important when examining corporate compliance as the mechanisms used to achieve this state serve to exacerbate

¹⁴⁴ That is, to maintain ‘cognitive consistency.’ On this, see: Michael Wenzel, ‘Motivation or Rationalisation? Causal Relations between Ethics, Norms and Tax Compliance,’ (2005) 26 *Journal of Economic Psychology* 491, 494.

¹⁴⁵ Leon Festinger, *A Theory of Cognitive Dissonance* (Stanford University Press 1957), 1 and 260

¹⁴⁶ *Ibid.*, 3.

¹⁴⁷ This goes some way to answering the question of why is that individuals who wouldn’t act unethically outside of the firm can nevertheless perpetrate a fraud, or implement an abusive tax structure when acting within the corporation. As Anand, Ashforth and Joshi observe, most of the acts were ‘committed by individuals who were upstanding members of the community.’ See: Vikas Anand, Blake E. Ashforth and Mahendra Joshi, ‘Business as Usual: The Acceptance and Perpetuation of Corruption in Organizations,’ (2004) 18(2) *Academy of Management Executive* 39, 39. Chapter five considers how the architecture of the firm contributes to this seeming paradox between individual values and actions within the corporation.

the legitimacy problem outlined in the previous section. Festinger identified several ways in which cognitive dissonance is reduced, two of which are particularly pertinent.¹⁴⁸ First, individuals may seek to justify the behaviour in question. For example, by claiming that creative compliance aligns with market ideology, that there is an obligation to shareholders to act in this way or simply that it is something that all corporations engage in. Secondly, they may ignore conflicting information or values that could otherwise suggest that creative compliance is either harmful or morally objectionable. Indeed, we see these strategies engaged in response to the scandals that gave rise to the GAAR. In replying to questions as to the ethicality of the tax structures his firm implemented, Eric Schmidt (the Chairman of Google) responded that such tax avoidance was ‘called capitalism’ and that there was ‘probably some law against’ implementing spirited compliance practices (if this reduced shareholder returns).¹⁴⁹ By either justifying creative compliance, or ignoring arguments against it, corporations not only disregard the damage it causes but they force themselves to positively deny there is anything wrong with it. That is, to consciously affirm creative compliance as a legitimate strategy to pursue. This has two profound consequences. First, it shapes a corporation’s culture, which now inculcates a view that technical compliance (even beyond tax regulation) is legitimate. Secondly, and as considered in part three in more detail, it influences the behaviours of other corporations that look to their competitor’s decisions to creative comply to further reinforce and justify their own similar conduct.

Importantly, the process of justification (or rationalisation) that is engaged to reduce cognitive dissonance impacts not only corporate culture as to abusive compliance practices but also more broadly as to ethical decision-making. This occurs as it is not possible to perfectly determine the extent of rationalisation required in any given situation. As such, when individuals seek to alleviate any anxiety they may feel, they

¹⁴⁸ Festinger (n 145), 19-24.

¹⁴⁹ ‘Google’s Tax Avoidance is Called ‘Capitalism,’ Says Chairman Eric Schmidt,’ *The Telegraph* (12 December 2012). See also: (n 70).

often need to over-rationalise their conduct, to ensure that it is adequately justified, thereby alleviating in full any cognitive discomfort.¹⁵⁰ The consequence of this over-rationalisation is that, in effect, a greater misdeed is ultimately justified than the one in question.¹⁵¹ As a result, the boundary of what is considered ‘ethical’ (or justifiable) expands with each iteration of over-rationalisation. In this way, the corporate ethical parameters (or culture) that individuals operate within become more and more permissive, changing the frame of reference in which decisions are made and compliance is defined.¹⁵² It is perhaps not surprising therefore, that when considering the accounting scandals of 2001, we saw that creative compliance escalated into a culture of systemic illegal behaviour.¹⁵³ It was also abundantly clear from the scandals of that time that the individuals concerned often saw nothing wrong with their behaviour, a perspective that is, somewhat worryingly, reflected in Eric Schmidt’s comments outlined above.¹⁵⁴

PART THREE: THE COMPLIANCE DEGENERATION CYCLE

The interplay between compliance and legitimacy helps to explain a self-perpetuating cycle of creative compliance that I term the ‘compliance degeneration cycle.’¹⁵⁵ That is, once the decision to creatively comply has been made the desire to avoid cognitive dissonance both legitimises creative compliance, whilst exacerbating the already

¹⁵⁰ Stelios C. Zyglidopoulos, Peter J. Fleming and Sandra Rothenberg, ‘Rationalization, Overcompensation and the Escalation of Corruption in Organizations,’ (2009) 84 *Journal of Business Ethics* 65, 66.

¹⁵¹ *Ibid*, 66.

¹⁵² *Ibid*, 70.

¹⁵³ *Ibid*, 69.

¹⁵⁴ The extent to which an actor will engage in these dissonance reduction processes is influenced, in part, by the extent to which they are committed to (or invested in) a particular position. Not only does the individual need to feel justified by their decision to act in that way but they are then subject to confirmation bias in which they have regard to (or actively seek) only those opinions or positions that support their own. See: Pam Jenoff, ‘Going Native: Incentive, Identity and the Inherent Ethical Problem of In-house Counsel,’ (2011) 114 *West Virginia Law Review* 725, 743.

¹⁵⁵ Degeneration is used in this context to denote both the state of something getting worse, but also to encapsulate the notion of a low standard of behavior.

existing perception that, in contrast, regulation such as the GAAR lacks such legitimacy. As this part three explains, this process of legitimising behaviour creates an ongoing (and reinforcing) cycle of technical compliance. By understanding this model of behaviour we can start to understand both why single-issue regulation is insufficient to prevent creative compliance whilst also identifying the point in the cycle that we need to intervene in and disrupt if we are to achieve meaningful reform.

(i) Stage one: initial drivers of creative compliance

The first stage of the cycle encapsulates the initial decision to creatively comply and the factors that motivate this. As the thesis introduction explained, citizens define compliance in accordance with their perceptions of ‘legality, morality and rationality.’¹⁵⁶ For individuals, this construction can be informed by a wide range of influences, including education, religion and shame,¹⁵⁷ which often contribute to broad (and diverse) notions of what compliance should mean. In contrast, for corporate actors, compliance is a term that is more singularly defined by industry and market norms, which eventually become ‘institutionalised’¹⁵⁸ and, ultimately, legitimised. These norms, and their institutionalisation, are explored in more detail in chapter four but, in summary, commonly coalesce to legitimise profit-maximising behaviour, whilst the corporate architecture (discussed in chapter five) operates to minimise the militating

¹⁵⁶ Edelman, *To Comply or Not to Comply* (n 21), 103. In the case of creative compliance, this rationalisation is further helped by the use of ‘euphemistic language,’ that helps to reduce stigma, see: Ashforth *et al* (n 147), 47. When adopted, such language helps to reduce any stigma associated with the conduct concerned. For example, conduct is not discussed or labelled as being contrary to the spirit of the law, removing funds from the public purse or transferring an undue burden onto fellow citizens. Rather it is deemed to be ‘creative’ compliance, whilst specific structures are given project names such as ‘Repo 105’ (a specific structure adopted by Lehman Brothers that is discussed further in chapter six). It is perhaps not surprising that Doreen McBarnet referred to this type of conduct as ‘whiter than white collar crime,’ see: McBarnet (n 16). These factors coalesce to entrench the legitimacy of creative compliance as a market and industry norm, something that is the acceptable within a capitalist economy.

¹⁵⁷ The role of shame, and its lack of application to corporations, is discussed further in chapter four.

¹⁵⁸ Edelman, *To Comply or Not to Comply* (n 21), 103.

impact that individual values may have on this otherwise singular corporate norm.¹⁵⁹

Within this framework, profitable, yet creative, interpretations of compliance become acceptable and, eventually, institutionalised themselves.

Thus, the first stage of the compliance degeneration cycle is the perceived legitimacy and implementation of creative compliance strategies, as informed by corporate norms. As outlined in part two, this legitimacy is then entrenched by the engagement of behavioural mechanisms that operate to mitigate any dissonance felt as a result of such conduct, whilst excluding any suggestions that creative compliance is, itself, an illegitimate practice to pursue.

(ii) Stage two: undermining legitimacy

In contrast to the legitimisation of creative compliance, the legitimacy of the regulation itself is increasingly undermined as creative compliance becomes more widespread. The primary reason for this is that not all citizens are equally positioned to creatively comply. Rather, as discussed further in chapter three, it is a practice that is predominantly available to large corporate groups that have the legal and economic capacity to operate in this way.¹⁶⁰ Therefore, this difference in capability applies not only between corporations and individuals but also between larger corporate groups and smaller private entities. As a result, a limited number of corporations can effectively elect how regulation applies to them, giving rise to a system where the regulated, rather than the regulator, determine the application of legislation. As a consequence,

¹⁵⁹ Bankman discusses the factors that corporations take into account when undertaking a cost-benefit analysis of engaging aggressive, creative, tax structures. These include the expenses of implementing the structure, the likelihood of sanction and the cost of sanction (if at all). See: Joseph Bankman, *The New Market in Corporate Tax Shelters*, (1999) 83 *Tax Notes* 1775, 1778.

¹⁶⁰ In brief, the reason being that multinational groups can utilise the multiple ‘personalities’ within the group to manufacture legal relationships, economic positions (such as dividends or tax deductible losses) and ring-fence liability. Further, these groups commonly have the economic resources to pay for the requisite professional advice to implement such structures.

regulation no longer applies (and is perceived to no longer apply) equally to all legal subjects.

As part two introduced, this unequal application of law has two, related, effects. First, other large corporations feel justified in adopting a similarly creative approach to compliance.¹⁶¹ Put another way, ‘if it is not necessary that everybody should play fair, why should I?’¹⁶² Therefore, we see that unfairness encourages avoidance,¹⁶³ leading to what Wheatcroft described as the practice of a neighbour seeing you ‘get away with it’¹⁶⁴ and seeking to replicate the benefit by whatever means possible. This reflects the fact that our behaviour, much like law, also has an expressive function. By implementing creative compliance strategies, corporations are expressing, through action, their perspective that such conduct is normatively permissible.¹⁶⁵ In this way, our conduct is a function of both the existence of social norms and also the observation of the conduct of others (as a reflection, and reinforcement, of those norms).¹⁶⁶

Secondly, this manipulation, and unequal application, of regulation erodes the legitimacy of both the regulation in question and also of the wider legal system as a whole.¹⁶⁷ As Tyler recognised, our perception of legislative legitimacy is shaped not simply by the content of any given rule but also its implementation. Creative compliance is a striking demonstration of the inequality of regulatory application as only those corporations with the requisite legal and financial resources to implement

¹⁶¹ Kenneth Arrow, *The Limits of Organization*, (W. W. Norton & Company 1974), 72.

¹⁶² John Murray, ‘The problem of Mr Rawls's Problem’ in Sidney Hook (ed.) *Law and Philosophy a Symposium* (New York University Press 1964), 33.

¹⁶³ Judith Freedman, ‘Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle,’ [2004] 4 *British Tax Review* 332, 343.

¹⁶⁴ Wheatcroft (n 45), 212-213.

¹⁶⁵ Elizabeth S. Anderson and Richard H. Pildes, ‘Expressive Theories of Law: A General Restatement (2000) 148 *University of Pennsylvania Law Review* 1503, 1508.

¹⁶⁶ Cass Sunstein, ‘Social Norms and Social Roles,’ (1996) 96(4) *Columbia Law Review* 903, 905.

¹⁶⁷ As to illegitimacy as an output of inequality see: Michael Levi, ‘Legitimacy, Crimes and Compliance in ‘the City’: *De Maximis Non Curat Lex?*’ in Justice Tankebe and Alison Liebling (eds.) *Legitimacy and Criminal Justice, an International Exploration* (Oxford University Press 2013), 157.

such technical structures can do so. This observable inequality before the law serves to significantly undermine legal legitimacy and, indeed, trust in the wider legal and corporate systems. This relationship between such inequality and general legitimacy was, anecdotally, apparent from the public response to the corporate scandals that gave rise to the GAAR. As to the impact of legitimacy (premised on equality) on compliance behaviours, this was witnessed in Australia, where a number of corporate tax avoidance schemes were highly publicised. In response, the greater the awareness that corporations were not paying ‘their share, the more non-compliance increased.’¹⁶⁸

(iii) Stage three: illegitimacy and creative compliance

It is this loss of legitimacy that brings the cycle full circle. The practice of creative compliance (stage one) undermines the legitimacy of regulation (stage two), which, as outlined in part two, undermines an actor’s approach to compliance. Thus, the act of creative compliance itself gives rise to a wider, systemic, compliance problem (stage three).¹⁶⁹ The ‘perception of unfairness ... overshadow[s] any moral obligations’¹⁷⁰ to comply with the law. Moreover, legitimate authority (and as a consequence compliance with its demands) is the subject of ‘convergent expectations. An individual obeys authority because he expects that others will obey it.’¹⁷¹ When a citizen sees that others are not complying with the spirit of the law (and doing so with impunity) then they will not feel bound to do so.

We thus have a cycle of behaviour, where corporate norms are seen to support creative compliance, these initial acts of creative compliance result in a loss of legitimacy that

¹⁶⁸ Torgler (n 109), 22.

¹⁶⁹ See: Murray (n 162).

¹⁷⁰ Leo Martinez, (n 134), 548.

¹⁷¹ Arrow, (n 161), 72.

itself contributes to further creative compliance.¹⁷² Understood in this way, we can start to see how creative compliance forms part of a self-perpetuating cycle of behaviour that also serves to reinforce the early norms that defined compliance in such narrow terms. To interrupt this cycle effectively we must first address the perceived norms of corporate conduct that contribute to a corporation's narrow definition of what constitutes legitimate compliance obligations. Without this, *ad hoc* regulation such as the GAAR is likely to have only limited success as it fails to interrupt this cycle of behaviour. Rather, it serves to apply only after the damage has occurred, that is, after the initial stages of legitimisation (of creative compliance) and illegitimacy (of regulation) has occurred.

PART FOUR: TOWARDS LEGAL INTEGRITY

In challenging the first stage of the compliance degeneration cycle, namely the corporate perception that creative compliance is a legitimate practice to adopt, this thesis argues (primarily in chapters two and three) that creative compliance fundamentally undermines the social systems that civil society depends on, drawing on the market as a paradigm case. Specifically, it suggests that creative compliance threatens the integrity¹⁷³ of such social systems.¹⁷⁴ This part briefly frames those discussions by outlining what is meant by integrity in this context and why an important

¹⁷² Chapter two explains the importance of predictability to market order, and argues that creative compliance undermines that predictability. One challenge to this claim, premised on the compliance degeneration cycle, could be that the cycle itself is sufficiently certain to create a new predictability (albeit of undesirable behaviour). However, as discussed in section one, the inequality in corporations' abilities to creative comply means that the cycle is not sufficient to create a new pattern of predictability and does not therefore provide an adequate basis to contest the arguments set out in chapter two. See also: chapter two, part four, section two for a more detailed explanation as to why creative compliance does not itself create sufficient predictability for the market order to operate efficiently.

¹⁷³ Integrity is used here in both definitions of the term. Both as to the 'honesty' or 'morality' of the system but also as to it being 'complete' or 'whole.' As to the latter, the assertion of this thesis is that without spirited compliance the system is incomplete and, as is discussed in chapter two, is liable to failure. On the integrity of a system more generally see: Erhard *et al* (n 15).

¹⁷⁴ By undermining the rule of law and eroding the trust and equality that such systems depend upon.

part of the solution to the problem of creative compliance is to instil a greater commitment to legal integrity within the corporate decision making framework.

Erhard, Jensen and Zaffron offer a positive model of integrity, which they define as ‘a state or condition of being whole, complete, unbroken, unimpaired.’¹⁷⁵ Thus for a *system* (such as the market) to have integrity, the components that comprise the system (and the relationship between them) needs to be complete.¹⁷⁶ In this regard, Erhard *et al* draw on the example of a bicycle wheel, that if you remove spokes from the wheel it is no longer whole and the integrity of the wheel is diminished.¹⁷⁷ When looking at a social system such as the market, and as chapter two explains in more detail, crucial components of that system include trust, predictability and equality, in particular, equality before the law (as enshrined in the rule of law).¹⁷⁸ Therefore, for the market to have integrity, these components and the relationship between them must be whole and unbroken.¹⁷⁹ Without integrity, the system is no longer capable of producing the desired result and its workability is reduced.¹⁸⁰ Thus, there is a ‘clear and unambiguous relationship between integrity and performance,’¹⁸¹ such that a diminution in integrity results in a diminution of performance. Importantly, the integrity of a system can also be compromised if the system participants do not use it properly (for example, if corporations manipulate the regulatory infrastructure in an unintended way).¹⁸²

It is not surprising that, on this construction, achieving integrity provides a route to

¹⁷⁵ Erhard *et al* (n 15), 2.

¹⁷⁶ Erhard *et al* (n 15), 21.

¹⁷⁷ Erhard *et al* (n 15), 40.

¹⁷⁸ Mark Carney, ‘Rebuilding Trust in Global Banking’ (Remarks to the 7th Annual Thomas d’Aquino Lecture on Leadership, Lawrence National Centre for Policy and Management, Richard Ivey School of Business, Western University, London, Ontario, (25 February 2013) <<http://www.bis.org/review/r130226c.pdf>> accessed 10 September 2016. See also the discussion of the functional importance of trust and predictability to market order in chapter two.

¹⁷⁹ The instrumental importance of these characteristics to the market order are considered further in chapter two.

¹⁸⁰ Erhard *et al* (n 15), 43 - 44.

¹⁸¹ Erhard *et al* (n 15), 42 and 44.

¹⁸² Erhard *et al* (n 15), 44.

‘earning and maintaining the trust of others.’¹⁸³ Chapter two explores how integrity, comprising of both trust and completeness, is essential to the proper function of the market order. Moreover, that chapter further explains how creative compliance fundamentally undermines this integrity and, as a consequence, the social institutions that corporations (and natural citizens) depend on. Crucially, this integrity can only be created by a ‘culture in which people honor their word.’¹⁸⁴ It cannot be mandated, or regulated, it requires a consistent pattern of behaviour that creates a reasonable expectation that a person (or organisation) can be relied upon to act in a certain way, given certain conditions. As a consequence, what is required is to move corporate compliance standards to a new legal integrity. That is, a state where the regulatory, market and social systems that corporations interact and engage with are complete, by maintaining *inter alia* the elements of trust and equality that they depend upon.

By developing a new legal integrity, this standard operates as an overlay to regulation. This overlay serves to both signpost the necessarily broad terms engaged by regulation whilst helping to fill any regulatory ‘gaps’ in a manner that upholds, rather than undermines, the rule of law.¹⁸⁵ That said, the term ‘integrity,’ even defined as requiring ‘completeness,’ is nevertheless subject to similar criticisms as to vagueness. However, chapter two examines how completeness (in the context of the market) incorporates notions of trust and equality whilst chapter three explores what equality means in this context.

CONCLUSION

Creative compliance has been present throughout, and indeed legitimised by, the development of modern company law. Nevertheless, the challenge of defining

¹⁸³ Erhard *et al* (n 15), 30.

¹⁸⁴ Erhard *et al* (n 15), 92.

¹⁸⁵ Freedman (n 163), 352.

‘compliance’ is an increasingly critical one. Trust in the corporate community is diminishing, as is the integrity of the wider market and legal system. In response to this loss of trust, governments are introducing reactionary regulation that, whilst welcome in part, fails to address the cause of this compliance problem. That is, the way in which corporations define compliance and the factors that cause this definition and enhance its perceived legitimacy.

To achieve meaningful and sustainable change to corporate compliance practices, it is instead necessary to understand the environmental factors and norms that contribute to (and legitimise) such a narrow definition of compliance. One instrumental factor in this construction is the belief that the dominant market ideology of classical liberalism supports such an individualistic and self-interested approach to compliance. The following chapter examines, and disputes, this claim drawing on the perhaps surprising relationship between the principles of classical liberalism and calls to constrain creative compliance.

In exploring classical liberalism in this way, chapter two also develops the fundamental importance of integrity (as defined in part four of this chapter). This chapter has explained that to have integrity, all of the components of a system need to be complete for it to perform as intended. Chapter two distils the, perhaps surprising, yet instrumental components of trust and equality that are integral to the proper function of complex social systems, examining the market as a paradigm case. In doing so, it explores how creative compliance fundamentally undermines trust and equality and, as a consequence, damages the integrity of the market. In this way, chapter two starts to develop normative support for claims that creative compliance should be constrained, developing the essential legitimacy that the GAAR is currently missing.

CHAPTER TWO

PREDICTABILITY AND THE MARKET ORDER

*'If man is not to do more harm than good in his efforts to improve the social order, he will have to learn that, in this, as in all other fields where essential complexity of an organised kind prevails, he cannot acquire the full knowledge which would make mastery of the events possible. He will therefore have to use what knowledge he can achieve, not to shape the results as the craftsman shapes his handiwork, but rather to cultivate a growth by providing the appropriate environment, as the gardener does for his plants.'*¹

INTRODUCTION

In a capitalist market economy, premised on a classical liberal ideology, should corporations comply with the spirit of the law? This normative enquiry is, of course, of fundamental theoretical and practical importance.² Nevertheless it also reflects one of the more difficult questions facing advocates of reform. 'Liberalism' is generally perceived to enshrine uncompromising principles of individualism, private property and limited state interference.³ Within this paradigm,⁴ creative compliance can be construed as a legitimate course of action,⁵ and this ideology is often relied upon to justify such

¹ F. A. Hayek, 'The Pretence of Knowledge,' Nobel Memorial Lecture (11 December 1974), 7.

² As discussed in chapter one, repositioning the normative value of compliance is much more likely to result in behavioural change. See also: Tom Tyler, 'The Psychology of Self-Regulation: Normative Motivations for Compliance,' in Christine Parker and Vibeke Lehmann Nielsen (eds) *Explaining Compliance Business Responses to Regulation* (Edward Elgar 2011), 78. As chapter four explains, it is a corporation's normative environment that can both seemingly endorse creative compliance, whilst rejecting claims for spirited compliance. As a consequence, it is the normative framing of compliance that is of crucial importance and one powerful influence on this framework is the norms of the political philosophy that dominates the market. It is for this reason that this research considers, as an ideological framework, classical liberalism rather than, for example, systems theory on which, see: Niklas Luhmann, *Law as a Social System* (Oxford University Press 2004).

³ These principles are discussed further in parts one and two (from a libertarian and classical liberal perspective respectively).

⁴ That is then reinforced by the wealth maximisation norm inherent within the Companies Act 2006, which is considered further in chapter four.

⁵ Encapsulated in the view that managers do not have an 'ethical duty to comply with regulatory laws ... that managers not only may but also should violate the rules when it is profitable to do so,' see: Frank H. Easterbrook and Daniel R. Fischel, 'Antitrust Suits by Targets of Tender Offers,' (1982) 80 Michigan Law Review 1155, 1177 at their (n 57). The formalistic approach that characterises creative compliance is often associated with a free-market ideology. See: Assaf Likhovski, 'The Duke and the Lady: *Helvering v Gregory* and the History of Tax Avoidance Adjudication,' (2004) 25(3) Cardozo Law Review 953, 965.

compliance strategies.⁶ In contrast, proposals to constrain creative compliance are seen as an illegitimate interference with a corporation's freedom to act within their private domain.⁷ As a consequence, two related but distinct challenges arise. First, can spirited compliance⁸ ever, ideologically, be accommodated within an economy premised on classical liberal philosophy? Secondly, does a normative case actually exist to constrain creative compliance within this market economy? Put another way, what is the value of spirited compliance (or, conversely, the harm caused by creative compliance) that justifies reform in this area?

This chapter answers these questions by challenging the now commonplace, but narrow, interpretation of the liberal philosophy that the market economy is based upon. It argues that classical liberalism, properly understood, not only promotes, but also is premised upon, wider notions of trust, equality and the maintenance of the rule of law.⁹ These principles are not offered by classical liberals simply as ethical ideals but as characteristics that are functionally integral to the proper order of society. In particular,

⁶ Recall Eric Schmidt's quote from chapter one that creative compliance is simply a manifestation of capitalism, see: 'Google's Tax Avoidance is Called 'Capitalism,' Says Chairman Eric Schmidt,' *The Telegraph* (12 December 2012).

⁷ This question of legitimacy, as discussed in chapter one, has a number of profound consequences concerning behavioral change and the scope of legitimate government. The primacy of individual property rights, an ostensibly liberal ideal, has been argued in support of the moral (and legal) legitimacy of tax avoidance. See *Weeks v Sibley* (1920) 269 Fed. 155, where the court held that the right to structure a corporation's affairs to avoid tax: 'is an incidental right, inseparably connected with an individual's right to own and control his property.' As to the potential tension between tax and the protection of private property more generally (whilst acknowledging that both are fundamental to civil society) see: Edward Troup, Unacceptable Discretion: Countering Tax Avoidance and Preserving the Rights of the Individual, (1992) 13(4) *Fiscal Studies* 128.

⁸ Throughout this chapter references to spirited compliance include regulatory attempts to constrain creative compliance.

⁹ These themes at first sight seem antithetical to market ideologies. However, they are commonly accepted as integral to the proper function of the market. For example, Mark Carney was clear that the 'real economy relies on the financial system. And the financial system depends on trust,' see: Mark Carney, 'Rebuilding Trust in Global Banking' (Remarks to the 7th Annual Thomas d'Aquino Lecture on Leadership, Lawrence National Centre for Policy and Management, Richard Ivey School of Business, Western University, London, Ontario, (25 February 2013) <<http://www.bis.org/review/r130226c.pdf>> accessed 10 September 2016. Further, John Kay explained that 'financial intermediation depends on trust confidence,' see: Department for Business Innovation and Skills, *The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report*, July 2012, 5.

they are necessary to facilitate the 'spontaneous orders'¹⁰ (of which the market is a paradigm case) that are essential for the coordination of complex social systems.¹¹ That is, drawing on the analysis in chapter one, they are components that must be present if such systems are to have integrity. It is these principles, and the order that is dependent upon them, that are fundamentally undermined by creative compliance. On this understanding, spirited compliance is not only accommodated within the classical liberal tradition but furthers one of its core beliefs, namely the facilitation of the unique coordination that is crucial for the development of society. Seen in this way, spirited compliance possesses both an intrinsic and an instrumental value;¹² a claim that rejects the view that compliance is merely a strategic decision derived from, and dependent upon, economic justification in any given case.¹³

By understanding the relationship between compliance and order (and, as a corollary, creative compliance and *disorder*) we are able to discern the importance, and impact, of the problem of creative compliance. It is not simply a question of an abuse of power, or limited to specific areas of conduct, but is an abuse of privilege¹⁴ and a threat to the order that is 'indispensable'¹⁵ for modern society. Moreover, its protection is not an erosion of personal freedom but a fundamental part of the mechanisms designed to

¹⁰ Michael Polanyi, *The Logic of Liberty*, (first published 1951, Liberty Fund Inc. 1998), 195. Hayek wrote extensively on the spontaneous order. However for an instructive introduction to his work on the market as a spontaneous order, see: Friedrich Hayek, *Law, Legislation and Liberty* (first published as one volume 1982, Routledge 2013), 34-52 (spontaneous orders generally) and 267-290 (markets as spontaneous orders).

¹¹ See for example: John Gray, *Liberalism* (2nd edn, OUP 1995), 61: 'free markets represent the only noncoercive means of coordinating economic activity in a complex industrial society.' Hayek, in contrast, would take this statement one step further and argue that the market, properly supported, is the *only* way (coercive or otherwise) to effectively coordinate economic activity in a complex society. See: Friedrich Hayek, 'Economic Order and Freedom,' Paper for Conference at Notre Dame, Symposium 'Scientific Alternatives to Communism' (3-5 January 1961), Box 108, Friedrich A. von Hayek Papers, Hoover Institution Archives.

¹² That is, spirited compliance is *intrinsically* valuable as it maintains the rule of law (discussed further in chapter three) and *instrumentally* valuable as, which is explored further in parts two and three, it facilitates the market order that society depends on.

¹³ A perspective that is discussed more fully in: Cynthia Williams, 'Corporate Compliance with the Law in the Era of Efficiency,' (1997) 76 North Carolina Law Review 1265.

¹⁴ That is, legal privilege, which is discussed in chapter three.

¹⁵ Friedrich Hayek, 'The Origins and Effects of Our Moral: a Problem for Science,' (undated), Box 103, Friedrich A. von Hayek Papers, Hoover Institution Archives. This order is examined further in parts two and three.

protect it. By identifying the wider role of compliance within society it becomes clear that compliance needs to be understood and addressed in a holistic way, starting with corporations' understanding of the role of law and their relationship with it.¹⁶

In exploring the normative case for spirited compliance this chapter proceeds as follows. Part one examines the perceived legitimacy of creative compliance within the market economy and, in particular, the influence of current misconceptions of the 'liberty tradition'¹⁷ on corporate compliance practices. In doing so, it suggests that the erroneous conflation of disparate political philosophies under the broad rubric of 'liberalism' has resulted in a mischaracterisation of classical liberalism, distorting our understanding of legitimate compliance practices within a market economy.¹⁸ Dispelling this misconception, part two then explores the true interpretation of the paradigms of individualism and limited state interference within the classical liberal tradition. It explains why a classical construction of individual freedom does not endorse an unfettered right to pursue self-interest and introduces the perhaps surprising relationship between individualism and the realisation of broader social benefits. As a consequence, we start to understand the important role that classical liberals ascribe to government in protecting this freedom and the legitimate role (and function) of law in society. Moreover, part two makes clear the value that classical liberalism, notwithstanding its foundation of individualism, places on social cooperation and order.

¹⁶ It is at this juncture that the Sumner quote from the first chapter starts to be understood: Drawing on the Sumner quote from the first chapter, to 'err in prescribing for a man is at worst to kill him; to err in prescribing for a society is to set in operation injurious forces which extend ... throughout an indefinite future,' see: William Graham Sumner, 'Sociology' in Robert C. Bannister (ed) *On Liberty, Society and Politics The Essential Essays of William Graham Sumner*, (Liberty Fund Inc 1992), 186.

¹⁷ This term is offered by Mack and Gaus to capture the wide spectrum of views within the broad spectrum of 'liberalism' that whilst different ideologies nevertheless share sufficient 'fundamental agreements' to fall within MacIntyre's characterization of a 'tradition.' See: Erick Mack and Gerald F. Gaus, 'Classical Liberalism and Libertarianism: The Liberty Tradition,' in *Handbook of Political Theory*, Gerald F. Gaus and Chandran Kukathas (eds.) (Sage Publications 2004), 11 citing Alasdair MacIntyre, *Whose Justice? Which Rationality?* (University of Notre Dame Press 1988), 12.

¹⁸ For a discussion of the principles of classical liberalism and their relationship with a capitalist market see: Samuel Freeman, 'Capitalism in the Classic and High Traditions,' (2011) 28(2) *Social Philosophy and Policy* 19.

Having established the importance of social cooperation and order, part three examines the market as a paradigm case of such an order.¹⁹ By looking at the market as a case study, part three distils the particular way in which complex social systems operate together with the unique value that such order contributes to civil society. In particular, it examines how the complexity of social systems (complexity in this context meaning that the system is comprised of multiple variables) necessitates their operation as a polycentric system, with each constituent part acting and reacting to each other. Understanding this fluidity of operation enables us to better understand the importance of the relationships between system participants together with the particular regulatory architecture that is required to support a polycentric order.

Developing this analysis, part four looks at what this regulatory framework should look like. Specifically, it examines how complex systems (unlike those with limited variables) operate as spontaneous, rather than planned, orders.²⁰ Drawing primarily on the work of Friedrich Hayek, it explores how spontaneous orders can be achieved by adopting a framework of general rules of behaviour that are applied equally to all. It is this principle of equality, and the predictability of behaviour that it engenders, that is critical to the success of a spontaneous order. Without it, the system lacks integrity as it is missing a vital component, risking failure of the system (at worst) or, at best, the introduction of reactionary regulation to address such shortcomings that itself undermines the optimum architecture for the system to survive. As such, taken together, parts three and four introduce both the harm caused by creative compliance and also the unintended consequences that can arise when introducing proposals for reform.

¹⁹ Other examples include language, money and queuing, see: Edwin van de Haar, *Classical Liberalism and International Relations Theory: Hume, Smith, Mises, and Hayek* (Palgrave Macmillan 2009), 28.

²⁰ The term 'spontaneous order' was originally used by Polanyi (see n 10) and later developed in a market context by Hayek, see: Hayek, *Law, Legislation and Liberty* (n 10), 37-52.

By looking at the operation of society in this way, this chapter seeks to reframe how we address the question of compliance by recognising the intrinsic and instrumental value of compliance itself. In doing so, it offers the foundation for changing wider normative environment that corporate compliance is analysed within, providing normative support for reform. Importantly, this perspective, starting from an understanding of the value of compliance and only then analysing corporate responsibility to maintain it, provides a framework in which to consider the additional and often challenging questions that it necessarily raises.²¹

PART ONE: (MIS)CONCEPTIONS OF THE ‘LIBERTY TRADITION’

Chapter one explained how wider environmental norms shape a citizen’s definition of compliance. One such norm for corporate subjects, which persists as a powerful impediment to reform, is the belief that creative compliance is not a moral wrong (a perception that is tacitly, if not expressly, informed by the norms of the liberal ideology of the market economy).²² That is, market norms are seen to support the view that the sole obligation of the corporation is, to refer to Milton Friedman’s oft-cited observation, ‘to increase its profits,’²³ whilst creative compliance is justified on the basis that ‘it’s called capitalism.’²⁴ This part explores this view to understand why market ideology is commonly believed to define compliance in such narrow terms. In doing so, it concludes that, properly understood, this interpretation does not reflect the true

²¹ For example, within a paradigm based on principles of equality and the rule of law what does ‘equality’ mean and are there justifications for a departure from this principle (namely to hold corporations accountable to a higher standard of compliance than their natural counterparts)? These questions are considered in chapter three.

²² Chapter four explains how such norms can create a ‘reality’ through which decisions are made.

²³ Milton Friedman, ‘The Social Responsibility of Business is to Increase its Profits,’ *New York Times Magazine* (13 September 1970), 1.

²⁴ Eric Schmidt (n 6).

principles that the market economy is based upon, principles that are then considered further in part two.

(i) Perceptions of self-interest and illegitimate government interference

At its core, creative compliance reflects a view that the pursuit of self-interest, through the adoption of profitable compliance strategies, is entirely legitimate, notwithstanding the harm that this can cause.²⁵ This enshrines a view that the individual citizen is, and should be, free to pursue whatever ends they please, a view that has been readily transposed to, and adopted by, the corporate citizen (indeed more so than their natural counterparts).²⁶

This primacy of the individual, to the exclusion of wider considerations, reflects the (libertarian) view that individuals are full 'self-owners,'²⁷ much like one can own property. The consequence of this perspective, and its analogy with property ownership, is significant. To the libertarian, property ownership confers on an owner the right to exercise complete control over the underlying asset including, given the

²⁵ The harm of creative compliance includes not only the fiscal impact of lost tax but also the wider repercussions of such conduct. For example, as is well known, the recent tax scandals resulted in regulatory reform and a deepening public distrust in the corporate community. As this chapter explains, this conduct can also have a fundamental, structural impact on the social orders that society depends upon.

²⁶ This anthropomorphisation of the firm is the root of a significant number of issues in this debate (on which, see: Max Radin, 'The Endless Problem of Corporate Personality,' (1932) 32 *Columbia Law Review*, 642). By identifying the corporation as a 'legal person' this has eroded the clear distinctions between legal and natural legal subjects. As a result, corporations are often held (or it is thought that they should be held) to the same standard as their natural counterparts (compliance being a prime example). These claims are made without the necessary consideration being given to the fact that corporate behaviour is not constrained in the same way that a natural citizen's is, for example through shame, religion or personal reputation (considered further in chapter four). Moreover, and as considered further in chapter three, it ignores the fact that corporations are, legally, in a position to creatively comply in a way that natural citizens cannot.

²⁷ For a discussion of self-ownership, see: Walter Block, 'Toward a Libertarian Theory of Inalienability: A Critique of Rothbard, Barnett, Smith, Kinsella, Gordon, and Epstein,' (2003) 17(2) *Journal of Libertarian Studies* 39.

definition of self-ownership, oneself.²⁸ On this view, not only is an individual free to control what they do (without a duty to help others) but it also enshrines an enforceable claim that third parties cannot interfere with this personal sovereignty.²⁹ Within this paradigm creative compliance as a means of pursuing a corporation's self interest (to increase its profits) becomes a legitimate strategy to adopt, notwithstanding the externalities that it may cause. It is also the reason that libertarianism is seen to advocate an 'unbridled selfish materialism,'³⁰ whilst the market economy it endorses is perceived to be an 'impersonal monster.'³¹

Given this 'extreme individualism,'³² it follows that libertarians reject most forms of government intervention,³³ which is considered to be an illegitimate violation of an individual's freedom.³⁴ For example, applying this philosophy, taxation can be construed as an illegitimate demand for the transfer of individual assets.³⁵ In contrast, creative compliance can be construed as simply the permissible pursuit of self-interest and the legitimate exercise of control over one's own property. Moreover, under a libertarian analysis, regulatory intervention is considered to be inefficient, as it undermines individual utility. When individuals are free to act as they wish, they will

²⁸ Thus, for a libertarian, citizens have the right to freely contract themselves into servitude (see Block (n 27)), a view that is not shared by classical liberals (see, Freeman (n 18), 20).

²⁹ Aligned with this robust notion of self-ownership is the libertarian conception of the absolute nature of economic rights, such as the right to freedom of contract and property ownership. On which, see: Freeman (n 18), 20.

³⁰ Murray N. Rothbard, *Man, Economy, and State with Power and Market*, (2nd edn, Mises Institute 2009), 1321.

³¹ *Ibid*, 1324.

³² Sally Razeen, *Classical Liberalism and International Economic Order*, (Routledge 1998), 16.

³³ Rothbard outlines three forms of intervention: (i) autistic intervention (the unilateral coercion by the state over a citizen without receiving anything in return e.g. the prohibition on murder); (ii) binary intervention (coerced exchange where the state received something in return, such as taxation); and (iii) triangular intervention (where the state compels or prohibits exchanges between two subjects, such as price control and licensing). See: Rothbard (n 30), 877-878.

³⁴ To the extent that individual coercion is required (and few admissions are made in this regard), libertarians argue that it can (and should) be left to the freely competitive market to identify a private agency that would perform such services, see: Rothbard (n 30), 1030. This broad commitment to the primacy of the market extends to the provision of 'public' goods such as police or judicial protection, see: Rothbard (n 30), 1048. It is not surprising that libertarian approaches to compliance adopt a highly formalist practice, on this see: William H. Simon, 'After Confidentiality: Rethinking the Professional Responsibilities of the Business Lawyer,' (2006) 75(3) *Fordham Law Review* 1453, 1459.

³⁵ Liam Murphy and Thomas Nagel, *The Myth of Ownership* (Oxford University Press 2002), 9.

naturally choose to do so in a utility maximising way.³⁶ In contrast, by compelling action through regulation, libertarians would argue that this is, by its very nature, demanding conduct that would not have been entered into voluntarily and that is not therefore utility maximising.³⁷

It is these libertarian principles of self-ownership and minimal government intervention that coalesce to facilitate a perception that the liberal market economy rejects spirited compliance, whilst endorsing creative compliance. In particular, the market is perceived to promote the unfettered pursuit of self-interest, which ‘repudiates sacrifice’³⁸ and where individuals are concerned with ‘nothing but [their] own enrichment.’³⁹ However, these conclusions do not, as part two explains, reflect the *classical* liberalism that the market is in fact premised upon, giving rise to the question as to how this misconception has occurred.

(ii) *The emergence of ‘everyday’ liberalism*

The difficulty in distilling the true principles of the market economy is that ‘liberalism’ or the ‘liberty tradition’ enshrines a number of diverse philosophies, including libertarianism and classical liberalism.⁴⁰ At their core, all ‘liberals’ share a

³⁶ Rothbard (n 30), 879.

³⁷ Ibid.

³⁸ Eric Mack, ‘Individualism, Rights and the Open Society,’ in Tibor Machan (ed.) *The Libertarian Reader* (Rowman and Littlefield 1982), 4.

³⁹ Ludwig von Mises, *Liberalism, the Classical Tradition* (first published 1927, Liberty Fund 2005), xxvi.

⁴⁰ In general terms, a helpful taxonomy (understanding that the extent of variations are such that a precise definition, and one without criticism, is a difficult task) is that offered by Edwin van de Haar: social liberalism (a modern variant that calls for the greatest government intervention); libertarianism (which advocates individualism in the strictest sense and favours minimal state intervention); and classical liberalism that occupies the middle ground. See: Edwin van de Haar, *Classical Liberalism and International Relations Theory: Hume, Smith, Mises, and Hayek*, (Palgrave Macmillan 2009), 19. The distinctions between these schools of thought, which are premised on different philosophical foundations, result in important policy consequences (for example, as to the legitimacy of state interference and the provision of public goods, on this see: Norman P. Barry, *On Classical Liberalism and Libertarianism* (Palgrave Macmillan 1986), 3.

commitment to the ‘polar star’⁴¹ of freedom.⁴² That is, freedom of the person is seen as a fundamental (or basic) liberty that, whilst not wholly absolute,⁴³ is to be protected from coercion, be it by the government or fellow citizens.⁴⁴ As a consequence, most liberals also agree that the role of government should be limited, often to the protection of the individual rights that are necessary to maintain this freedom.⁴⁵ However, notwithstanding these broad similarities, significant differences exist across the liberal spectrum as to the appropriate scope of individual freedom and the corresponding sphere of legitimate government intervention (and, as a corollary, compliance with such intervention).⁴⁶ In particular, and as outlined in part two, there are important distinctions between libertarian thinkers and their classical liberal counterparts.

Regardless of these differences, the perceived similarities between ‘liberal’ ideologies have caused an ‘everyday’⁴⁷ liberalism to emerge, which conflates multiple liberal philosophies into a single school of thought. In doing so, the important diversity across the liberal spectrum is lost⁴⁸ as elements of a particular liberal ideology are ‘taken to be

⁴¹A liberal is a person whose ‘polar star is liberty,’ Lord Acton, cited in: George H. Smith, *The System of Liberty, Themes in this History of Classical Liberalism* (Cambridge University Press 2013), 2.

⁴² Hence the name liberal from *liber* ‘to be free.’

⁴³ Important exceptions do exist for the classical liberal, which are discussed in part two. These basic liberties, whilst not ‘absolute’ can only be infringed to ‘protect other basic liberties and maintain essential background conditions for their effective exercise, see: Freeman (n 18), 19.

⁴⁴ For a discussion of basic liberties (including the qualification that basic liberties should be capable of equal coterminous enjoyment by all citizens, which is discussed in part two) see: Philip Pettit, ‘The Basic Liberties,’ in Mathew H. Kramer (ed.) *The Legacy of H.L.A. Hart: Legal, Political and Moral Philosophy* (Oxford University Press 2008), 201-224.

⁴⁵ Edwin van de Haar (n 40), 19-20; Gray (n 11), 70–77. These rights include the basic liberty of freedom of the person, together with economic rights such as the freedom of contract and property, on which see: Freeman (n 18), 31-35; Samuel Freeman, ‘Illiberal Libertarians: Why Libertarianism is Not a Liberal View,’ (2001) 30(2) *Philosophy and Public Affairs* 105, 108-111.

⁴⁶ Freeman (n 45); Edwin van der Haar (n 40), 19.

⁴⁷ This ‘everyday liberalism’ reflects the ‘extension of more restricted concepts beyond the boundaries within which they actually apply...a muted or confused version of the real thing.’ See: Liam Murphy and Thomas Nagel (n 35) 34-35. See also: Razeen (n 32), 16.

⁴⁸ The ‘idea that there is one doctrine of *liberalism* is illusory,’ see: Barry (n 40), 17. Indeed, the search for unity across this ideology ‘disintegrate[s] even under the most superficial of analyses,’ Barry (n 40), 11. Ludwig von Mises lamented that the ‘term ‘liberalism’ today ... stands in direct opposition to what the history of ideas must designate as *liberalism*,’ see: Ludwig von Mises (n 39), 157.

the whole liberal story'⁴⁹ giving rise to 'much misunderstanding.'⁵⁰ In particular, it is the more extreme libertarian ideologies discussed in section one that are adopted as key tenets of this 'everyday' liberalism. Notwithstanding its lack of conceptual coherence, this conflated, hybrid philosophy gains legitimacy as a school of thought as its libertarian-esque principles align with common perceptions of the shortcomings of a capitalist market economy.⁵¹ As a consequence, the nuances of various liberal ideologies become lost, resulting in a somewhat binary interpretation of the needs and values of classical liberal thinking.

It is clear that this superficial convergence of broad ideals is unlikely to survive more than a cursory analysis. However, it is the perception of these norms that shape a citizen's understanding of the legitimacy of regulation and their corresponding compliance obligations, with profound effects. Therefore, it is perhaps not surprising that if we return to Friedman's oft-cited quote, we see that it is circumscribed to simply refer to a corporation's singular responsibility to increase profits, presenting a view that aligns with libertarian thinking. However, in doing so, this obscures the fact that Friedman proceeded to expressly restrict this duty in a manner that demonstrates the stark contrast between libertarian and classical liberal principles (particularly from a compliance perspective). That is, Friedman was clear that the obligation to increase profits was subject to a duty to conform 'to the basic rules of the society, both those embodied in law and those embodied in ethical custom.'⁵²

⁴⁹ Edwin van de Haar (n 40), 1.

⁵⁰ Barry (n 40), 17.

⁵¹ See notes 30 and 31, with associated text.

⁵² Friedman (n 23), 1.

PART TWO: DEFINING (AND CONSTRAINING) FREEDOM WITHIN THE CLASSICAL TRADITION

In contrast to this highly libertarian approach, classical liberalism acknowledges an important, but not absolute, role for the state within society. As such, whilst classical liberalism clearly endorses personal freedom as a basic liberty it nevertheless recognises vital constraints that preclude an unfettered right for a citizen to do as they please (including the adoption of creative compliance strategies). This part explores the foundations of individualism within the classical tradition, the consequences that this has for the legitimacy of regulatory intervention and the importance that classical liberals place on cooperation to civil society. In establishing this general legitimacy, this part provides context to parts three and four of this chapter, which consider the functional consequences of these general principles and their relationship with compliance.

(i) Freedom of the individual

In common with other liberal traditions, and by its very definition, classical liberalism is normatively individualistic,⁵³ recognising freedom as a basic liberty.⁵⁴ Its central claim is that citizens should be free to pursue their own self-interest across all aspects of life: social, political and economic, subject only to the corresponding right of others to do the same (an important qualification that this part will return to).⁵⁵ Thus, the primary objective of classical liberalism (and the government that it endorses) is to maintain the equal freedom of citizens as a bulwark against illegitimate encroachment, be it from the

⁵³ That is, it endorses both the freedom of the individual and a methodological individualism (Razeev (n 32), 16. On the latter see Hayek (n 59).

⁵⁴ Gaus and Mack (n 17), 116; Maurice (1967).

⁵⁵ See section two. For classical liberals, the individualism that characterises their philosophy was that introduced by Locke, Mandeville and Hume and developed by the Scottish Enlightenment, in particular Ferguson and Smith, see: F. A. Hayek, *Individualism and Economic Order*, (first published 1948, University of Chicago Press 1980), 4.

monarchy, the state or other citizens.⁵⁶ It follows from this characterisation, that any restriction (or coercion) of that freedom, whilst not prohibited, must nevertheless be justified, regardless of the source of such interference.⁵⁷

For the classical liberal, this focus on the individual encompasses both a positive and normative analysis.⁵⁸ Positively, it adopts a methodological individualism that, far from disregarding social cooperation (or responsibility), acknowledges the role and importance of collectives within society.⁵⁹ Rather, what it suggests is that as society (or other collectives) are comprised of, and act by, individuals then the individual should be the first unit of analysis.⁶⁰ Thus, whilst the actions of such collectives or institutions are important,⁶¹ to understand them we must first discern what motivates the individuals that form them. Therefore, in contrast to libertarian notions of individualism, the classical liberal does not reject the value of society or cooperation and the need to protect the frameworks that support them. Instead, it simply acknowledges that to understand society we must first understand its individual citizens.

Normatively, this respect for self-interest enables the diversity of a society to develop, as citizens are free to pursue a wide range of personal preferences.⁶² In doing so,

⁵⁶ It is important to note that the right to freedom extends to protection from encroachment by both the state and fellow citizens. Chapter three considers this right further to consider whether it extends a corresponding duty to citizens as well as the state.

⁵⁷ Friedrich Hayek, 'Freedom Under the Law' (undated), Box 103, Friedrich A. von Hayek Papers, Hoover Institution Archives.

⁵⁸ David Boaz, *The Libertarian Reader*, (Free Press 1997), 117.

⁵⁹ Hayek described individualism as 'a theory of society, an attempt to understand the forces which determines the social life of man, an only in the second instance a set of political maxims derived from this view of society. This fact should by itself be sufficient to refute the silliest of the common misunderstandings: the belief that individualism postulates ... the existence of isolated or self-contained individuals instead of starting from men whose whole nature and character is determined by their existence in society,' see: Hayek, *Individualism and Economic Order*, (n 55), 6.

⁶⁰ *Ibid.*

⁶¹ The impact of corporate actions, norms and architecture are considered in chapters four and five.

⁶² Friedrich Hayek, *The Meanings of Law and Order*, Stanford Lecture (1968), Box 108, Friedrich A. von Hayek Papers, Hoover Institutions Archives; F. A. Hayek, 'The Use of Knowledge in Society,' (1945) 35(4) *The American Economic Review* 519.

individuals are able to contribute their own perspective, abilities and knowledge to society and part three examines the integral role that these contributions make to the proper order (and development) of the market as a fundamental social system. However, at this juncture it is important to note that there is a significant public utility in facilitating the freedom to pursue self-interest. It is by striving to meet our own needs (for example, wealth maximisation) that we identify and serve the needs of others.⁶³ As Adam Smith famously observed, ‘it is not from the benevolence of the butcher, the brewer or the baker that we get our dinner, but from their regard to their own self-interest.’⁶⁴ It is these benefits (amongst others) that are at risk if we damage, through creative compliance, the institutional architecture that supports them.

The fallacy of the claim that a capitalist market society, premised on classical liberal ideals, promotes (or should promote) an unbridled self-interest is immediately clear when we consider the implausibility of such a proposition. Whilst the broad classical liberal commitment to individual freedom is not in dispute, it is equally apparent that such a right cannot be absolute.⁶⁵ If each individual were free to pursue their own self-interest this would involve granting citizens an unhindered right over the otherwise private and protected domain of others. By way of example, my right to reside in my own property to the exclusion of others cannot coexist with an unfettered right in others to occupy it (should they so wish). Thus the question arises as to how, within an

⁶³ When the rights of this autonomous individual are protected, they will ‘exchange with ... fellow men so as to advance the values of each,’ see:: Barry (n 40), 4. However, as made clear in this part and chapters four and six, this pursuit of self-interest ought to be constrained when it intrudes on the equal rights of others and damages the legal and market orders.

⁶⁴ Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, (first published 1776, Oxford University Press 2008) Book 1, Chapter II, para 2. See also: ‘The advantages derived from peaceful cooperation and division of labor are universal. They immediately benefit every generation ... When social cooperation is intensified by enlarging the field in which there is division of labor or when legal protection and the safeguarding of peace are strengthened, the incentive is the desire of all those concerned to improve their own conditions. In striving after his own – rightly understood – interests the individual works toward an intensification of social cooperation and peaceful intercourse.’ Ludwig von Mises (n 39), xxii.

⁶⁵ Pierre Manent, *An Intellectual History of Liberalism*, (Princeton University Press 1995), xvi.

ideology of freedom and individualism, are citizens' respective rights to freedom compatible with each other?⁶⁶

The classical liberal response to this challenge is that the freedom of the individual is, broadly, constrained in one important way. That is, an individual's freedom is limited to the extent that it would otherwise encroach upon another citizen's equal right, such that 'every man may claim the fullest liberty to exercise his faculties compatible with the possession of like liberty by every other man.'⁶⁷ This negative conception of freedom⁶⁸ means that I can act as I wish so long as I do not interfere with your equal right to do so.⁶⁹ Therefore, to live (and prosper) in society, without fear of encroachment, requires mutual agreement between citizens to curtail the absolute freedoms they may otherwise enjoy. As Pettit acknowledges, as a right of citizenship, it is critical that the basic liberties coexist, that is, that they are capable of co-enjoyment.⁷⁰ We thus start to see the integral importance of mutual agreement and trust (namely that one's co-citizens will adhere to this agreement) to the order of society and the protection of individual freedom within it.

This right to freedom, subject only to a duty to respect the corresponding right of others, enshrines the classical liberal commitment to equal treatment.⁷¹ It is this commitment that delineates the 'classical liberal view, [that] liberty and the protection of the individual domain partly depend on protection through law secured by the state.'⁷² As a

⁶⁶ On 'compossible' rights see: Hillel Steiner, 'The Structure of a Set of Compossible Rights,' (1997) 74(12) *The Journal of Philosophy* 767.

⁶⁷ Herbert Spencer *Social Statistics; or, the Conditions Essential to Human Happiness Specified, and the First of them Developed*, (first published 1851), part two, chapter four, § 3.

⁶⁸ Namely, that 'liberty in this sense is simply the area within which a man can act unobstructed by others,' see: Isaiah Berlin, *Four Essays on Liberty* (first published 1969, Oxford University Press 2013), 122.

⁶⁹ Rights 'always have obligations as their correlative,' see: Mack (n 38), 5.

⁷⁰ Philip Pettit, 'The Basic Liberties,' in Mathew H. Kramer (ed.) *The Legacy of H.L.A. Hart: Legal, Political and Moral Philosophy* (Oxford University Press 2008), 207.

⁷¹ Barry (n 40), 4. This commitment reflects a particular understanding of equal rights and, as a corollary, equal liberties. This concept of equality is examined further in chapter two.

⁷² Edwin van de Haar, (n 40), 30.

consequence, we start to understand the two principles that inform a classical liberal interpretation of what individual compliance obligations should be. First, that the state has a legitimate right of intervention (or coercion) over individual freedom. Secondly, that the proper order of society is premised on a strong principle of equality, and, in particular, equality before the law (a principle considered further in chapter three).

(ii) *Limited state interference*

Pursuant to this negative conception of freedom, it follows that it is legitimate (indeed, necessary) for the state to create a protected sphere of individual action.⁷³ That is, the legal space within which an individual is able to act, free from illegitimate coercion, but subject to (namely, delineated by) the equal right of other citizens. Seen in this way, the ‘common misconception’⁷⁴ that classical liberals advocate an absolute laissez-faire state becomes clear.⁷⁵ That far from endorsing a lack of regulation, it would be ‘disastrous’⁷⁶ to suggest that it is not possible to limit personal freedom. Rather, classical liberals seek to understand the appropriate scope of legitimate government action,⁷⁷ premised on this negative construction of freedom and the belief that the onus of proof on justifying such intrusion rests on those seeking to introduce regulation.⁷⁸

⁷³ Hayek, *Economic Order and Freedom* (n 11), 19.

⁷⁴ Brian Z. Tamanaha, *On the Rule of Law: History, Politics, Theory* (Cambridge University Press 2004), 45.

⁷⁵ Indeed, ‘probably nothing has done so much harm to the liberal cause as the wooden insistence of some liberals on certain rough rules of thumb, above all the principle of laissez faire,’ see: Friedrich Hayek, *The Road to Serfdom*, (first published 1944, Routledge Classics 2001), 21.

⁷⁶ Charles King, ‘Moral Theory and the Foundations of Social Order’ in Tibor Machan (ed.) *The Libertarian Reader* (Rowman and Littlefield 1982), 31.

⁷⁷ Friedrich Hayek, ‘The Meaning of Government Interference,’ (1950), Box 107, Friedrich A. von Hayek Papers, Hoover Institutions Archives, 1. The question that we need to be concerned with is ‘on what principles we ought to distinguish between desirable and undesirable state action,’ see: Friedrich Hayek, ‘Planning and Competitive Order,’ (undated), Box 104, Friedrich A. von Hayek Papers, Hoover Institutions Archives, 1. This then provides important transparency (and legitimacy) to the wider claim for reform, a characteristic that is important if an argument is to adequately address the normative question. See: Christine M. Korsgaard, *The Sources of Normativity*, (Cambridge University Press 1996), 17.

⁷⁸ The onus of proof ‘of making out a case always lies on the defenders of legal prohibitions,’ see: John Stuart Mill, *Principles of Political Economy and Chapters on Socialism*, Jonathan Riley (ed.) (first published 1899, Oxford University Press 1998), 327.

It follows from this analysis that one role of government is to establish and enforce the rights necessary to facilitate such personal freedom whilst protecting ‘every member of society from the injustice or oppression of every other member.’⁷⁹ In broad terms, these rights include the performance of promises (including the freedom of contract), the protection of property rights and the maintenance of the rule of law.⁸⁰ Protecting the performance of promises not only facilitates the freedom to engage with (and control) individual property but it reflects a deeper need to be able to rely on the voluntary agreements that we enter into with others. That is, to trust that others will act in the way that they have agreed to. Put another way, that they will honour their word. In doing so, it helps to ensure the certainty and predictability of behaviour that parts three and four explain are vital to the order that complex social systems depend upon.

Perhaps unsurprisingly, property rights are fundamental to a classical liberal society. Importantly, they reflect not a relation between a citizen and an asset, but ‘between a person and a person.’⁸¹ In particular, they delineate what other citizens cannot do (enshrining a right to exclude both citizens and the state from interfering with a person’s property). By protecting a person’s title to their property, they are free to exchange the asset, to create and extract value from it. Thus, the protection of promises and property rights are, largely, permissive. They enable a citizen to act and enter into relationships on a voluntary basis so as to pursue their own interests. In contrast, it is the rule of law and, in particular the principle of equality before the law, which operates to constrain the otherwise broad freedom of the individual. It is this principle that provides the necessary protection to ensure that ‘individualism’ is not construed to mean an ‘unfettered right to do as one pleases’ with the attendant difficulties and chaos that this

⁷⁹ Adam Smith (n 64) book four, chapter 9, para 51.

⁸⁰ For a more detailed discussion of these rights see: Boaz (n 52), 64 -70.

⁸¹ Issa Shivji, ‘Lawyers in Neoliberalism: Authority’s Professional Supplicants or Society’s Amateurish Conscience?’ *Valedictory Lecture* (15 July 2006) 6 < http://mokoro.co.uk/wp-content/uploads/shivji_lawyers_in_neoliberalism.pdf> accessed 10 September 2016.

will cause. Moreover, as shall be seen in parts three and four, it is this principle that is under threat by creative compliance, risking damage to the order that society is dependent upon.

We start to see therefore that, for the classical liberal, the state is justified in intervening to establish the regulatory and institutional frameworks that are necessary to protect individual freedom.⁸² Perhaps surprisingly, these frameworks are premised on broader notions of trust and equality, the functional importance of which are considered later in the chapter. Further, these frameworks, serve to protect both individual freedom and the coordination (or order) of the complex social systems that such freedom operates within and, as shall be seen, depends upon. As a corollary, when these frameworks break down ‘it is government’s role to intervene.’⁸³ As such, the view set out in part one that the classical liberalism of the market denies the right of government intervention is fundamentally mistaken. Indeed, Ludwig von Mises argued that this suggestion was a strategy adopted by critics to misrepresent and impose a completely ‘pejorative connotation’⁸⁴ to classical liberal philosophy. To the contrary, a great deal of attention was paid by the classical liberals to the appropriate ‘rules of the game’ and the subsequent parts of this chapter consider what these rules are and their relationship with compliance.

(iii) *Dispelling the paradox: individualism and cooperation*

Creative compliance is, inherently, an act of self-interest. It prioritises the pursuit of individual profit over broader social interests including, as will be explained in parts

⁸² Oakeshott observed that civil society had identified a set of ‘arrangements in which we are associated with each other ... agreed-upon procedures that secure opportunities for self-regulating individuals to pursue their self-chosen, widely varying forms of flourishing in voluntary associations, supported especially by the rule of law,’ see: Michael Oakeshott, *On History and Other Essays* (Liberty Fund 1999), xii.

⁸³ Freeman (n 18), 23.

⁸⁴ Ludwig von Mises (n 39), xxvi.

three and four, the order that is crucial to civil society. Section one of this part explained that to constrain this freedom within a classical liberal ideology requires justification but that there is, nevertheless, legitimate scope to do so. However, there is a seeming paradox between a philosophy premised on individualism and calls for spirited compliance that are based (as shall be seen in the following part) on broader notions of social order.

Notwithstanding this ostensible conflict, classical liberalism does not exclude considerations of social coordination.⁸⁵ On the contrary, the need to protect the order of society is a ‘central element’⁸⁶ of classical liberal thinking. It is this order that helps facilitate the benefits outlined in section one, including the diversity of society and the attainment of social needs. For individuals to prosper and live peacefully together within society, they necessarily need to (and do) engage with each other. It is, therefore, important to be clear that ‘individualism and community are coextensive, not in conflict.’⁸⁷

Moreover, achieving voluntary (and, as shall be seen in part four, spontaneous) social order is not actually in conflict with individual freedom but rather a mechanism for protecting it. Early classical liberals, including Adam Smith, accepted that the Great Society was a ‘complex and productive society made possible by social interaction.’⁸⁸ The challenge that arises is how to achieve such coordination, namely how the apparent chaos of a complex social system can find order.⁸⁹ The risk identified by classical liberals is that if order is not achieved voluntarily then citizens are at risk of

⁸⁵ Hayek, *Individualism and Economic Order* (n 55), 6.

⁸⁶ Described as a ‘central element’ of classical liberalism. See: Edwin van de Haar (n 40), 17.

⁸⁷ Boaz (n 52), 51.

⁸⁸ David Boaz, *The Libertarian Mind*, (Simon & Schuster 1997), 120. In this way, society is a produce of human action in which individuals cooperate to best meet their needs, see: Ludwig von Mises, *Human Action, a Treatise on Economics Volume I* (first published 1949, Liberty Fund 2007), 146-147.

⁸⁹ Hayek, *The Meanings of Law and Order* (n 62).

compulsion.⁹⁰ Therefore, what is important to the classical liberal is establishing the necessary regulatory and institutional architecture that facilitates voluntary cooperation, rather than facing a centrally planned (or dictated) order that restricts individual freedom.

To the classical liberal, individualism serves both as a protection against illegitimate coercion and as a means of contributing to the interests of society as a whole.⁹¹ Part three considers the market as a paradigm case of such order. Thereafter, part four explores how the regulatory framework may be structured to facilitate social order. Taken together, these parts demonstrate the value of order to society, the unique regulatory support that is need to maintain them and how creative compliance fundamentally undermines the principles of trust and equality that they are premised upon.

PART THREE: IN DEFENCE OF THE MARKET ORDER

As part two explained, for the classical liberal social cooperation is 'one of the essential conditions of civilised life.'⁹² Indeed, within civil society, citizens are largely dependent on others to meet their individual goals, for example through the provision of work, food, infrastructure and support. A paradigm case of the importance of such cooperation, and an example of the (perhaps unexpected) interaction between individual freedom and such cooperation, is that of the market. This part explores the unique benefit of the market to society, providing normative support for its protection. In doing so, it also examines the complex and nuanced relationships that the market depends upon, providing insight into the interactions that the regulatory architecture

⁹⁰ Herbert Spencer, 'The New Toryism' in *The Man Versus the State* Albert Jay Nock (ed.) (first published 1892 Liberty Classics 1981), 10.

⁹¹ Edwin van de Haar (n 40), 27; Ludwig von Mises, *Human Action* (n 88), 731.

⁹² Hayek, *The Meanings of Law and Order* (n 62), 1.

supporting the market must be both cognisant of and protect. Part four then examines this infrastructure in more detail.

(i) *The market as a conduit of knowledge*

Notwithstanding its importance, the primary function of the market is often misunderstood. The critical problem that a modern economy faces, and that the market resolves, is not how to logically allocate resources in any given situation premised on complete knowledge (as is often thought to be the case).⁹³ Rather, those that are tasked with the decision as to where to invest their resources (or the resources under their control) need to know the needs of others to enable them to act accordingly to meet such needs.⁹⁴ Without this information, we are unable to 'allocate resources according to consumer preferences.'⁹⁵ As such, the challenge we face in society is how to allocate resources when no single individual possesses the entire knowledge necessary to make such a decision.⁹⁶

It thus becomes clear that the primary function of the market is not resource allocation but the necessary precursor to that (secondary) function, namely the collation and communication of knowledge. The ability of the market to convey such knowledge is crucial to the development of society, facilitating research and development, the growth of business, the creation of jobs and the protection of competition (in favour of the consumer). However, this function as a conduit of knowledge is commonly forgotten (or, at best, taken for granted) giving rise to a dangerous complacency as to the role of the market in society and the unique framework required to support it.

⁹³ Hayek, *Use of Knowledge* (n 62), 519.

⁹⁴ Friedrich Hayek, 'Economic Planning,' (December 1941), Box 106, Friedrich A. von Hayek Papers, Hoover Institution Archives.

⁹⁵ Boaz (n 52), 12.

⁹⁶ Hayek, *Use of Knowledge* (n 62), 519.

The complexity of this communication task becomes clear when we examine the nature of the information that the market conveys. The knowledge that the market communicates is highly fragmented, dispersed and, importantly, context specific.⁹⁷ That is, this information is held on a piecemeal and global basis, across a wide array of unconnected individuals. Nevertheless, the market is able to collate this information from multiple market actors and communicate it to otherwise unconnected market participants.⁹⁸ As a consequence, those operating within the market are able to employ information that neither they, nor any one individual within the market, possesses in totality.⁹⁹ The outcome is that market participants are able to utilise knowledge that they do not, and cannot, possess,¹⁰⁰ to satisfy the demands of people whom they have never met and whose needs they do not, personally, know. It is therefore the utilisation, not possession, of knowledge that is a distinguishing feature of the market.¹⁰¹

The scale of this coordination and communication exercise can be understood by considering, briefly, a simple yet common transaction. Each morning busy commuters purchase cups of coffee at train stations across the country; drinks that are purchased with little thought and are a fleeting part of a person's day. However, this seemingly simple purchase is part of a transaction that brings together plantation owners and workers in South America, landlords in Europe, franchisors from North America, utility companies, branding executives and a supporting plethora of professional advisers including lawyers and accountants: all to produce a hot drink for a busy traveller that is forgotten within half an hour. Yet how does the coffee franchisee know where to locate

⁹⁷ Ibid, 526.

⁹⁸ Ibid.

⁹⁹ This is the fundamental value of the market, namely that partial knowledge can be acted on and contribute to the whole, see: Razeen (n 32) 19.

¹⁰⁰ Hayek, *Law, Legislation and Liberty* (n 10), 16.

¹⁰¹ The function of the market as an aggregator of dispersed knowledge was something that Friedrich Hayek wrote on extensively (particularly in response to what he saw as the threat of central planning in a socialist political environment). His work in this regard is extensive but see: Friedrich Hayek, 'The Creative Powers of a Free Civilisation,' (1958), Box 107, Friedrich A. von Hayek Papers, Hoover Institution Archives; Friedrich Hayek, 'The Presumption of Reason,' 7 (1985), Box 131, Friedrich A. von Hayek Papers, Hoover Institution Archives; Hayek *Economic Order and Freedom* (n 11), 1.

his or her shop, the landlord know how much to charge for the lease, the professional advisers know what to charge for their services and where to advertise them, the plantation owner know which type of bean to grow, in what quantities and for how much?¹⁰²

The magnitude of this task, and its ramifications, are remarkable. The market enables individuals to act upon an ever-changing cycle of information, which they do not personally possess. In this way, business has developed on a global scale with concomitant increases in knowledge, research and development and financial prosperity. However, this information cannot be realistically gained from a costly and time-consuming process of due diligence. The question considered in the following section is how this knowledge is conveyed in a quick, efficient and meaningful way enabling market participants to determine how best to allocate their resources.

(ii) *Conveying knowledge through the price mechanism*

To communicate such dispersed and fragmented knowledge effectively, the market requires a communication method that satisfies two conditions. First, whilst the information to be conveyed is highly fragmented and complex, the method of communication must be simple, accessible by each market participant at the same time and able to respond quickly to changes in market knowledge. Secondly, the knowledge that market participants require (and that needs to be conveyed) is not absolute knowledge but the relative value of particular goods or services, namely the fact of their scarcity or demand, not the reason why they are so coveted.¹⁰³ For example, the coffee vendor simply needs to know that he or she should invest resources into a particular

¹⁰² This example is drawn from: Tim Harford, *The Undercover Economist*, (Abacus 2011), 2.

¹⁰³ Hayek, *Use of Knowledge* (n 62), 528.

location because there is a particular demand (not that this demand exists because of a lack of competition or popularity of route).¹⁰⁴

The market meets these two challenges through the operation of the price mechanism.

¹⁰⁵ The price mechanism is, ostensibly, a deceptively simple process that aggregates information concerning the scarcity of a particular commodity and communicates it, via a single number, to the market as a whole.¹⁰⁶ In doing so, it takes the local knowledge of all market participants and, through a single number, enables the rest of the market to utilise that knowledge; knowledge that they do not possess themselves. Crucially, this system is automatic, communicating the ‘peculiar conditions prevailing in each enterprise’¹⁰⁷ without the need for intermediaries. Effectively, the system ‘works itself.’¹⁰⁸ In response, market participants are able to adjust their own behaviour to facts that they simply do not know and, in doing so, further contribute to the aggregate knowledge of the market.¹⁰⁹ Returning to our coffee shop owner, the owner is able to increase prices to reflect the scarcity of coffee beans (premised on the increase of the cost of the raw materials) as a consequence of a drought that he or she was completely unaware of. Thus, the price mechanism facilitates ‘the marvel’¹¹⁰ that information which only a handful of people are aware of can be utilised by the whole market. That

¹⁰⁴ This decision as to resource allocation is made possible because of the economic calculation facilitated by the simplicity of the price system: ‘Capitalist economic calculation, which alone makes rational production possible, is based on monetary calculation. Only because the prices of all goods and services in the market can be expressed in terms of money is it possible for them, in spite of their heterogeneity to enter into a calculation involving homogeneous units of measurement,’ see: Ludwig von Mises, *Liberalism* (n 39), 47.

¹⁰⁵ The price mechanism is ‘the sum of information reflected or precipitated in the prices is wholly the product of competition, or at least of the openness of the market to anyone who has relevant information about some source of demand or supply for the good in question ... Competition operates as a discovery procedure not only by giving anyone who has the opportunity to exploit special circumstances the possibility to do so profitably but also by conveying to the other parties the information that there is some such opportunity. It is by this conveying of information in coded form that the competitive efforts of the market game secure the utilisation of widely dispersed knowledge,’ see: Hayek, *Law, Legislation and Liberty* (n 10), 276–277.

¹⁰⁶ Hayek, *Planning and Competitive Order* (n 77).

¹⁰⁷ Friedrich Hayek, ‘Socialist Planning: Comic Fiction?’ (undated), Box 61 Friedrich A. von Hayek Papers, Hoover Institution Archives.

¹⁰⁸ R. H. Coase, ‘The Nature of the Firm,’ (1937) 16(4) *Economica* 386, 387.

¹⁰⁹ Hayek, *Economic Order and Freedom* (n 11), 16.

¹¹⁰ Hayek, *Use of Knowledge* (n 62), 528.

is, in a market economy, an individual simply needs to watch the price fluctuations in the market and to act accordingly.¹¹¹

(iii) *Polycentric systems and market order*

The market facilitates the utilisation of this dispersed knowledge in a very specific way. Once the price mechanism has communicated information to the market, participants are free to respond in any manner that they choose. It is through their response to the price system that each market participant contributes information about their local environment, potentially causing further price adjustments. As the prices change, market participants continue to interact freely with each other and quickly adjust their own conduct in response to the decisions of others.¹¹² In this way, the market operates as a polycentric order that facilitates a fluidity of perpetual adjustment around decentralised *loci* of decision-making.¹¹³ This process of adjustment is continuous and self-generating; by pursuing individual self-interest in response to the price system each participant automatically contributes to the collective knowledge of the market. The order does not arise from ‘a single centre, but ... is produced by the responses of the individual elements to their respective surroundings.’¹¹⁴ Moreover, this process allows an order to be achieved without dictating an ultimate outcome, or evaluating and prioritising the interests of one group over another.¹¹⁵ It allows all participants the equal right (or, put another way, freedom) to pursue their own desires and for this to be aggregated and reflected in the overall knowledge of the market.¹¹⁶

¹¹¹ Hayek, *Economic Order and Freedom* (n 11), 16.

¹¹² This adjustment is, generally, premised on the notion of exchange, namely of buying and selling goods and services. These exchange transactions are dependent on the rules of contract and property ownership that were discussed in part two and it is here that we see their importance. It is only by having security of title, and the ability to exchange that title with confidence, that these exchange relationships can occur.

¹¹³ Polanyi, (n 10), 174-5 and 195-6.

¹¹⁴ Friedrich Hayek, ‘*The Collected Works of F. A. Hayek, The Market and Other Orders*’ Bruce Caldwell (ed.) (Routledge 2014), 161.

¹¹⁵ Hayek, *Law Legislation and Liberty* (n 10), 273.

¹¹⁶ This ‘strict’ definition of equality is considered further in chapter three.

Crucially, it is this polycentricism that renders the market incapable of central design. The market is comprised of a vast number of constituents (that could never be identified in full at any one time), each of whom are acting on multiple influences, any one of which could change their behaviour and the decisions of others accordingly.¹¹⁷ Thus, the motivations within the system can never be fully known, nor can the specific outcome of that system be predicted with certainty.¹¹⁸ As such, more knowledge enters into the system than can ever be known to a single authority.¹¹⁹ Therefore, not only is it undesirable for central direction of market participants (as this would undermine their freedom to respond to the price mechanism and thereby contribute to the knowledge of the market), nor is it possible, as a single authority cannot possess all the information necessary to direct the market system. Indeed, the complexity of the task is such that had the market been specifically designed by a central authority it would be considered one of the ultimate achievements of mankind.¹²⁰

It is at this juncture that the relationship between freedom and cooperation starts to emerge. It is the freedom that individuals have to pursue their self-interest in response to market movements that enables them to contribute local knowledge to the market.¹²¹ Were participants directed to act in a certain way, or to achieve a certain objective, then this contrived behaviour would not inform the market of local conditions (other than the existence of a central diktat). Not only would this distort the accuracy of the information in the market but it would also undermine trust in the price mechanism. Once this trust is lost, participants would no longer rely on the price mechanism and the coordination that it facilitates would start to be lost.

¹¹⁷ Hayek, *Economic Order and Freedom* (n 11), 6.

¹¹⁸ *Ibid*, 10.

¹¹⁹ *Ibid*, 16.

¹²⁰ Hayek, *Planning and Competitive Order* (n 77).

¹²¹ Hayek, *Economic Order and Freedom* (n 11), 19-20.

For market participants to operate within this polycentric process of adjustment and readjustment, it is essential that ‘market order’ be maintained. That is, for those operating within the market to have a reasonable certainty and expectation of the behaviours of their co-participants.¹²² This predictability enables individuals within the market to pursue their own interests, whilst making decisions premised on a reasonable expectation as to the conduct of others. Without this order (or predictability), participants would be engaged in an ongoing and complex operation akin to the prisoners’ dilemma, constantly trying to guess and second-guess the accuracy of information that the price mechanism is predicated upon and further how their co-participants will respond to it. To achieve this market order, it is necessary for the market system to be supported by the equal application of general rules of behaviour discussed in part four.

It is this functional requirement of predictability that distils the, perhaps surprising, yet integral role of trust in the proper operation of the market. That ‘trust is, and always has been, at the heart of financial markets.’¹²³ Without trust, the market is incomplete, as the system has lost an essential element and, as a consequence, its integrity.¹²⁴ It is this element of trust, of the performance of promises and of meeting market participants’ expectations that is lost through creative compliance. For this behavioural predictability is only possible if individuals ‘obey such rules as will produce an order.’¹²⁵ Whilst creative compliance involves technical legal obedience, part four explains why this is not sufficient. Namely, that the rules that produce market order

¹²² Hayek, *Law Legislation and Liberty* (n 7), 35.

¹²³ Mark Carney, ‘Rebuilding Trust in Global Banking’ (Remarks to the 7th Annual Thomas d’Aquino Lecture on Leadership, Lawrence National Centre for Policy and Management, Richard Ivey School of Business, Western University, London, Ontario, (25 February 2013) <<http://www.bis.org/review/r130226c.pdf>> accessed 10 September 2016.

¹²⁴ As defined by Erhard *at al* and discussed in chapter one. See: Werner Erhard, Michael C. Jensen and Steve Zaffron, ‘Integrity: A Positive Model that Incorporates the Normative Phenomena of Morality, Ethics and Legality,’ (March 23, 2009). Harvard Business School NOM Working Paper No. 06-11; Barbados Group Working Paper No. 06-03; Simon School Working Paper No. FR 08-05

¹²⁵ Hayek, *Law Legislation and Liberty* (n 7), 43.

require a level of compliance that ensures the equal application of law in practice, a standard that is lost through creative compliance practices.

PART FOUR: COMPLEX SYSTEMS AND SPONTANEOUS ORDER

The significant success of the market should not belie its complexity. Unlike their physical counterparts, social systems are incredibly complex and it is a ‘fatal conceit’¹²⁶ to think that social order is capable of central design. This part explores the challenges of ordering social (and, in particular, polycentric) systems and explains how ‘spontaneous’ orders arise to coordinate these systems that are otherwise beyond the capability of synthetic design. In doing so, this part concludes the substantive elements of this chapter by distilling the instrumental importance of the principle of equality before the law if such order is to be achieved, an equality that is fundamentally undermined by creative compliance. Thereafter, chapter three considers in more detail what is meant by equality in this context.

(i) The architecture of order

In broad terms, order within a system can be achieved deliberately by design (the corporation being an example of a planned order) or arise spontaneously (which, as shall be seen, is the case with the market and other social systems). Whilst effective, there are two critical features of a planned (or synthetic) order that distinguish it from a spontaneous one and that render it unsuitable for complex organisms. First, synthetic orders often serve a clear purpose of the ‘designer’ (for example, in the case of the corporation, the reduction of transaction costs).¹²⁷ Secondly, by their nature, as they are

¹²⁶ F. A. Hayek, *The Fatal Conceit, the Errors of Socialism*, W. W. Bartley (ed.) (first published 1988, Routledge 1998), 21. For specific application of the fatal conceit to the market see: Hayek, *Creative Powers of a Free Civilisation* (n 101).

¹²⁷ Coase (n 108), 19.

capable of design, planned orders generally relate to relatively simple systems (as all variables need to be known to the designer).¹²⁸ A planned order is not therefore readily transposable onto a complex system with multiple, unknown variables and an undefined outcome (characteristics that are, as discussed in part three, typical of social systems such as the market).¹²⁹

In contrast to planned orders, spontaneous orders ‘consist of a system of abstract relations.’¹³⁰ Within social systems, decisions are made by individual actors whose strategies may be influenced by an innumerable number of factors, influences that neither their co-participants nor a central regulator can possibly ever know.¹³¹ It is therefore impossible for a central authority to regulate such polycentric systems fully to achieve an intended output, as they are simply not able to anticipate all of the decisions that the market participants will make. Moreover, once one participant acts, others will respond creating a continuous relationship of decision-making and adjustment. Thus, to legislate for every eventuality, a regulator would need to know not only all of the variables that contribute to one participant’s decision making process but also those that influence how the rest of the market will respond to that decision and so on and so forth. This, clearly, is simply not possible. Moreover, even if it were possible to initially ‘design’ a social order, this would then be constrained by the capability of the regulatory infrastructure put in place to support it. The benefit of a spontaneous order is that it is not limited by human knowledge, vision or decree.¹³² It is this ability to support ever-increasing complex systems that renders the protection of the spontaneous order so important.

¹²⁸ Hayek Law, Legislation and Liberty (n 10), 37.

¹²⁹ It is the fact that in a polycentric system the knowledge of that system is ‘simply not knowable to anybody’ that prohibits central planning. See: Friedrich Hayek, ‘Central Planning,’ (1988) Box 131, Friedrich A. von Hayek Papers, Hoover Institution Archives.

¹³⁰ Hayek Law, Legislation and Liberty (n 10), 37.

¹³¹ Hayek, Economic Order and Freedom (n 11).

¹³² Hayek Law, Legislation and Liberty (n 10), 37.

Rather, for order to arise, what is required is the implementation of general rules of conduct, the so-called ‘rules of the game,’¹³³ that facilitate a certain predictability of behaviour amongst constituents within the system. It is from this framework that spontaneous orders arise as the product of human action, not design.¹³⁴ In general terms, the rules required to support a spontaneous order are those rules of general behaviour, explored in part two, that establish ‘stability of possession, of transference by consent, and of the performance of promises.’¹³⁵ If followed, these rules leave individuals free and able to act with ‘the maximum degree of certainty according to their individual plans’¹³⁶ and are integral to economic security and prosperity.¹³⁷ Scully’s empirical work on the institutional frameworks that are necessary to support economic growth found that societies that ‘subscribe to the rule of law to private property, and to the market allocation of resources,’¹³⁸ grew at three times the rate of those without,¹³⁹ whilst markets in particular depend on ‘the establishment of an environment in which legal rights, especially property and contractual rights, are enforced and protected.’¹⁴⁰

Whilst property and contract rules are fundamental to market order, it is crucial that these rules are bound by the rule of law and, in particular, the principle of equality before the law. Historically, exchange relationships (and, in particular, the expectation

¹³³ That is, ‘within the known rules of the game the individual is free to pursue his personal ends and desires,’ see: Hayek, *Road to Serfdom* (n 75), 73.

¹³⁴ Adam Ferguson, ‘An Essay on the History of Civil Society,’ 5th edn. (first published 1782 T. Cadell) <http://lf-oll.s3.amazonaws.com/titles/1428/1229_Bk.pdf> accessed 10 September 2016. Hayek, drawing on Whately’s earlier work, described this order that arises from the ‘mutual adjustment of many individual economies in a market’ as a catalaxy from the Greek ‘kattalattein’ meaning ‘to exchange [and] ... admit into the community.’ See: Hayek, *Law Legislation and Liberty* (n 10), 268-9.

¹³⁵ Friedrich Hayek, *The Constitution of Liberty* (first published 1960, Routledge Classics 2006), 138.

¹³⁶ Hayek, *Markets and Other Orders* (n 114), 162.

¹³⁷ Svetozar Pejovich, *Law, Informal Rules and Economic Performance: the Case for Common Law* (Edward Elgar 2008), 41-43.

¹³⁸ Gerald Scully, ‘The Institutional Framework and Economic Development,’ (1988) 96(3) *Journal of Political Economy* 652, 652

¹³⁹ *Ibid*, 658

¹⁴⁰ Richard Posner, ‘Creating a Legal Framework for Economic Development, (1998) 13(1) *World Bank Research Observer* 1, 1.

that others would perform their promises) were premised on personal relationships. That is, the parties to a transaction knew each other and possessed expectations as to the behaviour of their counterparty from previous dealings. This is what North described as the first historical type of exchange, which did not rely upon robust legal institutions to create the conditions necessary for trade.¹⁴¹ However, in modern society, exchange now takes place on an impersonal and global market. In this environment, legal institutions are required to ensure that the requisite trust and predictability of behaviour (considered in section two below) that are integral to exchange relationships exists.¹⁴² In a modern exchange (such as the market), it is the application of, and adherence to, the rule of law that creates and embeds these principles (inherent in early exchange) within the modern, impersonal, market exchange. That is, a regulatory framework that ensures laws apply equally to all participants, creating the certainty of behaviour that the spontaneous order requires.¹⁴³

Thus, for the classical liberal we see in practice the important, and legitimate, role that regulation plays in achieving economic and social order. Law is seen as the ‘glue that holds a complex society together’¹⁴⁴ whilst the government is required to ‘enforce the rules of the game as an ‘umpire.’¹⁴⁵ Within this regulatory framework, individuals are free ‘to interact with each other on their own initiative – subject only to laws which uniformly apply to all of them.’¹⁴⁶

¹⁴¹ Douglas North, *Institutions, Institutional Change and economic Performance*, (Cambridge University Press 1990), 34-5.

¹⁴² *Ibid*, 35.

¹⁴³ Hayek *The Constitution of Liberty* (n 135), 193-5.

¹⁴⁴ Razeen (n 32), 184-5.

¹⁴⁵ *Ibid*.

¹⁴⁶ Polanyi (n 10), 195.

(ii) Predictability, order and the rule of law

The question that remains is to understand how this market analysis contributes to our analysis of corporate compliance. The answer is this. The challenge with creative compliance is that it undermines the predictability of behaviour that a spontaneous order requires. The previous sections explained that for order to arise in a social system, citizens need the freedom to act whilst knowing that (within reason) their fellow citizens will act, and react, in a certain way. This is achieved by protecting a citizen's freedom to act whilst requiring that they nevertheless obey certain general rules of behaviour. More specifically, that each constituent within the system 'obey[s] the same rules.'¹⁴⁷ When these rules are not followed, the order is threatened as behaviour becomes unpredictable, participants no longer share an expectation of conduct and the natural equilibrium of the polycentric system is lost. Moreover, and as explained in chapter one, when these rules are not followed, eventually reactionary regulation can be introduced which itself risks disrupting the particular regulatory framework that otherwise supports order. In contrast, when rules are applied and followed equally, market order (that is, behavioural predictability) ensues.

Within a market governed by a regulatory framework, a critical component of achieving this predictability of behaviour is the equal application of rules to all market participants. This equality, which also serves to enhance the legitimacy of the market system, is achieved by the maintenance of the rule of law and, in particular, the principle of equality before the law.¹⁴⁸ Once the exclusive purview of law and politics, the rule of law is, as explained above, increasingly recognised as central to the

¹⁴⁷ Hayek, *Law, Legislation and Liberty* (n 10), 39.

¹⁴⁸ It also provides a standard by which to determine legitimate government interference, whilst the potentially 'predatory extremes' of self interest are kept in check by procedural justice that proscribes harm to others' protected sphere of interest, see: Razeen (n 32), 26.

development of economic growth.¹⁴⁹ Indeed, it is ‘necessary as a precondition of capitalist society,’¹⁵⁰ which requires a dependability and generality of law. This broad requirement of equality serves to create a predictable framework of behaviours within the market, whilst maintaining each citizen’s freedom to act. The perennial question of what we mean by ‘equality’ in this context and whether citizens have an obligation to maintain it, is considered in chapter three. However, at this juncture it is prudent to note that equality before the law should be achieved in the actual operation of the law, not simply its theoretical application.¹⁵¹ Thus, arguments that an entity has technically complied with the letter of the law (albeit in defeat of its spirit) do little to satisfy this standard.

One challenge to this thesis, which claims that creative compliance damages the spontaneous order that society depends upon, would be to suggest that if most large multinationals were motivated to creatively comply then this would, on one level, create its own sense of order. Therefore, it is important to make clear that not all rules, equally followed, create order. Some rules, exactly followed, will create disorder.¹⁵² Hayek draws on the example that if a rule required an individual to ‘flee as soon as he saw another’¹⁵³ only disorder would follow. Moreover, the claim that creative compliance generates its own order meets two difficulties. First, this practice (no matter how regular) is one that creates disorder. As the extent of creative compliance adopted by each corporation is not known (and the ability of each corporation to creatively comply differs),¹⁵⁴ it continues to lead to a level of uncertainty and the prisoners’ dilemma

¹⁴⁹ See for example: ‘Economics and the Rule of Law, Order in the Jungle,’ *The Economist* (13 March 2008) <<http://www.economist.com/node/10849115>> accessed 10 September 2016; Christopher May, *The Rule of Law, The Common Sense of Global Politics* (Edward Elgar, 2014), xxiv and 108-133.

¹⁵⁰ Franz Neumann, ‘The Change in the Function of Law in a Modern Society,’ in Franz Neumann, Herbert Marcuse (ed.), *The Democratic and Authoritarian State* (The Free Press 1957), 40.

¹⁵¹ *Railway Express Agency Inc. v New York*, 336 U.S. 106 (1949), 112-3.

¹⁵² Hayek, Law, Legislation and Liberty (n 10), 42.

¹⁵³ *Ibid.*

¹⁵⁴ For example, depending on their resources, geographical presence and risk profile.

outlined in part one. Corporations adopt varying approaches to compliance, as they are unsure of how other corporate citizens will be acting. This in turn can influence broader notions of regulatory and compliance legitimacy, which in turn influences corporate compliance with the rules that society depends upon. Secondly, creative compliance is a practice that fundamentally undermines trust in the corporate, market and regulatory systems. Once this trust is lost, corporations risk 'compulsion'¹⁵⁵ as direct regulatory intervention is introduced.

Examining the symbiotic relationship between rules and order in this way demonstrates the instrumental importance of complying with rules in a manner that ensures that they apply equally to all. The difficulty with creative compliance is that it fundamentally undermines the equal application of such rules of behaviour. It manifests in the 'manipulation of law - no matter what the intention of legislators or enforcers.'¹⁵⁶ As a consequence, corporations can, within broad boundaries, choose how to apply the rules of the game. In doing so, regulation is applied inconsistently, subverting the rule of law and, as a consequence, disrupting the behavioural predictability that is central to social order.

CONCLUSION

Those that dispute the legitimacy of calls to constrain creative compliance claim, in part, that creative compliance is lawful behaviour that aligns with the norms of the market economy. On this basis, such constraints are seen to embody the illegitimate coercion of the freedom of the individual.¹⁵⁷ Furthermore, the perceived norms of the

¹⁵⁵ Hayek, *Individualism and Economic Order* (n 55), 18.

¹⁵⁶ D. McBarnet and C. Whelan, 'The Elusive Spirit of the Law: Formalism and the Struggle for Legal Control' (1991) 54 *Modern Law Review* 849, 849.

¹⁵⁷ This chapter is concerned with the primary question of the normative justification of corporate spirited compliance. However, the question necessarily raises a company law question, namely the legitimacy of pursuing potentially less profitable strategies (in the direct,

market serve to inform how corporations define compliance and the scope of their compliance obligations. However, this chapter has examined how creative compliance erodes the predictability of behaviour that is essential for the proper order of society, including the market itself. This erosion of market order leads to, *inter alia*, reactionary regulatory responses and, ultimately, jeopardises both the market order and its primary function as a conduit of knowledge. Examined in this way, we see both the interdependence and ‘mutual reinforcement of the economic, political and legal orders of society.’¹⁵⁸ Whilst this chapter has explored the economic and political orders that underpin a market economy, chapter four considers how the legal order can, surprisingly, contribute to the current compliance crisis.

By understanding the role of compliance in this way, we see it as a functional means to achieve social cooperation, whilst protecting the individualism that classical liberalism promotes. In doing so, we remove metaphysical or ethical arguments in favour of spirited compliance that are premised on relative power and morality, arguments that are always open to subjective analysis and attack. However, this analysis, predicated on a need to protect equality within such a system, nevertheless raises a number of challenging questions itself. In particular, this concept of equality is often used but little defined. Chapter three considers what we mean by equality in this context and, importantly, provides a framework in which to examine one outstanding, but crucial, question. That is, whether corporations (in addition to the state) are under an obligation to uphold the principle of equality before the law. Conversely, were McBarnet’s interviewees¹⁵⁹ (much like Lord Russell)¹⁶⁰ correct in their view that it is for the

short term understanding of the word ‘profitable’) to do so. This enquiry requires a consideration of *inter alia* the proper application of s 172 of the Companies Act 2006 (duty to promote the success of the company), which is an enquiry undertaken by chapters four and five.

¹⁵⁸ Razeen (n 32), 18.

¹⁵⁹ See: Doreen McBarnet, ‘Financial Engineering or Legal Engineering? Legal Work, Legal Integrity and the Banking Crisis,’ in Iain MacNeil and Justin O’Brien (eds) *The Future of Financial Regulation* (Hart Publishing 2010), 69.

legislature to achieve the requisite behavioural standard in its citizens? Furthermore, if we can conclude that corporations *should* uphold the principle of equality before the law, on what basis is it legitimate for corporations to be held to a different standard of compliance from their natural counterparts?

¹⁶⁰ See the discussion of *The Commissioners of Inland Revenue v His Grace the Duke of Westminster* [1936] AC 1 in chapter one, part one.

CHAPTER THREE

EQUALITY, PRIVILEGE AND OBLIGATION

‘Authority is not needed (although much exists) to show that there is no principle more basic to our system of law than the maintenance of rule of law itself.’¹

‘While the idea of the rule of law continues to mean the safety of the individual from big government, it also has come to imply the need for a government that is strong enough to protect individuals from illegal attacks by their fellow men.’²

INTRODUCTION

Chapter two introduced the functional relationship between the rule of law, equality and the market order that is crucial to the operation of civil society. However, the ‘rule of law’ and ‘equality’ are nebulous terms that, whilst often used, are scarcely defined and susceptible to subjective interpretation, not least the distinction between legal and material *inequality*.³ Without further clarification, reliance on a rule of law argument in support of enhanced compliance standards is susceptible to several challenges. For example, what do we mean by equality? Why is it, conceptually, that we find lawful behaviour (such as creative compliance) to be so egregious? To what extent, if any, should citizens (rather than states) be under a positive obligation to uphold the rule of law? Moreover, if a key criticism of creative compliance is that it undermines the principle of equality before the law, then is it not paradoxical to argue that corporations should be held to a different standard of account than their natural counterparts?

To answer these questions, and offer a framework in which to analyse the legitimacy of reform, this chapter examines the role of the rule of law in society and, more

¹ *R (on the application of Cart) v The Upper Tribunal* [2011] UKSC 28, [2011] 3 WLR 107, [122].

² Gottfried Dietze, Hayek on the Rule of Law, in *Essays on Hayek* Machlup (ed.) (New York University Press 1976), 107.

³ Note that the term is not even defined when used in regulation, see section 1 of the Constitutional Reform Act 2005.

specifically, the meaning of equality before the law. In doing so, it challenges the perception that the rule of law is simply a proxy for good governance⁴ or an abstract doctrine to determine the legality of government behaviour,⁵ which has no (or very little) bearing on individual conduct. Rather, in rejecting this superficial view, this chapter explores in more detail the claim introduced in chapter two that the rule of law in fact serves to legitimately constrain individual decision-making and behaviour.⁶ It is this analysis that not only supports the argument that corporations should adopt a wider concept of compliance but, importantly, also delineates the boundaries of that obligation, namely so as to maintain strict legal equality as defined in part one. In doing so, the chapter also offers a basis from which to consider the conceptually challenging question as to why it would be legitimate to hold corporations to an enhanced compliance standard even though this in itself seemingly undermines the rule of law's mandate of equality.

In exploring the relationship between the rule of law and corporate compliance obligations, this chapter proceeds as follows. Part one offers a definition of 'equality' before the law within the context of the rule of law. Beyond providing useful contextual information, an examination of such an often-used term may seem otiose. However, as this first part explains, the common acceptance of the rhetoric of equality reflects a critical challenge in modern discourse. Whilst the rule of law and the principles that it enshrines are the product of many hard-fought battles, modern society has arguably become complacent as to both their existence and meaning.⁷ As a consequence, the rule of law has increasingly been engaged simply as shorthand to

⁴ This use of the 'rule of law' as a proxy for good governance (or general legality) has meant that it has 'largely lost [its] meaning.' See: Friedrich Hayek, 'Freedom Under the Law' (undated), Box 103, Friedrich A. von Hayek Papers, Hoover Institution Archives.

⁵ Friedrich Hayek, The Rise and Decline of the Rule of Law (IV), *Time and Tide* 28 March 1953, Box 107, Friedrich A. von Hayek Papers, Hoover Institution Archives.

⁶ Friedrich Hayek, *The Constitution of Liberty* (first published 1960, Routledge Classics 2006), 180.

⁷ Friedrich Hayek, The Rise and Decline of the Rule of Law (I), *Time and Tide* 7 March 1953, Box 107, Friedrich A. von Hayek Papers, Hoover Institution Archives.

denote that a 'legal system is legally in good shape.'⁸ Moreover, the term 'equality' is itself a challenging concept in respect of which opinion is divided as to whether it is, or should be, defined in strict or material terms. Part one explains why, notwithstanding the difficult outcomes that this can cause, it is strict legal equality that is required (subject to one important derogation discussed in part four).

Having defined equality, part two then examines the role of the rule of law (and, specifically, the principle of equality before the law) as a meta-rule. That is, an overarching principle (that should itself be complied with), which governs the application of specific regulations. Seen through this lens, equality is both a rule to be complied with and, as a consequence, a basis on which to constrain otherwise seemingly lawful behaviour (namely, behaviour that technically complies with the underlying substantive legislation in question). By understanding this function and position of the principle of equality within the broader legal framework, we are able to identify why there was such widespread consternation in respect of lawful, albeit creative, tax practices. That is, such condemnation was not predicated on the technical compliance with the underlying regulation *per se* but rather the breach of the requirements of this overarching, meta-rule of equality.

Following this examination of the interplay between equality and substantive regulation, part three then considers whether corporations have a positive obligation to maintain these principles, which are commonly seen as constraints on government, not individual, power. The acquiescence, and corresponding obligation, to the law is generally premised on consent. Namely, that a citizen has, tacitly at least, consented to be bound by the provisions of the law. This argument is not without its difficulties, although as this part explains, these are significantly reduced when looking at corporate citizens. In particular, corporations choose to incorporate in a jurisdiction and, in doing

⁸ John Finnis, *Natural Law and Natural Rights* (Oxford, 1980), 270.

so, elect to adhere to the legal system of that territory. Importantly, subsequent investors similarly invest in a corporation aware of the regulatory framework by which it will be bound. Moreover, corporations, in contrast to individuals, are significantly more geographically mobile and therefore better placed to leave a jurisdiction should they no longer want to be bound by a particular regulatory framework.

Part four concludes the chapter by addressing the apparent paradox between a claim to formal equality and the argument that corporations should adopt a higher compliance standard than non-corporate (and indeed private, closely held, corporate) citizens. It does so by exploring the concept of legal privilege as the only legitimate derogation from the principle that all legal subjects are subject to the equal application of law. That is, it is only where the law creates a privilege (facilitating a transgression of the rule of law itself) that a departure from the principle of equality can be permitted, namely to mitigate the impact of such privilege.

PART ONE: DEFINING ‘EQUALITY’ BEFORE THE LAW

An academic enquiry into the origins, meaning and implications of the rule of law and, more specifically, the principle of equality before the law (being that aspect of the rule of law that this work is primarily concerned with) would be a significant exercise to say the least. Therefore, it must be made clear from the outset that such an endeavour is not what this part proposes to do. Rather, its more modest intentions are to provide some context to the doctrine that classical liberals such as Hayek placed such importance on, whilst outlining the conceptual framework that we define equality within. This discussion is important as the increasing acceptance of the rule of law as ‘unobjectionable common sense’⁹ risks reducing the doctrine to an ‘empty’¹⁰ concept,

⁹ Christopher May, *The Rule of Law, The Common Sense of Global Politics* (Edward Elgar 2014), 9.

one with little practical utility.¹¹ As a minimum, this tendency renders the rule of law itself, much less its precepts, an ‘exceedingly elusive notion.’¹² To address this uncertainty, this part offers a definition of equality that then forms the foundation for the claim (put forward in part three) that corporations are subject to a positive obligation to maintain equality before the law as defined.

(i) The rule of law: precepts and conceptions

The rule of law is inherently entwined with the development of liberal ideology. As chapter two intimated, it is perhaps surprising that a philosophy predicated on the protection of individual freedom recognises an important role for a coercive instrument such as the law (broadly defined).¹³ However, drawing on its social contract traditions,¹⁴ classical liberalism accepts the existence of law, itself a clear constraint on individual freedom, as the consideration an individual pays for the broader benefits of social cooperation. Understood in this way, citizens are deemed to have consented to the operation of the law (although part three explains some of the challenges of this view) and thus are ‘at once ruler and ruled.’¹⁵ However, this agreement to the imposition of law is not absolute. Rather, it is predicated (and arguably conditional) on the protection offered by the rule of law as a bulwark against government coercion that operates to constrain the exercise of arbitrary government power.

¹⁰ Balarkrishnan Rajagopal, ‘Invoking the Rule of Law in Post-conflict Rebuilding: a Critical Examination,’ (2008) 49 William and Mary Law Review 1347, 1359.

¹¹ Adriaan Bedner, ‘An Elementary Approach to the Rule of Law’ (2010) 2(1) Hague Journal on the Rule of Law 48, 50.

¹² Brian Z. Tamanaha, *On the Rule of Law: History, Politics, Theory* (Cambridge University Press 2004), 3.

¹³ Hayek, *Freedom Under the Law* (n 4), 205.

¹⁴ Tamanaha (n 12), 48.

¹⁵ Tamanaha (n 12), 34. This notion of consent is not unproblematic and is considered further in part three.

An early formulation of the rule of law can be found in Locke's *Second Treatise of Government*.¹⁶ In his seminal work, Locke recognised that in a state of nature, whilst freedom and equality may be protected, a difficulty arose when an individual sought to enforce their individual rights against a fellow citizen.¹⁷ It was clear that, without an independent arbiter, the parties to the dispute would favour their own interests and therefore resolution would be impossible. As such, Locke concluded that a governing body was required to make and enforce laws for the benefit of the members of society. However, Locke's primary concern was that in conceding such authority, citizens should not be subject to an 'arbitrary power ... which men would not quit the freedom of the state of nature for.' It was against these concerns that Locke offered his concept of the rule of law, which would act to both facilitate the need for a governing body whilst protecting against the fear of arbitrary control.¹⁸ That is, individual freedom would be protected, notwithstanding the grant of power to a central authority, by having 'a standing rule to live by, common to every one of that society, and made by the legislative power erected in it ... and not to be subject to the inconstant, uncertain, unknown, arbitrary will of another man.'¹⁹

Missing from Locke's formulation of the rule of law was the existence of a separate judiciary. This omission was later recognised by Montesquieu who prescribed a separation of powers, and in particular an independent judiciary, without which he argued 'there can be no liberty'²⁰ as a citizen would be 'subject to arbitrary control.'²¹ Of note, is that Montesquieu recognised that a legitimate function of government, as

¹⁶ John Locke, *The Second Treatise of Government and a Letter Concerning Toleration*, Tom Crawford (ed.) (first published 1690, Dover Publications 2002).

¹⁷ Tamanaha (n 12), 49.

¹⁸ 'Arbitrary' meaning 'rule-less' or determined by particular will rather than according to recognized rules,' see: Friedrich Hayek, 'The Miscarriage of the Democratic Ideal,' (1978), Box 130, Friedrich A. von Hayek Papers, Hoover Institution Archives, 6.

¹⁹ Locke (n 16), section 23.

²⁰ Charles Louis de Secondat Montesquieu, *The Spirit of the Laws*, (Anne. M Cohler, Basia C. Miller and Harold S. Stone eds.) (first published 1777, Cambridge University Press 1989), Book XI section 4.

²¹ Ibid.

discussed in chapter two, was creating a protected sphere of conduct in which an individual is free to act. Seen in this way, Montesquieu also observed that liberty is not a freedom to ‘do whatever one pleases’²² but a requirement to act within the boundaries of the law, provided citizens are free from tyranny. Therefore, we see that even in such early conceptions of the rule of law, it is recognised that there is a basis for individual obligations to obey the law which, as part two will argue, includes observing the rule of law.

It was these early formulations that provided the foundation for Dicey’s classic exposition of the rule of law.²³ As is well known, Dicey put forward a conception of the rule of law comprising of three precepts.²⁴ First, the supremacy of the law rather than of the arbitrary authority of man. Secondly, the principle of equality before the law,²⁵ and finally that the law is ‘defined and enforced by the Courts.’²⁶ Inherent within Dicey’s definition was the view that discretion, in the form of discretionary powers of constraint, was the antithesis to the rule of law. It is clear that Dicey was concerned with the discretion of government. However, in modern society, the question arises as to whether it is possible to constrain the discretion that powerful corporate citizens are able to exercise. In this regard, it is of note that in formulating his principle of equality, Dicey was, much like Hayek,²⁷ very critical of special privileges being awarded to officials. Part four examines the implication of corporate privilege as a basis for constraining creative compliance practices.²⁸

²² Tamanaha (n 12), 52.

²³ Albert V. Dicey, *Introduction to the Study of the Law of the Constitution*, Roger E. Michener (ed.) (first published 1902 Elibron Classics 2005).

²⁴ *Ibid*, 8.

²⁵ *Ibid*, 114.

²⁶ *Ibid*, 115.

²⁷ Friedrich Hayek, *The Road to Serfdom*, (first published 1944, Routledge Classics 2001), 82.

²⁸ Paul P. Craig, ‘Formal and Substantive Conceptions of the Rule of Law: an Analytical Framework,’ (1997) 21 *Public Law* 467, 472.

More modern formulations of the rule of law have sought to develop Dicey's conception (see, for example, Lord Bingham's eight sub-rules of the rule of law).²⁹ However, as with Dicey's predecessors, all share a commitment to the equal application of law. Indeed, it is of no surprise that in Hayek's own conception of the rule of law he claimed that laws themselves must be 'general, equal and certain.'³⁰ That is, general in the sense that they are written in the abstract and not aimed at any particular individual. Aligned with this is the notion of impartiality, namely that such general rules must make 'no distinctions between classes of persons which are not equally approved by those inside and those outside the class singled out.'³¹ Equal, in that the law applies to all, without arbitrary distinction and certain, such that subjects are aware of the content of the rules (thereby facilitating predictability, which itself is fundamental to individual freedom). Constructed in this way, Hayek argued that the law acted as a signpost on a road, allowing citizens the requisite certainty to plan their own conduct but without telling them which direction to travel in.³² By doing so, the law performs the ordering function considered in chapter two, as it allows individuals the requisite freedom to act whilst constraining all citizens within the requisite legal framework necessary to maintain order. In particular, it is the requirement that the law comprises of 'uniform rules equally applicable to all'³³ that facilitates such an order. However, the difficulty that remains is that equality in any context is a subjective and somewhat nebulous term. In the context of the rule of law, the meaning of equality is further obscured as the doctrine becomes taken for granted, or used simply as rhetoric.³⁴ Thus, the question that the following section considers is what exactly is meant by 'equality' in this context.

²⁹ Lord Bingham, 'The Rule of Law,' (2007) 66(1) Cambridge Law Journal 67.

³⁰ Hayek, Road to Serfdom (n 27), 80.

³¹ Hayek, Freedom Under the Law (n 4), 3.

³² Hayek, Road to Serfdom (n 27), 78.

³³ Hayek, The Miscarriage of the Democratic Ideal (n 18), 3.

³⁴ Ibid.

(ii) Equality of law, not outcome

From its inception, the rule of law has enshrined notions of equality. Derived from the Greek ‘*isonomia*,’ meaning ‘equality of laws to all manner of persons’³⁵ even the earliest iterations of the rule of law contained a commitment to equality in some form. In particular, the doctrine has promulgated the principle that it should not be lawful to propose a law unless it applies equally to all, as ‘every citizen has an equal share in civil rights, so everybody should have an equal share in the laws.’³⁶

Nevertheless, and perhaps not surprisingly, the concept of equality is both challenging and normatively difficult to define. In the context of the rule of law, ‘equality’ suffers both as an expression, the meaning of which ‘users ... assume to be clear,’³⁷ but also as a prescriptive term that is highly value laden and susceptible to subjective interpretation. In particular, it is the distinction between legal and material (or substantive) equality that is the most challenging, but also the most pertinent, to determine. Not only does this distinction raise potentially difficult outcomes, which therefore demand justification, but it also shapes the framework in which corporate compliance standards are defined and, if necessary, refined. For example, if we are to hold corporations to a higher compliance threshold than their natural counterparts, a strict application of equality would require an exception (or derogation) to be made to that formal standard. In contrast, a material (or substantive) definition suggests that corporations should already be applying compliance standards that put them on an equal footing with other citizens (corporate or otherwise) that are not similarly positioned to creatively comply.

³⁵ Hayek, *The Rise and Decline of the Rule of Law* (n 7).

³⁶ Here, Hayek cites an account given by Demosthenes of an Athenian law, see: Hayek, *The Rise and Decline of the Rule of Law* (n 7).

³⁷ Ugo Mattei and Laura Nader, *Plunder: When the Rule of Law is Illegal*, (Blackwell Publishing 2008), 10.

In this context, a strict (or formal) definition of equality before the law requires the equal application of laws, without the grant of any privileges designed to achieve ‘material’ or substantive equality.³⁸ This formal determination flows from the precept that the law must be general and achieve equality of objective opportunity, not of subjective result.³⁹ In this way, the law protects the freedom of citizens to act in the manner that they deem fit, subject only to pre-determined rules that are known by, and applied to, all. The clear difficulty with this approach is that whilst it gives everybody the same right to, for example, purchase a Rolls Royce or to enter the Olympics, the reality is that only those with significant wealth or sporting excellence can do so. In these extreme examples, the adoption of a principle of formal equality may not be so unpalatable. However, the application of formal legal equality can become more difficult when looking at the ability to purchase a home, provide food for one’s family or satisfy basic sustenance needs. We thus are met with a situation where strict legal equality leads to material inequality.⁴⁰ That is, that the law ‘forbids the rich as well as the poor to sleep under bridges.’⁴¹

To mitigate this apparent unfairness, an alternative interpretation of equality is that it should be defined to achieve ‘substantive’ equality (or distributive justice). That is, rather than strict (or formal) equality, we should act to ensure that citizens are put in an equal, material, position. Within this view, equality should, in effect, mean sameness (or a position as near to sameness as possible). Intuitively, a substantive definition of equality is attractive. However, it raises a number of difficult challenges. One immediate difficulty is that it requires a determination of what a ‘fair’ distribution would entail. This would be a significant (arguably, impossible) exercise, namely to evaluate each individual’s entitlement and agree the values to apply. However, the

³⁸ Hayek, *Road to Serfdom* (n 27), 82.

³⁹ *Ibid.*

⁴⁰ *Ibid.*

⁴¹ Anatole France, *The Red Lily* (first published 1894, Yurica Press 2015), chapter 7.

greater challenge (and the one that Hayek argued forcibly)⁴² is that distributive justice, premised on notions of substantive equality, cannot be sustained. Aside from the difficulties of determination, once the initial allocation has been made it would need to be continuously remade as an individual's position changes. Once a distribution has been completed, if a person then spends all, or even part, of their allocation do we engage in a further round of redistribution? Even if such a loss was not attributable to perceived 'unreasonable' conduct, the different requirements of individuals will result in a constant need for redistribution.

One further difficulty arises with distributive justice (meaning allocations outside of those that are required to achieve minimum standards of living, which are discussed further in this part). That is, such a specific allocation of resources undermines the principle of the rule of law, which mandates abstract and general rules, agreed in advance and then applied equally to all.⁴³ By undermining the rule of law in this way, we risk damaging (much like creative compliance) the framework that is necessary to support the social orders, such as the market, that create wealth and opportunity in the first instance. Thus to protect the individual freedom and legal institutions that the rule of law was developed to facilitate, it is a principle of formal equality that we need to adopt. However, it is important to be clear that formal equality does not mandate that we ignore social inequality. To the extent that the formal application of law creates unacceptable economic inequality then (and, again, in contrast to common

⁴² See for example: *The Meanings of Law and Order*, Stanford Lecture (1968), Box 108, Friedrich A. von Hayek Papers, Hoover Institutions Archives; and Friedrich Hayek, 'Planning and Competitive Order,' (undated), Box 104, Friedrich A. von Hayek Papers, Hoover Institutions Archives.

⁴³ As Hayek, citing Rousseau, observed: 'the object of laws is always general, I mean that the law always considers the subject in the round and actions in the abstract and never any individual man or one particular action,' see: Friedrich Hayek, *The Collected Works of F. A. Hayek, The Market and Other Orders* Bruce Caldwell (ed.) (Routledge 2014), 144. This reflects the genesis of the doctrine, designed to constrain the arbitrary authority of the party in power or of other elites (see: Daron Acemoglu and James A. Robinson, *Why Nations Fail* (Profile Books 2013), 308.

misconceptions as to classical liberal policy on government welfare)⁴⁴ this should be addressed by other means. Hayek, unlike his libertarian counterparts,⁴⁵ was cognisant of the need to provide certain levels of social welfare, noting that ‘there can be no doubt that some minimum of food shelter, and clothing, sufficient to preserve health and the capacity to work,’⁴⁶ should be assured to all. It cannot be, and is not, suggested that such welfare will fully address the inevitable unfairness that arises from the lottery of opportunity at birth. However, by protecting equal opportunity before the law we do at least protect against the ‘arbitrariness of government action’⁴⁷ and ensure that ‘the same principles irrespective of the different circumstances of different people’⁴⁸ be applied. Whilst no system will ever perfectly address material inequality, the protection of the rule of law in this way goes further to support the institutions necessary to try to increase the overall welfare of, and opportunities within, society.

(iii) The rule of law: between thick and thin conceptions?

There is one final question to consider regarding the construction of the rule of law, concerning the conceptual role that the rule of law *should* perform (the next part considers its interaction with substantive regulation). That is, should the rule of law be conceived in formal (thin) or substantive (thick) terms?⁴⁹ Put another way, does the rule

⁴⁴ As explained in chapter two, classical liberalism does not eschew the imposition of law or any state intervention. Rather, the question is ‘what government action is legitimate,’ see: Friedrich Hayek, ‘The Meaning of Government Interference,’ (1950), Box 107, Friedrich A. von Hayek Papers, Hoover Institutions Archives, 1.

⁴⁵ For example: Robert Nozick, *Anarchy State and Utopia*, (first published 1974, Blackwell Publishing 2003), 149.

⁴⁶ Hayek, *Road to Serfdom* (n 27), 124-125.

⁴⁷ Hayek, *The Meaning of Government Interference* (n 44), 3.

⁴⁸ *Ibid.*

⁴⁹ Different taxonomy concerning these conceptions of the rule are engaged. Craig utilizes the terms ‘formal’ and ‘substantive,’ Pech expounds the differences between ‘thin’ and ‘thick,’ whilst fuller suggests ‘procedural’ and ‘substantive.’ See: Craig, *Formal and Substantive Concepts* (n 28); Laurent Pech, ‘A Union Founded on the Rule of Law: Meaning and Reality of the Rule of Law as a Constitutional Principle of EU Law’ (2010) 6 *European Constitutional Law Review* 359, 369; Lon Fuller, *The Morality of Law*, (Yale University 1969), 96.

of law comprise merely a set of procedural requirements to be satisfied, or does it demand something more?

In brief, formal (or thin) conceptions of the rule of law concern the ‘manner in which the law was promulgated.’⁵⁰ That is, was the law properly authorised? Is it capable of guiding individual conduct? Is the legislation prospective and is there an independent judiciary? A formal construction of the rule of law is not therefore concerned with the substance of the law, namely whether it is a good or a just law, merely that the law was passed in the proper manner. Advocates of a thin construction defend their claim in the following way. Namely, that to shroud the rule of law in concerns of ‘justice’ or ‘fairness’ is to ‘propound a complete social philosophy’⁵¹ obfuscating any function that the rule of law has, independent from the political philosophies that would necessarily be engaged to argue for a just or fair law. That is, the determination of a just society should be made by reference to the relevant political theory, not the rule of law.⁵² The classic criticism of this approach is that manifestly unjust or undesirable laws could satisfy this construction of the rule of law, for example, those enacted in Nazi Germany.⁵³ Conversely, those enacted by a democracy could fail to meet this standard.

In contrast, advocates of a substantive (or thick) conception of the rule of law suggest that the doctrine should aspire to be more than a set of procedural requirements. That is, the rule of law should be the foundation to help distinguish between ‘good’ and ‘bad’ laws (through the recognition of certain individual rights).⁵⁴ Seen in this way, an individual’s moral rights should be recognised in law so that they may then be

⁵⁰ Craig (n 28), 467.

⁵¹ Ibid, 468.

⁵² On which see: Joseph Raz, ‘The Rule of Law and its Virtue,’ (1977) 93 *Law Quarterly Review* 195.

⁵³ Jonathan Rose, ‘The Rule of Law in the Western World: an Overview,’ (2004) 35(4) *Journal of Social Philosophy* 457, 460.

⁵⁴ Craig (n 28), 467.

enforced.⁵⁵ Thus, in contrast to a purely procedural or formal perspective, a ‘state which savagely represses or persecutes sections of its people cannot in my view be regarded as observing the rule of law.’⁵⁶ On this view, proponents of a substantive view do not suggest that the rule of law comprises the ‘full range of [individual] freedoms’⁵⁷ but that it should nevertheless protect certain fundamental rights.

Much like the definition itself, confusion abounds as to which classification a scholar endorses, arguably due in part to the challenges of adopting such a binary classification to a broad continuum of views. This uncertainty is particularly prevalent when considering a classical liberal view of the rule of law and its role in maintaining the spontaneous orders examined in chapter two. In brief, Hayek endorses the maintenance of the rule of law to both constrain illegitimate government intrusion but also to protect the stability of behaviours necessary for the spontaneous order to emerge. In this regard, it is the equal application of laws that is important. This definition has caused scholars such as Tamanaha⁵⁸ to argue that Hayek endorses a thin conception of the rule of law. In doing so, this label is used in a pejorative sense, claiming that Hayek’s conception of the rule of law had no regard to the substantive aims of the law. Indeed, a liberal interpretation of the rule of law is commonly argued to be ‘substantially procedural in bent.’⁵⁹

However, this claim both misunderstands the classical liberal view of the rule of law and illustrates the difficulty in the limited classification of thick and thin definitions. Indeed, moving from this stark classification, May acknowledges that Hayek adopts an ‘essentially’ thin conception, whilst nevertheless accepting that Hayek advocated that the rule of law has some substantive content and promoted equality as an essential

⁵⁵ Ronald Dworkin, *A Matter of Principle*, (Harvard University Press 1985), 12.

⁵⁶ Bingham (n 29), 76.

⁵⁷ *Ibid.*

⁵⁸ Tamanaha (n 12), 94.

⁵⁹ *Ibid.*, 41.

characteristic.⁶⁰ If we look at what Hayek actually claimed, he argued that the law should be indifferent to ends, that it operated to guide behaviour rather than to dictate it.⁶¹ This is in stark contrast to commands or orders, which constrain people's freedom and tell them how to act. This perspective does not endorse a view that the law can impose whatever it pleases, provided it complies with certain procedural demands. Rather, whilst the rule of law acts as a constraint on government power it also exists 'as the governing opinion about the attributes good laws should possess.'⁶² Thus, the classical liberal conception of the rule of law belies the traditional interpretation of a 'thin' view of the rule of law, demanding that it perform a more substantive role, one that is discussed further in the following section.

PART TWO: CONSTRAINING 'LAWFUL' CONDUCT: EQUALITY AS A META-RULE

The challenge with claims to constrain creative compliance is that these are claims to constrain seemingly lawful conduct. Therefore, the immediate challenge that such proposals meet is to identify the basis on which such constraint is legitimate. Chapter two identified the harm that creative compliance caused, predicated on the consequences of undermining the rule of law. This part builds on that analysis by considering the relationship, and interplay, between the principle of equality and substantive regulation.

⁶⁰ May (n 9), 41.

⁶¹ Hayek, *The Meaning of Government Interference* (n 44).

⁶² Hayek, *The Market and Other Orders* (n 43), 155, rejecting the argument that the rule of law meant mere legality.

As part one explained, the rule of law protects the principle that it is only as the servants of law, not men, that a citizen can be free.⁶³ Moreover, that such laws must be applied equally to all, without discrimination or discretion. The function of the rule of law, eschewing a thin conception of the doctrine, does not simply require legality of regulation (although it presupposes this) but demands that such regulation when applied meets certain standards. Namely, standards that constrain the exercise of coercion and protect the principle of equality.⁶⁴ In this way, the requirement for the equal application of law is not a positive rule (which would be capable of repeal) but a standard that other rules are required to meet. It is, in effect, a rule about what the law, and the exercise of power, ought to be,⁶⁵ that is a ‘meta-legal principle’⁶⁶ that binds other legal rules.

Understanding equality (as defined) in this way is crucial as it defines how we should engage with its principles and our obligations as citizens to them. Seen in this way, the equal application of law is a meta-norm or, more precisely, a ‘regulatory meta-norm.’⁶⁷ That is, it is an overriding principle that ‘governs how agents are to conduct themselves with respect to the system’s ‘primary’ norms,’⁶⁸ with the primary norm being the underlying regulatory requirement. Understood in this way, the principle of the equal application of laws is a norm that tells a legal subject how they should comply with a regulatory provision.

The relationship between the primary norm and meta-norm can be better understood by looking at an example. When considering tax regulation, the primary norm (statutory provision) might stipulate that a corporation should pay tax on any capital gain. The

⁶³ Marcus Tullius Cicero, *Pro Cluentio* 53.146 ‘The Magistrates who administer the law, the jurors who interpret it – all of us in short – obey the law to the end that we may be free,’ cited in: Hayek, *The Constitution of Liberty* (n 6), 146.

⁶⁴ *Ibid.*, 180-181.

⁶⁵ Friedrich Hayek, ‘Freedom and the Rule of Law, (1956), Box 107, Friedrich A. von Hayek, Hoover Institution Archives.

⁶⁶ Hayek, *The Rise and Decline of the Rule of Law* (n 7).

⁶⁷ Mitchell Berman, ‘Cheating, Loopholing and Metanorms’ (forthcoming), 25.

⁶⁸ *Ibid.*

meta-norm stipulates that the subject must comply with the primary norm in a way that ensures the equal application of laws (put another way, compliance with the spirit of the law). On the face of it, the meta-norm seems otiose; it is not adding anything to the underlying rule.⁶⁹ However, this is not strictly the case. The underlying rule does not prohibit its own violation; it simply sets out a sanction for so doing (contributing to the law-as-price approach to compliance).⁷⁰ It is the meta-norm that provides normative force for complying with the spirit of the primary norm.⁷¹ Recognised in this way, the rule of law helps us to understand why we find lawful, yet creative, compliance to be so egregious. That is, whilst creative compliance might comply with the strict letter of the law (or, in this example, the primary norm requiring the payment of capital gains tax), it clearly contravenes the requirement of the meta-norm that laws be applied equally to all.

This analysis also helps to identify a particular challenge with enforcing the principle of equality. That is, unlike a breach of the primary norm, a breach of the meta-norm is not always easily identifiable.⁷² Thus, whilst it is relatively easy to identify non-compliance (a failure to pay taxes) it is difficult to expose creative compliance (an intra-group transfer at an artificial loss).⁷³ We are commonly able to identify, to pursue, the breach of the primary norm. In contrast, a breach of the meta-norm can evade discovery,

⁶⁹ Ibid, 26.

⁷⁰ On which see: Cynthia Williams, 'Corporate Compliance with the Law in the Era of Efficiency,' (1997) 76 North Carolina Law Review 1265.

⁷¹ The challenge is how to instrumentalise this meta-norm, which is considered in chapter six.

⁷² This is also a point that Akerloff and Shiller recognise, that in complex societies 'sharp' practice is not always immediately identified and communicated, see: George Akerlof and Robert Shiller, *Animal Spirits: How Human Psychology Drives the Economy and Why it Matters for Global Capitalism*, (Princeton University Press 2009), 27-39.

⁷³ Isenbergh provides a simplistic but instructive example that can be applied when considering the primary norm and meta-norm distinction. A breach of the primary norm and the meta-norm is the difference between buying a dog and calling it a cow (to avail oneself of a farming subsidy) and being wealthy enough to buy cows that you would not otherwise need and do not otherwise intend to farm to gain the benefit of the farming subsidy. See: Joseph Isenbergh, *Musings on Form and Substance in Taxation*, (1982) 49 University of Chicago Law Review 859, 865. Of note, are historic distinctions between tax evasion and tax avoidance, with the latter being taken in 'good faith' defined, *inter alia*, to mean that such structures were taken 'openly and without pretense.' On this see: John Sears, *Effective and Lawful Avoidance of Taxes*, (1921) 8(2) Virginia Law Review 77, 84.

leading both to an inability to enforce,⁷⁴ which is in itself a problem, but also to the existence of the prisoners' dilemma discussed in respect of the compliance degeneration cycle in chapter one. As other actors anticipate this breach of the meta-norm, they do not know the extent to which it has been breached. Therefore in an attempt to put themselves in the same position as other market participants they must estimate what others have done, leading to a cycle of approximation and overestimation as to the normative breach and, as a consequence, the normative wrong.⁷⁵

Understanding equality as a meta-norm also serves a helpful purpose when looking at the need to 'fill the gaps' that are inevitably left by legislation. It is simply not possible for regulation to address every iteration of the issues, facts or challenges that may arise. It is always necessary for both a legal subject and, in the event of dispute, the judiciary to fill the gaps that remain. If we are able to reinforce equality as a meta-norm, to embed it as part of wider corporate culture, this serves as an overarching reference point, performing a normative ordering function⁷⁶ for legal subjects deciding how such gaps should be filled. To fill such gaps in this way is to do so within a common and legitimate boundary that applies to all subjects.

If the equal application of laws is a meta-rule, the question that arises is whether it creates a political obligation,⁷⁷ namely a moral duty, for corporations to comply with (or maintain) its principles. That is, does maintaining equality (in this case, through

⁷⁴ In a topical example we can see this with the recent disclosure of papers from the Panamanian law firm of Mossack Fonseca. These papers, if substantiated, reflect widespread tax avoidance and potentially evasion. Nevertheless, without the privacy breach that resulted in the publication of otherwise legally privileged documents, these are structures that we would not have been able to interrogate as, ostensibly, they reflect legitimate and lawful overseas incorporations.

⁷⁵ In this way, we see similar behaviour to that of the rationalisation, and over-rationalisation of general ethical breaches discussed in chapter one, part two, section three.

⁷⁶ On which see: Charles O'Reilly, 'Corporations, Culture, and Commitment: Motivation and Social Control in Organizations,' (1989) *California Management Review* 31(4), 12.

⁷⁷ Note that political obligation is utilised to reflect the broader, moral obligation, to that of a legal obligation. One has a legal obligation, that is, an obligation to obey the law only if they consider themselves under a moral, namely political, obligation to do so.

constraining creative compliance) become, effectively, mandatory such that non-compliance results in social judgment and, potentially, censure or sanction? Put another way, does this meta-norm have a right of obedience?

PART THREE: A CORPORATE OBLIGATION TO MAINTAIN EQUALITY BEFORE THE LAW?

The rule of law developed as a constraint on ‘the uninhibited exercise of government power,’⁷⁸ a device to militate against the risk of arbitrary authority. As such, it is commonly viewed as ‘expressive of how the state ought to behave towards individuals.’⁷⁹ More than that, there are consequences if state actors act contrary to the rule of law.⁸⁰ The question that this thesis raises is different. It looks not to the state but to citizens to ask whether corporate citizens are under a moral obligation (or duty) to not simply obey the rule of law but to maintain its principles? In particular, is there a basis on which to argue that corporations should constrain their ability to creatively comply so as to protect the equal application of law? This part answers this question in the affirmative by considering two claims. The first, and easier, being a familiar consent-based claim, premised on social contract arguments. The second looks to the obligation that a corporation has, unlike its natural counterparts, to maintain the integrity of the legal and social systems that it operates within and depends upon.

In the case of the individual citizen, a claim to be legitimately bound by (although not necessarily obliged to maintain) the law is traditionally premised on the notion of consent. Returning to a social contract argument,⁸¹ individuals have agreed to be bound

⁷⁸ Paul Craig, Select Committee on the Constitution, *Relations Between the Executive, the Judiciary and Parliament: Report With Evidence, 6th Report of Session 2006-07* (HL 2006, 151-I) 97, 101.

⁷⁹ Ibid.

⁸⁰ For example, judicial review.

⁸¹ As discussed in part one.

by the law (including, as argued in part two, the rule of law) as consideration for participation in civil society. Such an argument is, clearly, not without its difficulties. When can consent be revoked? Are there limits to what an individual can consent to? What about those deemed unfit or unable to consent? In particular, and aside from each of these questions, absent express consent, on what basis can we legitimately assert that an individual has agreed to be so bound?

Advocates of a consent-based model answer this last question by arguing that consent to this bargain is (tacitly) evidenced through participation in civil society. For example, by voting⁸² or, recognising that many individuals do not exercise such right, through tacit consent either by ongoing residence in a jurisdiction or notions of fair play (by availing themselves of the benefit of such society).⁸³ These arguments are not without their (significant) criticisms, most notably the reality of whether an individual can, realistically, have a choice about participation in, and therefore consent to, civil society.⁸⁴ Indeed, David Hume suggested that the claim that merely continuing to reside in your country of birth as consent to its system of laws was akin to saying that a sleeping person who had been carried onto a ship without their consent or knowledge had consented to being there if they remained on the vessel rather than jumping overboard to escape.⁸⁵

For the corporation, and particularly a large public company, this consent-based claim is, arguably, much easier to maintain. Unlike a natural person, a choice is made to incorporate. This choice does not extend simply to the decision to incorporate but, moreover, as to the jurisdiction of incorporation (potentially choosing to incorporate in

⁸² Peter Steinberger, *The Idea of the State*, (Cambridge University Press, 2014), 218-220.

⁸³ H. L. A. Hart, 'Are There Any Natural Rights?' (1955) 64(2) *Philosophy Review* 175, 185.

⁸⁴ See: Ronald Dworkin, *Justice for Hedgehogs*, (Harvard University Press 2011) chapter 14; John Simmons, *Moral Principles and Political Obligations* (Princeton University Press 1979) chapters 3 and 4.

⁸⁵ David Hume, 'Of the Original Contract,' in Knud Haakonssen (ed.) *Hume Political Essays* (Cambridge University Press 2006), 193.

multiple jurisdictions). In doing so, the original promoters elect (in full knowledge) the legal system that will apply to both the creation of the corporation and its ongoing operations. Thereafter, subsequent shareholders and officers choose to invest in, or work for, the corporation. Again, in full knowledge of the legal system and institutions that will apply. Furthermore, the corporation is much more geographically mobile than an individual. It can move jurisdictions in a number of ways. For example, by incorporating a subsidiary and transferring its assets to that entity (or, in some jurisdictions, via a merger), whilst choosing whether to notionally remain incorporated in the original jurisdiction or simply to wind up the original organisation. In this way, it is much easier to engage an express, consent-based, argument that the corporation is bound by the rule of law, without the need to engage in the somewhat contrived analysis as to tacit or implied consent that is required when considering natural citizens.

Nevertheless, the relative ease with applying a consent-based argument to corporations, although important, still leaves interpretive questions to be answered.⁸⁶ For example, consent to what? We have seen in part one that the definition of equality before the law is, itself, a developing concept. That it reflects the norms of the time. The risk with a purely consent based approach to obligation more generally is determining what it is that one consents to, how this is interpreted and whether this definition is temporally limited. These questions are exacerbated when looking at juridical persons who exist potentially in perpetuity. Moreover, it is difficult to assert that the law that applies to a citizen is only that which they acknowledge as law.⁸⁷ Given that a fundamental rationale for the rule of law (particularly within a classical liberal paradigm) is that of predictability of behaviour it cannot be right that citizens (especially significant economic actors such as the corporation) are able to simply consent to be being bound

⁸⁶ Indeed this was a question posed by Dworkin in respect of a similar rationale to state consent to international law. See: Ronald Dworkin, 'A New Philosophy for International Law,' (2013) 41(1) *Philosophy and Public Affairs* 2, 8.

⁸⁷ *Ibid*, 9.

and, by extension, able to withdraw such consent on their own volition. As a consequence, there is a need for a more resilient explanation as to why a corporation is not only bound by the rule of law but should be, irrevocably, obliged to maintain its principles.⁸⁸

The rule of law provides a narrative, a framework of expectations that everyone relies on. More than that, this chapter has explored the role of the equal application of laws as a meta-rule that governs a citizen's compliance standards with the underlying legislative requirement. If complied with, this meta-rule provides all citizens with the 'confidence that the law will underpin both sides' actions equally.'⁸⁹ This part has then explored how a corporation's coercive power further justifies a moral duty to maintain that meta-rule (by refraining from creative compliance) as part of its general obligation to maintain the legitimacy of both its own power and that of the system that it operates within, and imposes upon, those over whom it exercises dominion. However, one question remains to be answered, which is considered in the following section. That is, how do we align this moral duty with the earlier, formal, definition of equality?

PART FOUR: INEQUALITY AND LEGAL PRIVILEGE

Part two argued that 'equality' in the context of the rule of law should mean formal equality, that the requirement of the rule of law was that laws should apply equally, regardless of the material outcome. However, against this, part three suggested that corporations should be under an obligation to maintain the rule of law by restraining from engaging in the creative compliance practices that undermine it. These two assertions seem to be paradoxical, with the claim in part three seemingly endorsing a material or substantive definition of equality. This part addresses this apparent conflict,

⁸⁸ Ibid, 10.

⁸⁹ May (n 9), 130.

by exploring legal privilege (defined below) as the basis on which an exception to formal equality can be made.

Throughout its development, advocates of the rule of law have been clear that one of its objectives is to militate against privilege (used in this context to mean an exception from equality before the law, such that the law does not apply equally, either in theory or in effect).⁹⁰ Indeed, the very genesis of the principle of equality is that all citizens, regardless of rank or status, are equal before the law, such that the rule of law and special privilege are irreconcilable.⁹¹ Equality demands that citizens are subjected to, and comply with, rules that ‘must be observed ... for the possibility of order in a free society.’⁹² It is within this paradigm that we see, consistently, arguments levied against legal privilege⁹³ and, as a corollary, that the existence of such privilege is the one basis on which we can justify deviation from a formal definition of equality. That is, whilst it is contrary to the rule of law to use arbitrary distinctions to deviate from the principle of equality,⁹⁴ where the law itself creates a privilege (that enables a citizen to undermine the rule of law) then it is legitimate to depart from a formal definition of equality to restore equilibrium. Put another way, the law can treat citizens in a prima facie unequal manner to ensure ‘that laws [are] equal in operation.’⁹⁵

Notionally, all legal subjects can creatively comply, suggesting that it does not constitute a legal privilege as defined. However, as chapter one explained, it is a practice that is predominantly adopted by large multinational organisations indicating that there are characteristics unique to the corporation that encourage or facilitate such

⁹⁰ Hayek, *The Meaning of Government Interference* (n 44), 3

⁹¹ Friedrich Hayek, ‘The Muddle of the Middle,’ (undated), Box 131, Friedrich A. von Hayek Papers, Hoover Institution Archives.

⁹² Hayek, *The Meaning of Government Interference* (n 44), 4.

⁹³ Bingham (n 29), 73–75.

⁹⁴ *Ibid*, 73.

⁹⁵ *Railway Express Agency Inc v New York* 336 US 106, 112-113 (1949).

compliance standards.⁹⁶ To understand whether a corporation's ability to creatively comply constitutes, or is the product of, a legal privilege it is instructive to recall the 'Double Irish Dutch Sandwich' structure that was outlined in part one of chapter one (and which is typical of many aggressive tax structures). The structure is dependent on the existence of multiple subsidiaries in different jurisdictions (three as a minimum: Ireland, the Netherlands and a 'tax haven' such as Bermuda). Therefore, from a basic structural perspective the scheme necessitates the existence of multiple entities (each constituting a separate legal personality), which can operate in multiple jurisdictions at any one point in time (yet still be controlled, and the benefits accrue, to the same parent entity). This ability for a single group to comprise of multiple personalities in multiple territories is a uniquely corporate ability,⁹⁷ one that is not available to natural citizens *qua* natural citizen.⁹⁸

Beyond this structural ability to creatively comply, the corporation also facilitates, in two key ways, the necessary risk profile to implement such aggressive structures. First, the combination of separate legal personality and limited liability⁹⁹ operate to isolate and restrict the level of risk associated with a particular tax structure, should it subsequently be disallowed. In doing so, these principles enable a group to limit their exposure in the event a structure fails (that is, the tax benefit is denied), reducing the risk (and therefore increasing the likelihood) of implementing an 'abusive' transaction in the first instance. In contrast, an individual implementing a high-risk strategy risks their entire asset base in the event of failure. Secondly, for reasons explored in more detail in chapter five the corporate form enables individuals within the corporation to

⁹⁶ Gammie similarly recognizes the inequality of ability to creatively comply within society. See: Malcolm Gammie, 'Moral Taxation, Immoral Avoidance – What Role for the Law,' (2013) *British Tax Review* 577, 581.

⁹⁷ *Salomon v Salomon & Co Ltd* [1897] AC 22.

⁹⁸ Clearly individuals can, and do, incorporate entities to achieve such benefits (see for example Philip Green and the Arcadia group or Richard Branson and Virgin). However, in so doing it is the corporate form that enables them to do this for the reasons outlined in this part.

⁹⁹ Discussed in more detail in chapter five, part one.

implement riskier strategies than they may otherwise do if acting in their own capacity. In essence, an individual is able to distance themselves from the potential 'ethical' questions of their conduct, outsourcing that moral responsibility to the fact that the conduct in question is in fact that of the corporation and not of them personally. Once the decision to implement the structure has been made, and as chapter one outlined, individuals within the corporation are then likely to engage in a process of rationalisation to reduce any cognitive dissonance that they may otherwise feel as a result of the decision to creatively comply in this way.

One final, but not insignificant, point is that it is commonly (although not exclusively) the corporate group that has the requisite resources to obtain the professional advice need to implement such structures. Tax structuring requires the implementation of highly complex structures that require the execution of, often, many hundreds of documents across multiple jurisdictions. This necessitates the advice of tax specialists (to design the structure), solicitors in each jurisdiction to prepare the necessary documentation and, with regard to particularly high-risk transactions, the opinion of counsel to 'bless' the structure as a whole. Depending on the value of the structure to the corporation, these professional fees, in aggregate, will as a minimum amount to several hundred thousand pounds. The ability to pay for these fees is made possible by the corporate characteristics that are specifically intended to facilitate commerce and economic prosperity. That is, the principles of separate personality and limited liability (together with the associated benefits of dispersed ownership, transferable equity and board management that have enabled the corporation to become such a significant economic actor).¹⁰⁰ In contrast, most individuals, even those with a relatively high net worth, would not have the resources necessary (even if it were structurally possible) to

¹⁰⁰ For example, the corporate characteristics discussed in: Kraakman, Armour *et al*, *The Anatomy of Corporate Law, A Comparative and Functional Approach* (2nd edn, Oxford University Press 2009), 1-18.

implement such complex tax arrangements (beyond, for example, fairly standard family trusts).

We thus see that there are a number of statutory provisions that have the effect of imparting a privilege on the corporation, namely the extraordinary capacity to creatively comply. It is this ability to creatively comply that undermines the principle of equality (rather than the existence of separate personality and limited liability *per se*) as it enables corporations to undermine the principle of equality through creative compliance (in a way that both their natural counterparts, and smaller private corporations, simply cannot do). As a consequence, this privilege provides the justification to depart from a formal definition of equality (set out in part one) to the extent necessary to mitigate its impact, namely to maintain the meta-norm of equality. That is, to maintain the equal application of law in operation, not just in theory, by constraining their ability to creatively comply.

CONCLUSION

The rule of law developed as a constraint on, *inter alia*, the legal privilege that had been enjoyed by the government and social elite. In modern civil society it is now large corporations that benefit from such legal privilege, predicated on the unique structural qualities granted by the Companies Act 2006. As previous chapters have demonstrated, this privilege facilitates creatively compliance, which undermines the integrity of the legal and market systems that corporations operate within whilst creating significant fiscal consequences for wider society.

We are thus met with a claim that corporations should comply with the spirit, not simply the letter of the law in order to maintain the principle of equality that they otherwise transgress. However, this is a difficult argument to make. On what basis can

we claim that a problem of inequality is met with a similarly unequal application of compliance standards? This chapter has argued that, *inter alia*, notwithstanding the need for a formal definition of law, the existence of legal privilege justifies a claim that corporations, unlike their fellow citizens who are not so privileged, should be subject to an obligation to maintain the meta-norm of equality.

One benefit of this rule of law analysis is that it helps to define where the boundaries of compliance obligations should fall. Whilst there has been significant demand for spirited compliance and a prohibition of abusive or aggressive tax avoidance there has been no guidance as to ‘where the boundary should be drawn.’¹⁰¹ Applying the meta-rule of equality helps to draw that boundary, namely by delineating the obligation by reference to the need to mitigate this privilege. To ensure equality in operation of the law and thereby maintain the integrity of the legal and market orders.

This chapter concludes the first part of the thesis, which sought to develop a normative case in support of constraints on creative compliance. It did so by examining the relationship between equality and compliance, suggesting that the requirement for the equal application of law, properly understood as a meta-rule of society, imposes an obligation on corporations (as well as the state) to maintain its principles. The following chapters now turn to a more positive enquiry as to why reforming compliance practices has been so challenging to date and, as a corollary, what changes need to be made if we are to instrumentalise such calls for spirited compliance. In starting this analysis, chapter four explores the norms inherent within company law and theory that currently operate to define compliance in narrow and creative terms.

¹⁰¹ Michael Levi, ‘Legitimacy, Crimes and Compliance in ‘the City’: *De Maximis Non Curat Lex?*’ in Justice Tankebe and Alison Liebling (eds.) *Legitimacy and Criminal Justice, an International Exploration* (Oxford University Press 2013), 163.

CHAPTER FOUR

CONSTRUCTING COMPLIANCE: CORPORATE NORMS AND PROFESSIONAL ADVICE

*'All other things equal, most [business people] would unhesitatingly choose the high road. But, except in hypothetical situations, all other things are never equal. And we often see that factors with more motivational punch – sales quotas, corporate financial health and survival, competitive concerns, career advancement – outweigh ethical choices in business decisions.'*¹

INTRODUCTION

The previous chapters sought to demonstrate the very clear and functional harm that creative compliance can cause to society. In particular, they have explained how creative compliance is detrimental to corporate interests by threatening the social orders, including the market order, which corporations themselves depend upon.² However, this analysis raises one immediate query. That is, if creative compliance is this damaging, why is it a practice that so many corporations engage in? To answer this question is to understand how and why corporations define compliance in the way that they do. In particular, what is it about the corporate environment specifically that seems to endorse this approach? Put simply, why do corporations consider it legitimate to creatively comply with legislation and how has this perspective arisen?³

¹ Robert B. Cialdini, 'Social Influence and the Triple Tumor Structure of Organizational Dishonesty' in David M. Messick and Ann E. Tenbrunsel (eds.) *Codes of Conduct: Behavioral Research into Business Ethics* (Russell Sage Foundation 1996), 51.

² In the short term, ongoing technical compliance is likely to result in further *ad hoc* legislation, increasing compliance costs to the corporate community.

³ Traditionally, this was explained by reference to a purely economic model. However, as chapter one explained it is, in fact, legitimacy that is a greater driver of compliance behaviour (which itself may well incorporate economic considerations). See also: Michael Wenzel, 'The Social Side of Sanctions: Personal and Social Norms as Moderators of Deterrence,' (2004) 28(5) *Law and Human Behavior* 547, 547.

In responding to this question, this chapter examines compliance as a social construct.⁴ That is, it explores the normative environment that corporations operate within to identify how such norms become institutionalised, shaping (and thereafter legitimising) the way in which corporations define compliance.⁵ In particular, it focuses on the norms inherent within the corporate law and governance framework to understand the extent to which the ‘rules of the game’ contribute to the compliance standards that regulation such as the GAAR is now seeking to constrain.⁶ By adopting this approach, the chapter is able to distil how these norms not only legitimise creative compliance but also act as a powerful impediment to regulatory reform. Specifically, the chapter explains how the expressive function of law is such that the apparent endorsement of a shareholder wealth maximisation norm by the Companies Act 2006 is perceived to legitimise a singular profit focus and, as a consequence, the compliance behaviours that align with it. This legitimacy is then further entrenched by legal advice, provided by officers of the court, which similarly endorses a narrow view of, for example, section 172 of the Companies Act 2006. In doing so, this chapter starts to identify where mitigating action is needed in order to preserve fundamental principles of corporate law whilst nevertheless successfully encouraging a broader definition of compliance that supports the effective implementation of the GAAR.

In undertaking this enquiry, the chapter proceeds as follows. Part one briefly examines ‘compliance’ as a social construct. That is, it explains the process by which corporations define compliance and how this interpretive exercise is the product of their normative environment.⁷ In doing so, this enquiry also explains how creative

⁴ On social constructivism more generally, see: Peter L. Berger and Thomas Luckmann, *The Social Construction of Reality, A Treatise in the Sociology of Knowledge*, (Anchor Books 1966).

⁵ Christine M. Korsgaard, *The Sources of Normativity*, (Cambridge University Press, 1996), 8-9.

⁶ On the impact of, and interrelation between, social norms and corporate law more generally, see: Melvin A. Eisenberg, ‘Corporate Law and Social Norms,’ (1999) 99 *Columbia Law Review* 1253.

⁷ Lauren B. Edelman and Shauhin A. Talesh, ‘To Comply or Not to Comply – That isn’t the Question: How Organizations Construct the Meaning of Compliance,’ in Christine Parker and

compliance becomes institutionalised, effectively setting a normative standard for the whole corporate community (including, as shall be seen in part four, their legal advisers). It is this standard that then creates the threshold against which behaviours are judged (and legitimised), operating to resist behavioural claims, such as those made by the GAAR, which do not conform with these institutionalised norms.

Having established the process of defining compliance and its interplay with a corporation's normative environment, part two then explores the role of norms in decision making more fully. It considers how norms are developed and the ways in which they act as a constraint on behaviour. In exploring the difference between descriptive and injunctive norms, this part suggests that the successful implementation of a new injunctive norm (such as the GAAR) will be severely curtailed whilst attempting to embed it within an environment that enshrines a conflicting descriptive norm (such as unfettered wealth maximisation). This part also introduces the interplay between norms and shame, examining how the shame of transgressing a norm acts as a powerful *ex ante* restraint on individual behaviour. As a consequence, we start to see that whilst norms can legitimise and facilitate behaviour within the corporate community it is more challenging to engage them to constrain 'undesirable' conduct. That is, it is generally not possible to engage shame (the usual sanction for a breach of a social norm) in respect of a juridical entity (such as the corporation), which does not feel shame in the same way that a natural citizen does.⁸ Rather, to inculcate a new injunctive norm it is necessary to engage alternative techniques to do so, an understanding that informs the proposals set out in chapter six.

Vibeke Lehmann Nielsen (eds) *Explaining Compliance Business Responses to Regulation* (Edward Elgar 2011), 103.

⁸ A corporation is at some point concerned with the reputational damage that a normative breach may give rise to. However, this essentially financial concern operates in a very different way to individual shame.

Following this enquiry into the role of norms in decision-making, part three examines what corporate norms exist and how these are created. It considers the expressive function of law to understand the role that legislation plays in introducing, or reinforcing, social norms.⁹ From a corporate perspective, we see that the company law framework promotes (in a number of ways) a homogenous wealth maximising norm, the prevalence of which is such that it takes on a particularly symbolic (or expressive) force.¹⁰ Drawing on the analysis in part two, we see that this dominant norm serves to legitimise creative compliance whilst undermining the credibility (or legitimacy) of demands for constraint. As such, we start to see how the regulatory environment itself can operate to inhibit the behavioural change that the GAAR is now demanding.

Part four concludes the substantive parts of the chapter by examining how this wealth maximisation norm is further embedded within the corporate decision-making framework as a consequence of the legal advice that they receive. This advice, adopting an expressive function itself (given that it is provided by officers of the court), is not immune from the norms of the corporate environment that it is provided in. As a consequence, corporate counsel are similarly likely to interpret section 172 of the Companies Act 2006 in a manner that serves the interests of their clients by reinforcing a narrow profit maximising norm. Once initial advice in these terms has been given, lawyers are then at risk of commitment bias, operating to encourage the provision of future advice in the same terms as that which has already been provided. Thus, this unfettered interpretation of the shareholder wealth maximisation norm becomes deeply embedded within the corporate community and is not subject to meaningful challenge, legitimising practices such as creative compliance that align with the norm, whilst rejecting those demands (such as the GAAR) that do not.

⁹ Social norms being those of a group or community. That is an 'effective consensus obligation,' see: Robert Cooter, 'Expressive Law and Economics,' (1998) 27 *Journal of Legal Studies* 585, 587.

¹⁰ As to the expressive function of law, see Sunstein's seminal work: Cass R. Sunstein, 'On the Expressive Function of Law,' (1996) 144 *University of Pennsylvania Law Review* 2021.

It should be made clear from the outset that this chapter does not suggest that directors (or any other individuals acting on the corporation's behalf) consciously engage with a theoretical analysis of the purpose of the firm and then implement creative compliance strategies as these are deemed to align with these conceptual foundations. Rather, this normative analysis seeks to explain how social norms can develop and, moreover, how they coalesce to guide (and thereafter legitimise) certain decisions, such that choices that align with these norms seem 'natural.'¹¹ Indeed, it is the subtlety in how such norms influence behaviour that can make them so powerful, as they intrinsically (and oftentimes subconsciously) inform our sense of right and wrong. This understanding then provides important context against which to consider strategies for reform.

PART ONE: THE CONSTRUCTION AND INSTITUTIONALISATION OF CREATIVE COMPLIANCE

As explained in chapter one, the GAAR adopts a principles-based approach to regulation. Its prohibition on 'abusive' structures does not mandate those steps that a corporation must take to protect against this risk nor does it prescribe a detailed list of the structures that are now prohibited. Rather, it relies on reflexive engagement with its provisions to encourage more meaningful behavioural change and reduce the risk of the technical compliance that would inevitably occur were it more prescriptive. However, it is this (necessary) ambiguity inherent within principles-based regulation, indeed with the term 'compliance' itself, that generates the problem of definition that is considered in this part. That is, such ambiguity necessitates that the corporation, as with all legal

¹¹ David Jancsics, 'Imperatives in Information Organizational Resource Exchange in Central Europe,' (2014) 6(1) *Journal of Eurasian Studies* 59, 62.

subjects, determines for itself what compliance with the GAAR (and indeed other regulatory requirements) means.¹²

This lack of a clear, exogenous, compliance standard has the effect that compliance becomes a social construct.¹³ That is, each legal subject is required to engage in an interpretive exercise to determine the standard of compliance that they are to apply. As with all such definitional tasks, this determination is made in the context of, and informed by, the normative environment that a subject operates within.¹⁴ This environment, comprising of social, commercial and legal norms,¹⁵ creates a subject's 'reality'¹⁶ as to what is right and wrong, as to the standard that is, and ought to be, expected of them. Needless to say, this reality reflects the perspective of the legal subject in question and may well be contrary to the intention of the regulator, as well as the expectations of other citizens that occupy a different normative space.

Applying this normative reality to the question of compliance, we see that an actor, faced with ambiguous regulatory provisions and the equally nebulous need to 'comply' with them, is required to interpret these demands and will do so in accordance with the norms of their immediate community. For the corporation, these norms are generally understood to coalesce around a somewhat homogeneous profit maximising norm. Applying this norm, the corporation adopts a profitable, yet narrow, approach to compliance that allows it to, *inter alia*, implement the tax structures that were outlined in chapter one. The nature of this norm and the relevance of its homogeneity are discussed further in part three. However, for the purpose of this part, what is important

¹² Note that, as discussed further in part four this determination is undertaken not only by the corporation but also their professional advisors.

¹³ Edelman and Talesh, *To Comply or Not to Comply* (n 7), 103.

¹⁴ Laruen B. Edelman, 'Legal Ambiguity and Symbolic Structures: Organizational Mediation of Civil Rights Law,' (1992) 97(6) *American Journal of Sociology* 1531, 1535.

¹⁵ Lauren Edelman, 'Legal Environments and Organizational Governance: The Expansion of Due Process in the American Workplace,' (1990) 95(6) *American Journal of Sociology* 1401, 1403.

¹⁶ Berger and Luckmann (n 4), 19.

is that this norm (and the reality that it creates) entitles the corporation to construe their compliance obligations creatively. Having done so, this standard is then considered to be legitimate as it aligns with normative environment that this dominant profit maximising norm has contributed to. Moreover, once the decision to creatively comply has been made (and been deemed to align with the corporation's normative environment), it can then be repeated by the legal subject. That is, when faced with similar decisions in the future, the corporation can simply adopt a creative compliance strategy, without the need for further thought, as the normative analysis has already been undertaken and applied.¹⁷ In this way, the repetition of the action (or application of the compliance standard) means that the behaviour becomes 'habitual.'¹⁸ That is, the corporation can continue to implement creative compliance standards without the potential psychological discomfort of engaging with further normative analysis.¹⁹

It is this habitualisation of behaviour that then leads to the institutionalisation of creative compliance as a behaviour and norm itself. As other corporate decision-makers observe this conduct, and the benefits that it is perceived to generate,²⁰ they emulate the standard themselves (that is, we see the second stage of the compliance degeneration cycle in action).²¹ It is this emulation that embeds creative compliance across the corporate cohort such that it becomes an accepted norm itself and a legitimate standard of compliance to adopt. It is, in effect, a 'predefined pattern[s] of conduct.'²² The consequences of this institutionalisation are clear. Decisions that align with these patterns of conduct become normatively permissible, and 'take on a rule like status.'²³ Once this institutionalisation has occurred, these norms are 'in some measure beyond

¹⁷ Indeed to repeat the analysis, and come to a different conclusion, would give rise to the cognitive dissonance discussed in chapter one.

¹⁸ Berger and Luckmann (n 4), 51.

¹⁹ Ibid, 52.

²⁰ Namely, the reduction in tax.

²¹ Explained in chapter one, part three.

²² Berger and Luckmann (n 4), 54.

²³ John W. Meyer and Brian Rowan, 'Institutionalized Organizations: Formal Structure as Myth and Ceremony,' (1977) 83(2) *American Journal of Sociology* 340, 341.

the discretion of any individual participant or organization ...[and are]... taken for granted as legitimate.²⁴ As a consequence, corporation decision-makers, influenced by the norms of the corporate environment, and having adopted their own (narrow) definition of compliance, are able to ‘adapt the law to their own interests,’²⁵ effectively creating their own legal standard, rather than be constrained by an exogenous rule that applies to all subjects.²⁶

It is at this juncture that we also see one important consequence of the relatively homogeneous nature of corporate norms. Unlike their natural counterparts (who are arguably situated within a more heterogeneous normative environment) corporations, when judging the actions of fellow corporates, do so against the same set of norms. In this way, these norms are more likely to be accepted, replicated and institutionalised as there is unlikely to be significant normative disagreement.

Understanding the process of defining compliance, and the influence of context on this construction,²⁷ further explicates where reform is needed if we are to change corporate compliance practices. It makes it clear that to effectively reform compliance behaviour requires an understanding of the norms that motivate compliance (or otherwise). In particular, it reinforces the claim in chapter one that enhancing compliance standards cannot be limited to, or rely upon, the traditional deterrence (or sanctions-based) model.²⁸ For the reasons discussed in chapter one, we are never going to fully eliminate the ambiguity inherent in regulation (and nor would we want to). Therefore, what is needed is an understanding of how the corporate normative environment is constructed and how we can mitigate the impact of such norms where relevant (this latter endeavour

²⁴ Ibid 344.

²⁵ Edelman, *Legal Ambiguity* (n 14), 1534-1535.

²⁶ Edelman and Tatesh, *To comply or Not to Comply* (n 7), 103.

²⁷ Cass R. Sunstein, ‘Social Norms and Social Roles’ (1996) 96(4) *Columbia Law Review* 903, 913.

²⁸ Benno Torgler, ‘Speaking to Theorists and Searching for Facts: Tax Morale and Tax Compliance in Experiments, (2002) 16(5) *Journal of Economic Surveys* 657, 662.

is considered in chapter six). To do so, part two explores the nature and influence of norms more generally before part three looks at corporate norms specifically.

PART TWO: THE MEANING AND INFLUENCE OF NORMS

To understand how we can either influence, or ameliorate the impact of, potentially harmful norms it is necessary to understand more fully what these norms are and how they are able to exert such a powerful influence over the citizens that are subject to them.²⁹ This part explores the behavioural impact of both descriptive and injunctive norms, examining how the existence of unequivocal descriptive norms can serve to inhibit the introduction of potentially conflicting injunctive norms. In doing so, this part provides the conceptual foundations for part three, which then explores how these principles operate within the specific corporate environment. Namely, how the predominance of a wealth maximising norm across corporate law and governance can preclude the successful adoption of the GAAR.

(i) Defining 'norms'

As a preliminary matter it is necessary to consider what is meant in this context by a 'norm.' In brief, and as intimated in part one, a 'norm' operates in one of two key ways, although both serve to express 'social attitudes of approval or disapproval.'³⁰ That is, norms both explain a citizen's conduct (namely, how does behaviour appear to a third person) whilst also serving to answer the question, posed from a first person

²⁹ Note that the ethics of 'nudge,' which is a vast and extant literature, is outside of the scope of this work. See: Luc Bovens, 'The Ethics of Nudge,' in *Preference Change: Approaches from Philosophy, Economics and Psychology*, in Till Grüne-Yanoff and Sven Ove Hansson (eds.) (Springer 2010), 207-220.

³⁰ Sunstein, *Social Norms and Social Roles* (n 27), 914.

perspective, why is it that I ought to act in the way in which you are asking?³¹ In this way norms can be both descriptive (what is) and injunctive (what ought to be).³²

The difference between these two definitions is instructive in terms of understanding behavioural choices. The descriptive norm ‘describes what is normal’³³ and reflects what ‘most people do.’³⁴ In short, a descriptive norm explains (or indicates) what conduct has occurred and, therefore, by extension, what conduct is considered permissible within that particular environment.³⁵ As a consequence, descriptive norms motivate the behaviours of others as the observed actions of a community (like all actions) perform an expressive function, they communicate the norms and attitudes of the environment in question. Moreover, relying on a descriptive norm is cognitively attractive to a third party. It reduces the analysis (and therefore potential dissonance) that is otherwise required by that third party when seeking to determine what course of conduct to pursue.³⁶ Rather than undertake their own normative analysis, an individual can effectively outsource this (potentially challenging) exercise by replicating the conduct of others and relying on their determination instead. It is in this way that we also see the institutionalisation of norms and behaviours that were discussed in part one.

In contrast, although clearly related,³⁷ the injunctive norm describes what *ought* to be done (as opposed to what *is* done). It is this aspect of the normative environment that we are more commonly familiar with in wider discourse. That is, within the relevant community, what is considered the right course of conduct to adopt? What attitude do we want to convey, do we think should be expressed? It is commonly the injunctive

³¹ Korsgaard, (n 5), 16.

³² Robert B. Cialdini, Raymond R. Reno and Karl A. Kallgren, ‘A Focus Theory of Normative Conduct: Recycling the Concept of Norms to Reduce Littering in Public Places,’ (1990) 58(6) *Journal of Personality and Social Psychology* 1015-1026, 1015.

³³ *Ibid*, 1015.

³⁴ *Ibid*.

³⁵ Sunstein, *Social Norms and Social Roles* (n 27), 917.

³⁶ Cialdini *et al* (n 32), 1015.

³⁷ As behavior that we consider we ought to adopt is often behavior that we do adopt (*Ibid.*)

norm that engages social sanctions when breached,³⁸ in particular the potential judgment of a citizen's wider community (and, as we have seen with recent corporate scandals, those outwith the community). For individuals, it is typically a breach of the injunctive norm that gives rise to corresponding feelings of shame, which is discussed further in section two.

Importantly, norms are not always as entrenched as we might think. Given that our understanding of what we ought to do is the product of our social context, it stands that by changing the norms that influence this context we can change a citizen's perception of right and wrong. It is for this reason that we have witnessed significant (and often quite quick) attitude changes towards, for example, smoking in public places, equal suffrage and the protection of marriage rights for all.³⁹ It is this ability to alter social norms, predicated in part on legislative reform, which facilitates successful policy change.⁴⁰ However, the caveat to this ability of law to implement change, which is discussed further in part three, is that such normative change needs to align across the regulatory framework. For example, if the proposed policy change conflicts with the existing norms inherent within corporate legislation then the likelihood of success is diminished (as, *inter alia*, its legitimacy is undermined).

(ii) The psychological function of norms

The importance of norms, particularly injunctive norms, is that they operate as more than mere ethical ideals. Rather, they make a claim on our behaviour and suggest that we ought to act in a certain manner.⁴¹ Their influence is such that we respond to them

³⁸ Ibid.

³⁹ The speed of this change is attributable to what Sunstein describes as a 'norm cascade,' see: Sunstein, Expressive Function (n 10), 2033.

⁴⁰ Sunstein, Social Norms and Social Roles (n 27), 910.

⁴¹ Korsgaard (n 5), 8.

in both ‘practical and psychological ways.’⁴² Practically, they serve to actually guide our behaviour, we act in accordance with what we think is right, or refrain from that action that we think is wrong. In this way, most people do not commit acts of violence, not because it is unlawful, but because they inherently consider it morally wrong. In contrast, we might ensure that we maintain our property in good condition (notwithstanding that there is no legal mandate to do so) as we think it is the right thing to do to enhance or preserve the character of our neighbourhood. Importantly, this last example also alludes to another power of social (in contrast to personal) norms. That is, we may keep our property in good order, not because we personally think it is the right thing to do, but because we fear the judgment of our neighbours if we do not. It is here that we see the psychological impact of norms.

Psychologically, norms serve to facilitate judgment, both of others and ourselves. Norms provide the framework in which we judge that conduct.⁴³ For example, wearing a tracksuit to the gym would be considered completely acceptable, whereas to do so to a wedding is likely to result in the judgment of others. If an individual transgresses a norm, it shapes our interaction with them. We may judge them silently, express our dissatisfaction or, ultimately, even shun them from our social community.⁴⁴ It is this fear of social sanction, of shame when a norm is violated,⁴⁵ that operates as a powerful *ex ante* constraint on individual conduct.⁴⁶ Returning to the earlier example, we may look after our property, indeed incur expense in the process, even if we do not have a strong personal desire to maintain our house in this way. However, it is the fear of sanction from our immediate community that is a sufficient motivation for us to take action.

⁴² Ibid, 11.

⁴³ Sunstein, Expressive Function (n 10), 2032.

⁴⁴ Korsgaard, (n 5), 11.

⁴⁵ Sunstein, Social Norms and Social Roles (n 27), 909.

⁴⁶ Sunstein, Expressive Function (n 10), 2030.

It is this role of social judgment that suggests that the inculcation of shame is an effective mechanism for governments to utilise when seeking to change citizens' behaviour.⁴⁷ Indeed, this is often the case with individual citizens. However, the difficulty in utilising shame to control corporate behaviour is clear. First, shame as a sanction is most effective in 'close-knit communities'⁴⁸ as this is where the reputational impact of shame will be felt most acutely. However, this is not an environment that large public corporations traditionally operate within. Examples of significant corporate normative (not least legal) transgressions abound. From human rights abuses to bribery,⁴⁹ numerous examples exist that demonstrate a lack of *ex ante* control that the risk of reputational damage has on corporate decision-making.⁵⁰ Thus, whilst authors such as Skeel outline the 'tangible ways'⁵¹ in which a corporate norm violation can be punished, for example by 'investors refusing to buy their stock ... and consumers may avoid their product,'⁵² we have seen, repeatedly, in practice that this is not often the case. For example, the continued success of Nike, notwithstanding initial consumer outrage at their production practices.⁵³

⁴⁷ Sunstein, *Social Norms and Social Roles* (n 27), 8. Although shaming is not without its critics, for example the risk of shaming being 'too' effective, creating a 'sub-culture' of those who have been shamed who are then unable to reintegrate into society. See: John Braithwaite, *Crime, Shame and Reintegration* (Cambridge University Press 1989), 54-68. Also, the risk that shaming does not operate equally across all offenders, see: Toni M. Massaro, 'Shame, Culture and American Criminal Law,' (1991) 89 *Michigan Law Review* 1880, 1896. For a summary of common criticisms of shaming, see: David A. Skeel Jr., 'Shaming in Corporate Law,' (2001) 149(6) *University of Pennsylvania Law Review* 1811, 1817-1819.

⁴⁸ Skeel (n 47), 1811.

⁴⁹ For example, the human rights violations of retailers such as Gap: Gethin Chamberlain, 'Gap, M&S and Next in New Sweatshop Scandal,' *The Guardian* 8 August 2010 <<https://www.theguardian.com/world/2010/aug/08/gap-next-marks-spencer-sweatshops>> accessed 10 September 2016.

⁵⁰ That is not to say that market pressures are irrelevant when considering corporate normative transgressions. Rather, that the operation of the fiduciary ladder (explained in chapter five) is such that the norm violations do not register in a way so as to act as a behavioural constraint. For example, see the references in chapter one, footnote 29, as to the limited regard that executives who do nevertheless operate within entrepreneurial (albeit public corporation) have for norm violations.

⁵¹ Skeel (n 47), 1823.

⁵² *Ibid*, 1823.

⁵³ Burhan Wazir, 'Nike Accused of Tolerating Sweatshops,' *The Guardian* 20 May 2001 <<https://www.theguardian.com/world/2001/may/20/burhanwazir.theobserver>> accessed 20 September 2016.

Secondly, and more fundamentally, the reason for this lack of impact is that corporations, as juridical persons, clearly do not feel shame in the same way that natural citizens do. It is clear that, at some point, reputational damage will act as a proxy for shame. However, reputational concerns, in contrast to shame, are largely the product of a cost-benefit analysis. That is, a balancing of the anticipated gain from the conduct in question against the likelihood of detection and the anticipated reputational impact of any publicity that may arise. One way in which shame may apply to the corporation is for the transgression to be felt so acutely so as to confer individual shame on those natural citizens executing corporate decision-making.⁵⁴ However, for the reasons discussed in chapter five, this is a very high threshold to meet. Finally, shame, and shaming sanctions, only work if they are ‘enforced.’ The convergence of corporation norms means that (particularly in the case of compliance) the corporate community will not consider the conduct to be a norm transgression. When looking to shareholders the problem is twofold. If creative compliance furthers a shareholder’s interests they are unlikely to want to unravel that conduct. If they were so motivated, then we run into the usual collective action problems with any type of shareholder activity.⁵⁵ Thus, we are left with public enforcement, which whilst not insignificant, brings us full circle as such conduct is of limited effect for an entity that does not feel shame.

Recognising the inability (or severely restricted ability) to utilise shame as a control mechanism provides an important insight into how to respond to the problem of how corporations construe compliance. As we cannot rely on shame, as the usual mechanism to enforce injunctive norms, it is necessary to replicate its impact by some other means. Alternatively, or in parallel, we need to change (or mitigate) the norms that lead to the creative construction of compliance in the first instance.

⁵⁴ Arguably, it was this individual shame that operated as an effective sanction when (as cited by David Skeel as an example of corporate shame) Robert Monks and Nell Minow took out a full-page advert in the Wall Street Journal ‘shaming the directors of Sear by name.’ See: Skeel (n 47), 1814.

⁵⁵ Collective action problems are discussed further in chapter five, part two, section one.

(iii) *The interaction between descriptive and injunctive norms*

It is a ‘truism’⁵⁶ that norms influence our behaviour. However, it is important to understand how norms can (or are) engaged and the impact of one type of norm on another. In particular, it is pertinent to an analysis of the impact of corporate norms, to understand the interplay between descriptive and injunctive norms (each as defined in section one): specifically, how descriptive norms can impede attempts to instrumentalise new or conflicting injunctive norms.

Cialdini’s research sought to consider these questions by examining the hypothesis that norms are not necessarily guiding our behaviour at all times, rather that they are more likely to motivate behaviour when they have been activated.⁵⁷ Put another way, that encouraging (or forcing) an individual to focus on a particular norm serves to activate that norm and therefore causes it to have a greater influence on that actor’s behaviour. To test this account, Cialdini *et al* conducted empirical research into littering (an injunctive norm that does not necessarily correlate to the descriptive one).⁵⁸ They wanted to determine the extent to which the salience of the norm, namely how observable it was in practice, influenced an individual’s behaviour. In their research, they observed individuals leaving a hospital and returning to their vehicles in the car park.⁵⁹ In doing so, one half of the research subjects walked past members of the research team who were reading leaflets, which they then discarded (littered) onto the car park floor. The other half of the research subjects were not exposed to such littering. When the research subject reached their own vehicle, it had the same leaflet that the researchers had discarded placed under their windscreen wiper. To test the

⁵⁶ Solomon E. Asch, ‘Opinions and Social Pressure,’ (1955) 193(5) *Scientific American* 31, 31.

⁵⁷ Cialdini *et al* (n 32), 1015.

⁵⁸ *Ibid*, 1015-1026.

⁵⁹ Details of the experiment are explained in: *Ibid*, 1016-1017.

impact that the descriptive norm had on an individual's behaviour, variables to the research exercise included changing the physical condition of the car park so that in some cases the car park was heavily littered and at other times it had been cleaned.⁶⁰ A further variable included the extent to which the subject's attention was drawn to the norm in question, for example by including a highly noticeable piece of litter near to the litter pile, or varying the amount of litter that was present.

The research identified that in cases where the car park had been littered, 41% of subjects also littered by discarding their own leaflets on the floor. Such behaviour was also more likely when the subject had witnessed the littering of others, namely where there was 'high norm salience.'⁶¹ Moreover, when drawing the subject's attention to the relevant norm (either the presence or absence of litter, namely either the desirable or undesirable norm), they were more likely to act in accordance with that norm. Cialdini's findings provide important insight into how we can start to influence norm-based behaviour in two ways. First, we see that the descriptive (or observable) norms within an environment serve to inform an actor as to the norms of that particular environment and encourage conduct in conformity. Therefore, to change the conduct of someone within a community, we need to change such observable norms as well as encourage the dissemination of injunctive ones. Secondly, that a norm is more likely to be acted upon when a subject engages with it, namely when their attention is specifically drawn to it. Nevertheless, there is an obvious word of caution that arises when looking at the descriptive, rather than the injunctive norm. Focussing a citizen's attention on the descriptive norm (here the existing state of the physical environment) is only of social benefit if that norm aligns with desirable behaviour.⁶² That is, if the car park is not littered or, in the case of tax, if the observable norm is spirited, rather than creative compliance.

⁶⁰ Ibid, 1016.

⁶¹ Ibid, 1017.

⁶² Ibid, 1020.

Cialdini's findings are highly instructive, both in explaining the difficulty in changing creative compliance to date and the techniques that we may adopt to improve compliance standards moving forward. First, we see that the current descriptive normative environment (namely, that of shareholder wealth maximisation discussed in part three) may be impeding the implementation of a new injunctive norm. Secondly, that to help instrumentalise this new injunctive norm (for example, moving from creative to spirited compliance), we need to focus an actor's attention on that norm. It is insufficient simply to issue a new demand and trust that it will be complied with. Rather, we need to adopt processes to support that demand by focussing a subject's attention on that norm. Of note is that the influence of this norm salience can be further increased when accompanied by a clear, rather than tacit, expression of approval of the norm (or disapproval of breach). This was tested by Cialdini and his team by adding a variant to their littering experiment. That is, they replicated their littering study but this time introduced a variable that, for half of the research subjects, the litter had been swept into piles, indicating disapproval of littering (effectively enhancing the descriptive norm). In this instance, littering fell even further (to 18% in conditions of high norm salience).⁶³

Therefore, we start to see that whilst norms clearly do have an impact on individual behaviour, there are ways in which this influence can be increased (without relying directly on shame).⁶⁴ Moreover, for corporate compliance, this analysis strengthens the claims put forward in chapter one, that the descriptive (or observable) norms of the environment, namely the prevalence of creative compliance, serve to undermine the influence of any injunctive norms to the contrary (or, more accurately, the attempt to introduce such contrary norms). Part three now examines corporate norms in more

⁶³ Ibid, 1022.

⁶⁴ Ibid, 1024.

detail but first explores the particular influence that legislation can have on expressing social norms.

PART THREE: THE HOMOGENEITY OF CORPORATE NORMS

Distilling the norms inherent within company law and governance is, perhaps, a far simpler task than were we to undertake the same exercise for natural citizens. The social norms that apply to natural persons are complex and multifaceted, reflecting diverse influences and communities such as religion, education, race and family. In contrast, a corporation's norms are, generally,⁶⁵ derived from regulation that enshrines a dominant shareholder wealth maximisation norm. As this part explains, this results in a normative environment that is dominated by (or interpreted by corporations to be dominated by) a homogenous wealth maximisation norm, the power of which is enhanced given its apparent legislative endorsement.

(i) *The expressive function of law*

The law, much like social actions, can be 'expressive.'⁶⁶ That is, it carries a meaning so as to postulate a norm and not simply operate as a control on behaviour.⁶⁷ By mandating that citizens act in a certain way (or indeed refrain from so acting) the law is making a normative statement, expressing a view as to the rights or wrongs of the

⁶⁵ Of course, corporations act by individuals who bring their own norms to the corporate environment. However, as shall be seen in this part and chapter five, when acting in a corporate context, it is the corporate norms that tend to dominate those that would apply in an individual's personal life. Indeed, it is quite possible for a group to 'express attitudes that none of its members have individually' (see: Elizabeth S. Anderson and Richard H. Pildes, 'Expressive Theories of Law: a General Restatement,' (2000) 148 *University of Pennsylvania Law Review* 1503, 1518, citing the example of a building association that chooses not to discriminate against a disliked neighbor notwithstanding how all other residents feel). Here we see a further importance of ascribing norms to a particular role. That is, when acting in their capacity as a board member (for example) a director adopts the norms of that position rather than those that apply in their private domain.

⁶⁶ Sunstein, *Expressive Function* (n 10), 2022.

⁶⁷ *Ibid*, 2024.

conduct concerned.⁶⁸ When the GAAR demands that corporations refrain from implementing ‘abusive’ structures, it is not simply demanding certain behaviour without moral censure. It is also expressing a belief that such structures are unacceptable or, put another way, morally impermissible. Indeed, even the language adopted by the GAAR of ‘abusive’ (rather than, for example, ‘technical’) has expressive import.⁶⁹

In expressing this normative perspective, the law makes a public statement of the norm for all citizens to recognise and interpret.⁷⁰ As a consequence, social norms can be ‘fortified by ... [or] even owe their existence to law.’⁷¹ Crucially, when a norm is enshrined in regulation it adopts a particular status of authority, namely that it is the product of a democratic institution that speaks for society and has coercive force.⁷² In this way, the law expresses the view that the relevant norm is to be regarded as particularly important increasing the likelihood that it will be institutionalised by the relevant community. Moreover, the law serves to provide a hallmark of legitimacy to a particular point of view, especially when that point of view (or norm) is consistently repeated throughout the legislative framework. In this way, the law is able to make a particular norm ‘focal’⁷³ enhancing its symbolic or expressive status within a community.

Needless to say, the law is also capable of expressing undesirable norms. That is, norms that unintentionally signal roles or functions that lead to damaging behaviour. For

⁶⁸ Effectively it ‘manifests a state of mind.’ See: Anderson and Pildes (n 65), 1506.

⁶⁹ The same, but opposing, claim can be made of ‘creative compliance.’ The moniker itself suggests a view that such practices are clever and normatively acceptable.

⁷⁰ Anderson and Pildes (n 65), 1507.

⁷¹ Sunstein, *Social Norms and Social Roles* (n 27), 920.

⁷² Further, that ‘legal standards of conduct ... influence the social norms of directors, officers, and lawyers.’ See: Edward B. Rock, ‘Saints and Sinners: How Does Delaware Corporate Law Work?’ (1997) 44 *UCLA Law Review* 1009, 1016. Rock goes on to argue that company law provides a set of parables that ‘fill out the normative job description of’ directors and officers (Ibid, 1018). This latter observation endorses Sunstein’s view that in addition to social norms, we also have role norms. That is, that we identify certain norms with certain roles, such as lawyers, doctors or teachers. See: Sunstein, *Social Norms Social Roles* (n 27), 921.

⁷³ Eric A. Posner, ‘Symbols, Signals, and Social Norms in Politics and the Law,’ (1998) 27(S2) *The Journal of Legal Studies* 765, 772-3.

example, and considered further in the following section, the law can express that the ‘sole’ objective of the corporation is profit maximisation, justifying the creative compliance standards that are the subject of this research. Importantly, such legal provisions not only express social norms but can also cause ‘expressive harm.’ That is, the law can convey a message (albeit unintentionally) that a citizen can be, or is, ‘treated according to principles that express negative or inappropriate attitudes.’⁷⁴ Thus, when the law seemingly enshrines a singular profit maximising norm that applies to corporate conduct it expresses (again, potentially unintentionally) more than simply the state’s view as to the legitimate objective of the firm. Namely, it risks conveying the view that corporations are entitled to pursue profit over broader welfare concerns and that it is legitimate for non-corporate citizens to be subject to that conduct. That is, to occupy an inferior position to the corporation.

The expressive power of law is such that if the law expresses norms that are not justifiable, namely if it communicates the wrong norm, this risks ‘instrumental effects.’⁷⁵ For example, by endorsing a primary duty of shareholder wealth maximisation, section 172 is perceived to legitimise behaviour such as creative compliance. As a consequence, these effects are legitimate matters for policy to be concerned with and should be constrained or otherwise mitigated.⁷⁶ The following section considers this shareholder wealth maximisation norm with a particular focus on section 172 of the Companies Act 2006. It is this expressive function of law that applies not simply to entrench this norm but also to powerfully identify it with the function and the role of the corporation in society.⁷⁷

⁷⁴ Anderson and Pildes (n 65), 1527.

⁷⁵ Ibid, 1531.

⁷⁶ Ibid, 1531.

⁷⁷ For a discussion of the identification of certain norms with certain social roles see: Sunstein, *Social Norms and Social Roles* (n 27), 918.

(ii) *The dominance of the shareholder wealth maximisation norm*

The dominant norm enshrined within company law and practice is the paradigm of shareholder wealth maximisation. That is, the perspective that the legitimate (and sole) objective of the corporation should be to promote the success of the company (namely the ‘long-term increase in value’⁷⁸ of the company) for the benefit of the company’s members as a whole.⁷⁹ Were this perspective in doubt, the Company Law Review Steering Group made it clear that, notwithstanding the introduction of an ‘enlightened’ concept of shareholder value, the Companies Act 2006 was predicated on, and therefore endorsed, a model of shareholder exclusivity. Namely that the corporation was ‘managed for the benefit of shareholders’⁸⁰ and simply ‘subject to safeguards’⁸¹ for creditors and bound by disclosure obligations for the benefit of the wider community.

As a consequence, the significant reforms introduced by the Companies Act 2006 did not disrupt the view that the ultimate objective of the corporation was to ‘generate maximum value for shareholders.’⁸² Rather, what the Act provided for was the acknowledgement that in achieving this objective, directors should ‘have regard’ to, amongst others, the wider interests set out in section 172 of the Act. That is, in discharging this duty, directors should have regard to interests more commonly associated with a stakeholder approach to the corporation, such as the community, employees and the environment. The list of statutory factors is not exhaustive and could, quite feasibly, include an obligation to consider the impact of compliance practices on, for example, the local community (by reducing the public purse) and the

⁷⁸ Lord Goldsmith, Lords Grand Committee, 6 February 2006, column 255, cited in: Ministerial Statements, *Companies Act 2006, Duties of Company Directors*, June 2007, 7. <<http://www.berr.gov.uk/files/file40139.pdf>> accessed 10 September 2016.

⁷⁹ S 172, Companies Act 2006.

⁸⁰ Company Law Review Steering Group, *Modern Company Law For a Competitive Economy: The Strategic Framework*, (February 1999) para 5.1.4.

⁸¹ *Ibid.*

⁸² *Ibid.*, para 5.1.9

legitimacy and stability of the legal and market order (by undermining the principle of equality before the law)..

In response to the inevitable criticism as to the uncertainty of this provision, the government released a collection of ministerial statements that sought to expand upon (in a non-binding way) what was meant by section 172. These statements suggested that 'have regard to' should be construed to mean 'give proper consideration to'⁸³ the statutory factors set out in section 172. Returning to the expressive function of law, it is trite to say that a requirement to have 'proper consideration' of the statutory factors when discharging the primary duty to increase shareholder wealth has little, although granted, some, symbolic force. Thus, the challenge that exists is both the manner in which this duty is interpreted by the board, together with the lack of obligation to act on any concerns that may be identified once 'regard' has been given to the statutory factors.

There are several important consequences of this shareholder wealth maximising norm. First, it justifies and legitimises a suite of shareholder exclusivity rights in the Companies Act 2006.⁸⁴ In particular, it validates the claim that directors owe their fiduciary duties to the company (which, in effect is taken to mean the shareholder body),⁸⁵ and that shareholders possess the right to remove directors by a simple

⁸³ Margaret Hodge, Commons Report, 17 October 2006, column 789 cited in: Ministerial Statements, *Companies Act 2006, Duties of Company Directors*, June 2007, 9. <<http://www.berr.gov.uk/files/file40139.pdf>> accessed 10 September 2016.

⁸⁴ s 168 (right to remove directors); s 172 (duty to promote the success of the company for the benefit of its members); s 239 (ability to ratify acts of directors); s 260 (derivative claims); ss 302-305 and 338 (convening general meetings); s 314 (power to circulate statements); s 510 (power to remove auditors); s 551 (authorisation of share allotment); s 561 (rights of pre-emption); and rule 21, The City Code on Takeovers and Mergers (restrictions on frustrating action). The literature on shareholder exclusivity is vast. Key works include: S Bainbridge, 'In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green,' (1993) 50 *Washington and Lee Law Review* 1423; D G Smith, 'The Shareholder Primacy Norm,' (1997) 23 *Journal of Corporation Law*, 277; Lynn Stout, 'Bad and Not-So-Bad arguments for Shareholder Primacy,' (2009) 75 *Southern Californian Law Review* 1189.

⁸⁵ On this see chapter five part.

majority.⁸⁶ Crucially, this legislative endorsement of shareholder primacy is then reflected in internal incentive structures. As discussed in more detail in chapter five, remuneration and rewards packages are linked to firm ‘performance,’ which is itself equated with earnings per share. Further, it is shareholders who have the right to enforce a breach of section 172 by way of derivative claim.⁸⁷ These practical factors coalesce to mean that when considering how to discharge their obligation to have ‘proper consideration to’ the statutory factors, it is perhaps not surprising that many directors will do so in a manner that is going to satisfy their primary duty and, as a consequence, the cohort to whom they are accountable. Therefore, section 172 remains a duty that is commonly interpreted to mean, notwithstanding the breadth of discretion that it actually grants,⁸⁸ an obligation to increase shareholder returns.

From a compliance perspective, this manifestation of shareholder wealth maximisation across the corporate law and governance framework creates a homogenised norm within the corporate community, effectively creating and reinforcing an almost self-maintaining, normative system.⁸⁹ This self-perpetuating norm therefore adopts a position of authority, legitimising not only the norm *per se* but those acts, omissions and regulatory provisions that support it, whilst undermining the legitimacy of those adopting a contrary view.⁹⁰ It starts to imbue the very role of the corporation as a pure profit maximising entity, devoid of broader responsibilities and considerations (contributing to the views of the market that were considered in part one of chapter two). We thus start to appreciate the earlier hypothesis that within this corporate environment it becomes increasingly unrealistic to expect corporations to pursue

⁸⁶ Section 168 Companies Act 2006.

⁸⁷ Section 260(1), Companies Act 2006.

⁸⁸ Discussed further in chapter five).

⁸⁹ For a broader discussion of law as an autopoietic system see: G. Teubner, *Law as an Autopoietic System* (Blackwell, Oxford 1993). For a critical discussion of Teubner's theory, see: Anthony Beck, 'Is Law an Autopoietic System?' (1994) 14 *Oxford Journal of Legal Studies* 401.

⁹⁰ Recall Eric Schmidt's justification of creative compliance, namely that there was ‘probably some law’ against spirited tax compliance, see: Google's Tax Avoidance is Called ‘Capitalism,’ Says Chairman Eric Schmidt,’ *The Telegraph* (12 December 2012).

anything other than a ‘pricing’ approach to compliance, notwithstanding the actual breadth of discretion that the Companies Act 2006 grants to directors (which is considered in chapter five). Indeed, it starts to explain the view put forward by Easterbrook and Fischel that ‘managers not only may but also should violate the rules when it is profitable to do so.’⁹¹

To be clear, this section is not suggesting that shareholder wealth maximisation (and the provisions that reflect it) is an objectionable firm objective *per se*. As Carroll identified, the corporation has many faces, an important one of which is profit maximisation.⁹² Thus, as chapter two explained, the pursuit of self-interest has a number of benefits, both for the corporation itself and wider society. From a functional perspective, this singular objective serves to facilitate the efficiency of corporate decision-making as well as enhance (albeit relatively) corporate accountability.⁹³ Rather, the claim that the thesis makes is that there is a legitimate basis for constraining the harmful expressive and normative effects of this norm. Part four considers one final, but important, aspect of the legitimisation of creative compliance (predicated on a narrow understanding of corporate purpose and responsibility). That is, the impact of legal advice on a corporation’s interpretation of their responsibilities and how this advice can also be influenced by the norms that have been the subject of this chapter.

PART FOUR: CREATIVE ‘COUNSELLING’ AND CORPORATE NORMS

The legitimisation of the shareholder wealth maximising norm by the Companies Act 2006 is further enhanced by lawyers, as officers of the court, providing a similarly

⁹¹ Frank H. Easterbrook and Daniel R. Fischel, ‘Antitrust Suits by Targets of Tender Offers,’ (1982) 80 Michigan Law Review 1155, 1177 at their (n 57).

⁹² For a complementary argument see: Archie Carroll, ‘The Four Faces of Corporate Citizenship,’ (1998)100(1) Business and Society Review, 1.

⁹³ Stephen Bainbridge, ‘Director Primacy: The Means and Ends of Corporate Governance,’ (2002) 97 Northwestern University Law Review 547, 557-558.

narrow interpretation of what section 172 means for corporate boards. Lawyers play a significant role in determining how the law operates in practice, acting as the ‘interface’⁹⁴ between corporate law and the corporations that it governs. Occupying a position of trusted adviser, they both interpret and communicate the meaning of relevant provisions.⁹⁵ As such, it is no surprise that, particularly regarding ambiguous terms,⁹⁶ it is ‘what the business lawyer tells the client – rather than what the judge announces to the world – [that] is the ‘law.’’⁹⁷ Indeed, the more uncertain the law is, the more potential there is for legal construction as to what it should mean.⁹⁸ The question that this raises is the extent to which lawyers both inform, and are informed by, the norms inherent within the corporate environment.

The potential for lawyers’ interpretation of the law and, moreover, the norms that it expresses, was particularly prevalent with the introduction of section 172 of the Companies Act 2006. Not only was the legislation new and uncertain, but it was also subject to the ‘double whammy’⁹⁹ of the codification of directors’ duties and the derivative claim, giving rise to concerns as to the potential increase in exposure that boards now faced.¹⁰⁰ It is for this reason that Loughrey *et al* argued that claims ‘against directors are likely to be more prevalent.’¹⁰¹ Whilst this fear did not materialise,¹⁰² it is trite to say that legal advice was sought on the meaning of section 172 and how directors could discharge their duties thereunder. This focus on section 172 also served

⁹⁴ Joan Loughrey, Andrew Keay and Luca Cerioni, ‘Legal Practitioners, Enlightened Shareholder Value and the Shaping of Corporate Governance, (2008) (8)1 Journal of Corporate Law Studies 79, 82.

⁹⁵ Rock (n 72), 1014 and 1017.

⁹⁶ Legal advice is, of course, more likely to be sought in areas of law that are new or uncertain. See: Michael J. Powell, ‘Professional Innovation: Corporate Lawyers and Private Lawmaking,’ (1993) 18(3) *Law and Social Inquiry* 423, 450.

⁹⁷ Rock (n 72), 1096

⁹⁸ Lauren B. Edelman, Steven E. Abraham and Howard S. Erlanger, ‘Professional Construction of Law: The Threat of Wrongful Discharge,’ (1992) 26 *Law and Society Review* 47, 48.

⁹⁹ Loughrey *et al* (n 94), 96.

¹⁰⁰ For example, by extending the claim to acts of ‘pure’ negligence, section 260(3), Companies Act 2006.

¹⁰¹ Loughrey *et al* (n 94), 81.

¹⁰² Loughrey *et al* (n 94), 81.

to increase the salience of the section (and its meaning) to corporate boards, serving to enhance its expressive impact.

The challenge with professional legal advice, particularly to large corporations, is that lawyers are not immune from the pressures of commercial life, nor the psychological mechanisms that can apply to other actors. The character of a lawyer's relationship with their client is such that it can give rise to powerful biases that shape the lens through which legal advice is given, undermining the rigour of the independence obligations that the profession nevertheless demands.¹⁰³ It is these pressures that coalesce to, unintentionally, influence the interpretation of a regulatory provision, notwithstanding our desire to maintain that lawyers remain steadfastly independent.

The psychological factors that apply to external counsel are highly influential when it comes to the advice that they provide.¹⁰⁴ Using Robertson's taxonomy, many of these factors go to the question of a lawyer's identity.¹⁰⁵ When a lawyer is advising a long-term client, there can be a tendency to identify both with that client and the role of a 'corporate' lawyer. Related to this is the fact that the norms of the corporate environment infiltrate and influence the advice that is provided.¹⁰⁶ Indeed in Nelson's empirical study, one in-house counsel conceded that 'his responsibility is to the stockholder and that his job is first and foremost is to make sure that investment grows.'¹⁰⁷ Whilst these effects are arguably more pronounced for in-house counsel,

¹⁰³ For example: SRA Handbook, Principle 1 (to uphold the rule of law), Principle 2 (to act with integrity) principle 3 (not to allow your independence to be compromised).

¹⁰⁴ Arthur B. Laby, 'Differentiating Gatekeepers, (2006) 1 Brooklyn Journal of Corporate, Financial & Commercial Law 121, 121.

¹⁰⁵ Cassandra Burke Robertson, 'Judgment, Identity, and Independence,' (2009) 42(1) *Connecticut Law Review* 1, 13.

¹⁰⁶ It is instructive, that Edelman *et al* also argue that this legal advice is susceptible to influence by the insititutionalised norms of the corporation (see Edelman and Talesh, To comply or Not to Comply (n 7), 105).

¹⁰⁷ Nelson and Nielsen, 'Cops, Counsel, and Entrepreneurs: Constructing the Role of Inside Counsel in Large Corporations,' (2000) *Law & Society Review* 34(2) 457, 472.

they nevertheless also apply to external advisers,¹⁰⁸ often (as shall be seen in chapter six regarding Linklaters' advice to Lehman Brothers) with significant effect. Indeed, external counsel regularly work closely, and over a long period of time, for a particular client, giving rise to a 'close bond'¹⁰⁹ and sense of loyalty. In this context maintaining 'independence and neutrality may be easier said than done'¹¹⁰ and it is perhaps not surprising that Laby describes lawyers as 'dependent gatekeepers,'¹¹¹ whose primary focus is to further their clients' interests.

Regardless of the fact that a lawyer's duty to his or her client is constrained by an overarching duty to the court, this (arguably abstract)¹¹² restriction does not easily override the (arguably immediate) pressure of acting in the interests of the client.¹¹³ This is particularly the case given how the cognitive biases referred to earlier can operate. In particular, over time, the lawyer can start to identify with the objectives of the client, and once a client's objectives have been internalised in this way, lawyers can start to interpret statute (so far as is possible) in a manner that reflects their client's interests,¹¹⁴ whilst obscuring their ability to 'recognise the salience of ethical considerations in a given situation.'¹¹⁵ As a consequence, and as Powell observed, the role of lawyers in 'manipulating the law to fit their client's interests becomes central'¹¹⁶ to the interpretation of what a provision actually means. Of note is that this alignment (or, potentially, pressure) may come not only from the solicitor's actual client but also

¹⁰⁸ Pam Jenoff, 'Going Native: Incentive, Identity and the Inherent Ethical Problem of In-house Counsel,' (2011) 114 West Virginia Law Review 725, 738.

¹⁰⁹ Laby (n 104), 127.

¹¹⁰ Robertson (n 105), 6.

¹¹¹ Laby (n 104), 128.

¹¹² SRA Handbook, principle 1.

¹¹³ SRA Handbook, Principle 3.

¹¹⁴ Robertson notes how this cognitive bias can influence not only the interpretation of statutes but also the recognition (or otherwise) of facts and issues relevant to a client's case. See: Robertson (n 105), 6-9.

¹¹⁵ Milton C. Regan, 'Moral Intuitions and Organizational Culture,' (2007) 51 St Louis University Law Journal 51, 941, 949.

¹¹⁶ Powell (n 96), 426.

from the tax advisers or accountants who have designed the tax product in question and are keen to find counsel who will implement it.

One other consequence of working for a long-standing client is that of commitment bias.¹¹⁷ That is, having previously provided a particular form of advice to a client then a solicitor is not going to easily change their mind as to the advice so provided. Therefore, the solicitor finds him or herself in a cycle of affirming an interpretation already given. This conduct may not be as wilful as it first appears; the application of commitment bias is such that an actor will seek out information that will affirm or ‘bolster’¹¹⁸ the original advice. The challenge for present purposes is that this early advice, influenced by the lawyer’s alignment with their client’s objectives, could often be a narrow interpretation of section 172 that facilitates a creative approach to compliance.

This desire to provide clients with the advice that they want (potentially providing a generous interpretation of the relevant regulation) is particularly prevalent within tax structuring and chapter six examines the, highly criticised, opinion provide by Linklaters on a Lehmans refinancing structure. Arguably, this type of ‘creative counselling’ is perhaps more prevalent in areas such as tax where a regulatory breach is seen to be less ‘harmful’ and, moreover, where the risk of detection is relatively low. Moreover lawyers in this situation are protected by the cognitive comfort that arises from the separation of advice from effect, which is exacerbated by the fact that lawyers can assert that they are merely providing advice, and therefore that it is for the client to determine how to act. In this way, it is much easier to provide aggressive interpretations of section 172, which align with the client’s interests (namely a narrow interpretation of obligation) than to propose a broader obligation, which conflicts with

¹¹⁷ Jenoff (n 108), 749.

¹¹⁸ On this ‘defensive bolstering’ see: Laby (n 104), 144.

the normative environment that both corporations and their lawyers operate within. As a consequence, we find that both the law and its officers serve to reinforce the legitimacy of an unfettered shareholder wealth maximising norm, contributing to a cycle of (re-)endorsement.

CONCLUSION

This chapter has examined how (and why) the current pervasive wealth maximisation norm enshrined within company law has a powerful expressive effect. That is, it reflects both a descriptive and seemingly injunctive norm of shareholder wealth maximisation that coalesces to encourage and legitimise behaviour that aligns with this perspective. As a consequence, interventions such as the GAAR are unable to operate against the conflicting norms contained across such a broad spectrum of regulation. At best, corporations are likely to engage in superficial (or symbolic) efforts at compliance, rather than meaningful change: for example, the appointment of new compliance personnel, or a robustly worded annual report emphasising commitment to regulatory compliance or ‘responsible’ tax practices, without any meaningful change in practice.¹¹⁹ These gestures are visible to regulators and to the public but are designed to legitimise corporate conduct without actually achieving substantial change.¹²⁰

It is the power of this norm that explains both the current conduct of corporations and the difficulty in introducing reform. However, by identifying the role that company law plays in legitimising creative compliance, we also identify a basis on which to structure more meaningful reform. Chapter six, as the last substantive chapter of this thesis, builds upon this understanding to explore how such intervention may be designed. However, before doing so, there is one further issue to explore that necessarily arises as

¹¹⁹ Edelman, *Legal Ambiguity* (n 14), 1554.

¹²⁰ *Ibid*, 1542.

a consequence of the normative analysis adopted by this chapter. That is, whilst this chapter has looked at the pervasive nature of corporate norms, the corporation does of course act via individuals. Moreover, this chapter has intimated that individuals (unlike their corporate counterparts) are influenced by a more heterogeneous set of norms. Therefore, the following chapter explores the question that this observation naturally gives rise to. Namely, why is it that these intrinsic norms of natural citizens do not intrude to supersede those of the corporation?

CHAPTER FIVE

A PERSON WITHOUT PERSONALITY:

THE FIDUCIARY LADDER OF CORPORATE 'PERSONHOOD'

*'...the law has facilitated, and technological developments have motivated, an enormous growth of a new kind of person in society, a person not like you and me, but one which can and does act and one whose actions have extensive consequences for natural persons ...'*¹

INTRODUCTION

Why is it that corporations, imbued with legal personality and acting through individuals, nevertheless pursue conduct that is antithetical to values of personhood?² Specifically, why do individuals within a corporation implement creative compliance³ strategies premised on, *inter alia*, the normative justification that corporations should violate rules when it is profitable to do so? As chapter four explained, creative compliance is driven by a profit maximising norm, namely the axiom of company law that the overriding objective of a corporation is shareholder wealth maximisation.⁴ Nevertheless, this norm, reflected in directors' fiduciary duties, is not absolute. Directors have broad managerial discretion and therefore the question arises as to why directors, who are otherwise apparently law-abiding citizens, have allowed profit-maximisation to determine compliance strategies that the public clearly consider to be unethical?⁵

¹ James S. Coleman, *The Asymmetric Society*, (Syracuse University Press 1982), 9.

² For example, conduct that pursues profit maximisation above values such as fairness, equality and 'doing the right thing.' These values are often protected by individuals through non-legal behavioural constraints, which limit self-interested behaviour that undermines the values of society.

³ Creative compliance construes compliance as a mere pricing-exercise, that 'managers not only may but also should violate the rules when it is profitable to do so.' Frank H. Easterbrook and Daniel R. Fischel, 'Antitrust Suits by Targets of Tender Offers,' (1982) 80 Michigan Law Review 1155, 1177 their footnote 57.

⁴ This reflects the dominant Anglo-American norm that the corporation 'is carried on primarily for the profit of the stockholders' *Dodge v Ford Motor Co* 170 NW 668, 684. This principle is reinforced by the suite of shareholder governance rights discussed in chapter four, part three.

⁵ Namely, the recent tax scandals discussed in chapter one, part one.

In answering this question, this chapter examines the core features of the corporation, namely separate personality and limited liability, to understand how these structural characteristics influence the corporate decision making process. In doing so, it adopts a conceptual perspective that defines the corporation as a creature of law and that it is 'personality, not human nature'⁶ that the law grants to corporations. By viewing the corporation as an entity comprised of rights and duties, it is possible to analyse those legal attributes to identify their causal relationship with the apparent displacement of individual ethics within the corporation. The benefit of employing this analytical framework is that it avoids engaging in metaphorical debate that seeks to anthropomorphise the corporation (and risks conflating notions of human and corporate responsibility).⁷ Instead, we are able to better understand the profound influence that corporate form has on individual behaviour, an understanding that is vital not only for effective legal reform but for those individuals within a firm who want to 'do the right thing,' understand the true scope of their obligations⁸ and embed a more responsible culture within their organisation.⁹

By exploring the interplay between corporate structure and corporate decision-making this chapter puts forward three, cumulative, hypotheses (each considered in a separate part of the chapter). Part one explains how separate personality and limited liability

⁶ John Salmond, *Jurisprudence*, (first published 1913, 4th edn, Forgotten Books 2012), 272. See also: Bryant Smith, 'Legal Personality,' (1928) 37(3) Yale law Journal, 283 (that to confer legal personality is to impose legal duties or confer legal rights).

⁷ On this etymological posturing see: Max Radin, 'The Endless Problem of Corporate Personality,' (1932) 32 Columbia Law Review, 642; Martin Wolff, 'On the Nature of Legal Persons' (1938) 54 Law Quarterly Review, 484; Nicholas James, 'Separate Legal Personality; Legal Reality and Metaphor,' (1993) 5(2) Bond Law Review, 217.

⁸ Part two considers the incongruence between the scope of directors' legal obligations and how they are interpreted in practice.

⁹ The corporate responsibility debate is increasingly focusing on corporate culture; see for example the Bribery Act 2010 and accompanying Ministry of Justice Guidance, 'Bribery Act 2010: Guidance About Commercial Organisations Preventing Bribery,' 21 <<https://www.justice.gov.uk/downloads/legislation/bribery-act-2010-guidance.pdf>> accessed 10 September 2016.

coalesce to achieve the ‘complete’ separation of shareholders from the corporation.¹⁰ This part emphasises the importance of both the legal and economic separation of shareholders, which causes them to act as mere ‘functionless rentiers.’¹¹ Thereafter, part two suggests that this emancipation leads to significant changes in the shareholder demographic and increases shareholder passivity; with the result that shareholder wealth maximisation becomes a proxy for members' interests. This proxy then distorts the application of directors' fiduciary duty to ‘promote the success of the company for the benefit of its members as a whole.’¹² Specifically, the definition of ‘company,’ traditionally taken to encompass the entire shareholder body¹³ both present and future,¹⁴ is instead interpreted as the interests of the ‘market’ represented by short-term profit maximising objectives.

Thereafter, part three details how this profit-maximising objective is able to pervade corporate strategy (and displace personal values) as the corporate structure facilitates a decision-making hierarchy that this chapter terms the ‘fiduciary ladder.’ This hierarchy has a powerful psychological impact, which serves to insulate individuals within the firm from the reputational repercussions of their actions (an outcome demonstrated by reference to Milgram's infamous research in this area).¹⁵ The result of these three phenomena is that the corporation, imbued with legal personality, is bereft of the non-legal behavioural constraints (including values such as fairness and morality) that are commonly expected of personhood. As such, the corporation is able to pursue creative compliance strategies, driven by a profit maximising norm, unrestricted by individual

¹⁰ It is this requirement for both legal and economic emancipation of shareholders that means that this thesis is concerned with public, listed corporations, which can be contrasted with private companies where shareholders are legally, but not economically, emancipated.

¹¹ See: P Ireland, ‘Defending the Rentier: Corporate Theory and the Reprivatization of the Public Company,’ In: John Parkinson, Andrew Gamble and Gavin Kelly (eds) *The Political Economy of the Company* (Hart Publishing, 2000) 141, 146.

¹² s 172, Companies Act 2006.

¹³ *Greenhalgh v Arderne Cinemas Ltd and Others* [1951] Ch 286, 291.

¹⁴ *Gaiman v National Association for Mental Health* [1971] Ch 317, 330.

¹⁵ Discussed further in part three, section two.

ethics. Part four concludes the substantive parts of the chapter by briefly detailing the differences between public corporations and other economic actors to explain why the phenomenon of the fiduciary ladder only applies to public corporations and thus why it can legitimately be treated as a separate class of economic actor.

In considering the impact of corporate structure in this way, the chapter does not propose that these fundamental facets of corporate design should be revised. Rather, it seeks to understand the impact of corporate design on corporate behaviour to help understand why corporations are able to adopt compliance strategies that may not align with the views of the individuals who implement them and therefore help to inform normative and regulatory reform.

PART ONE: SEPARATE PERSONALITY, LIMITED LIABILITY AND THE REIFICATION OF THE CORPORATION

The paradigms of separate personality and limited liability are well known. Since the mid-nineteenth century it has been a ‘fundamental principle’¹⁶ of company law that corporations have a personality separate from their members¹⁷ and that shareholder liability is limited to the amount unpaid on any shares held by them.¹⁸ This part is not an exhaustive analysis of these principles, which have (at times) been divisive and raise many interesting, normative, questions.¹⁹ Instead, it draws on the historical

¹⁶ See: *Owners of Cargo Laden on Board the Albacruz v Owners of the Albazero (The Albazero)* [1977] AC 744, 807; and *Adams v Cape Industries Plc* [1990] Ch 433, 476.

¹⁷ *Salomon v A. Salomon & Co Ltd* [1897] A.C. 22.

¹⁸ s 3 Companies Act 2006 and Article 2, Schedule 3 (Model Articles for Public Companies), The Companies (Model Articles) Regulations 2008 (SI 2008/3229) (the ‘Model Articles’).

¹⁹ See: Cataldo ‘Limited Liability With One Man Companies and Subsidiary Corporations,’ 18 *Law & Contemporary Problems* (1953) 473-504 (as to ring fencing subsidiary liability); Richard Posner, ‘The Rights of Creditors of Affiliated Corporations,’ 43 *University of Chicago Law Review*, (1975-1976), 499-526, 506 (as to the inability of involuntary creditors to privately negotiate limited liability); Roger E. Meiners, James S. Mofsky and Robert D. Tollison, ‘Piercing the Veil of Limited Liability,’ (1978) 4 *Delaware Journal of Corporate Law* 351, 360 (looking at the relationship between limited liability and corporate creditors); Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law*, (Harvard

development of separate personality and limited liability to demonstrate how these fundamental features of corporate design caused shareholders to become completely separated from the corporation, transforming their relationship with it. This historical analysis illustrates the importance of both the legal and economic separation of ‘ownership’²⁰ and control,²¹ such that the corporation became an entity not simply independent from its members but ‘effectively cleansed of them.’²²

Incorporation by registration was first made available to the general public pursuant to the Joint Stock Companies Act 1844 (the ‘1844 Act’).²³ In doing so, members of the public could avail themselves of the benefits of the corporate form, although confirmation that incorporation conferred separate personality was not definitively settled until the seminal case of *Salomon v Salomon & Co.*,²⁴ (arguably the best known case of creative compliance in corporate history.) The grant of separate legal personality allowed corporations to exist in perpetuity, free from ‘the burdens of death and ageing,’²⁵ and created a suitable vehicle for limited liability.²⁶ Thus, the 1844 Act

University Press 1996), 41 (as to the technical ability to achieve limited liability through contract).

²⁰ For ease, this chapter adopts the traditional reference to shareholders as ‘owners’ of the corporation. However, it is difficult to maintain that modern shareholders can legitimately be classified as owners. See: R. Sappideen, ‘Ownership of the Large Corporation: Why Clothe the Emperor,’ (1996) 7 Kings College Law Journal 27; P. Ireland, ‘Company Law and the Myth of Shareholder Ownership,’ (1999) 62 Modern Law Review 32; J. Hendry, P. Sanderson, R. Barker and J. Roberts, ‘Owners or Traders? Conceptualizations of Institutional Investors and their Relationship with Corporate Managers,’ (2006) 59 Human Relations 1101.

²¹ The separation of ownership and control was, of course, a characteristic identified by Berle and Means in their seminal work: A Berle and G Means, *The Modern Corporation and Private Property*, (first published 1932, Transaction Publishers 2010). Meanwhile, Paddy Ireland has written extensively on the importance of both the legal and economic separation, see: Ireland, ‘Defending the Rentier’ (n 11), 141; P. W. Ireland, ‘The Rise of the Limited Liability Company,’ (1984) 12 International Journal of Sociology of Law, 239, 245; Paddy Ireland, ‘Capitalism Without the Capitalist: the Joint Stock Company Share and the Emergence of the Modern Doctrine of Separate Corporate Personality,’ (1996) 17(1) The Journal of Legal History, 41.

²² Ireland, ‘Capitalism Without the Capitalist’ (n 21), 41.

²³ The 1844 Act extended incorporation by registration to joint stock companies, the precursor to the modern public company. It was the Companies Act 1862 that extended registration to the equivalent of the modern private company.

²⁴ [1897] AC 22.

²⁵ Mark Bovens, *The Quest for Responsibility, Accountability and Citizenship in Complex Organisations*, (Cambridge University Press, 1998), 16.

²⁶ The 1844 Act also aligned the legal form of the corporation with its economic one. Prior to 1844, the joint stock company was identified by its economic form, typically that it had a large,

started the process of transforming the corporation from the original, colonial companies that required special Acts of Parliament or Royal Charters to the transnational corporations that exist today. It also performed an important ideological function as separate personality started to disjoin the corporation from its members and justified the grant of significant benefits to an otherwise artificial entity premised on ‘legal and moral conceptions of the corporate individual.’²⁷ The corporation thus started to take shape (and become accepted) as an independent economic actor, detached from both its managers and shareholders.²⁸

Notwithstanding the significant impact of the 1844 Act, its importance for the separation of ownership and control must be kept in context. Whilst shareholders remained exposed to the debts of the corporation (and potentially each other) it was clear that they would remain closely involved with its management, restricting those willing to invest capital. Therefore, it was the limitation of shareholder liability pursuant to the Limited Liability Act 1855 that enabled the onset of shareholders' economic separation, a development so transformative that it has been described as ‘the greatest single discovery of modern times.’²⁹ In extending these unique legal characteristics to the general public, external investment could be given to an entity, rather than a collection of individuals, in which liabilities could rest where they fall; that is, not only could the corporation incur its own liabilities but, importantly, it also bore sole responsibility for them.³⁰

dispersed body of investors who had freely transferable shares. The legal form of the joint stock company largely reflected the modern form of partnership, whilst the speculative nature of shares at this time also ensured that shareholders performed a significant oversight role. On this see: Jonathan Barron Baskin, 'The Development of Corporate Financial Markets in Britain and the United States, 1600-1914: Overcoming Asymmetric Information,' (1988) 62(2) *The Business History Review*, 199; Ireland, *Capitalism Without the Capitalist* (n 21).

²⁷ Scott Bowman, *The Modern Corporation and American Political Thought: Law, Power, and Ideology*, (Penn State Press, 1996), 3.

²⁸ Separate personality also facilitates innovative corporate structures that are now utilised to implement creative tax structures.

²⁹ President Nicholas Murray Butler of Columbia University as cited by Cataldo (n 19), 473.

³⁰ Save in limited cases where the corporate veil could be pierced. See cases where the corporation is considered to be a ‘shame or façade.’ *Gilford Motor Co Ltd v Horne* [1933] Ch

The true impact of the 1844 and 1855 Acts was realised with the complete, economic, separation of shareholders from the corporation, which came with the development of a liquid stock market at the end of the nineteenth century.³¹ The capital markets gained confidence in the early twentieth century when the public saw that equities could be ‘investment-grade securities’ and that all market participants could act as ‘prudent investors.’³² Furthermore, a liquid stock market enabled corporations to realise their purpose of raising capital from a large (and diverse) number of investors,³³ whilst providing shareholders with the comfort that they were able to transfer their shares ‘cheaply and efficiently.’³⁴ The development of the stock market also gave investors the protection of being able to diversify their investment portfolios to hedge against the risks of underperformance by any one company.

The establishment of strong capital markets meant that functionally, shareholders became separated from the corporation and they were able to invest in companies ‘*qua* investor,’³⁵ free from the demands of management and the burdens of property ownership. It was at this point of complete legal and economic separation that shareholders transformed from traditional owners to mere ‘functionless rentiers.’³⁶ Shareholders became fully emancipated from the corporation; they no longer needed to monitor the firm to mitigate their risks. Instead, they could simply sell their shares,

935; *Jones v Lipman* [1962] 1 WLR 832; *Woolfson v Strathclyde DC* (1978) 38 P & CR 521; *Adams v Cape Industries plc* [1990] BCC 786; *Trustor AB v Smallbone & Others (No 2)* [2001] 2 BCLC 436; also exceptional cases where an agency relationship is upheld: *Smith, Stone & Knight Ltd v Birmingham Corporation* [1939] 4 All ER 116, *Re F. G. (Films) Ltd* [1952] 1 WLR 483.

³¹ The timing of the emancipation of shareholders is reflected in the annual number of incorporations, rising from an average of: 500 each year between 1856-1865; 1500 between 1880-1886; and 6,700 per annum between 1909-1914. Figures cited by: Ireland 'The Rise of the Limited Liability Company' (n 21), 245.

³² Walter Werner, 'Management. Stock Market and Corporate Reform: Berle and Means Reconsidered,' (1977) 77 Columbia Law Review 388, 400.

³³ Henry Manne, 'Our Two Corporation Systems: Law and Economics,' (1967) 53(2) Virginia Law Review 259, 260.

³⁴ Meiners *et al* (n 19), 364.

³⁵ Manne (n 33), 261.

³⁶ Ireland 'Defending the Rentier' (n 11), 146.

exercising the right of 'exit' (namely, share sale) over 'voice' (that is, governance).³⁷ This separation was also reflected in the changing nature of the share.³⁸ No longer was the share treated as an aliquot part of the corporation's assets but was reconceptualised as a right to dividends and to assign title.³⁹

The reality is that the general incorporation statutes did, as the court confirmed in *Salomon*, create a separate legal entity. However, it did not fully separate that entity from its members. Rather, it was the economic separation, which came when shares transformed from an interest in the company to an interest in profits, which completed the reification of, and abstraction of shareholders from, the corporation.⁴⁰ Shareholders were no longer closely aligned with corporate management, rather they were able to invest in larger numbers of companies and their objectives were simply to increase financial returns. In doing so, the separation laid the foundations for directors to act free from shareholder oversight, subject only to an overriding objective to promote the success of the company, which as the next part will demonstrate, has become supplanted by a practice of furthering the homogenous interests of the 'market.'

PART TWO: REDEFINING THE BENEFICIARY; FROM 'COMPANY' TO 'MARKET'

The complete emancipation of shareholders resulted in a profound paradigm shift in the

³⁷ On this, see Albert O. Hirschman, *Exit, Voice and Loyalty*, (Cambridge MA: Harvard University Press, 1970).

³⁸ Early cases considered that shareholders had a direct interest in the property: *Buckeridge v Ingram* (1795) 2 Ves. Jun 652. This view was challenged in the seminal case of *Bligh v Brent* (1837) 2 Y. & C. Ex 268 although mixed judicial treatment following *Bligh* was eventually settled in *Borland's Trustee v Steel Brothers & Co Limited* [1901] 1 Ch 279, 288 which held that a share is the 'interest of the shareholder in the company measured by a sum of money, for the purposes of liability in the first place, and of interest in the second.'

³⁹ For a comprehensive analysis of the common law development see: Ireland 'Capitalism without the Capitalist' (n 21); D. Rice, *The Legal Nature of a Share*, (1957) 21 *The Conveyancer*, 439.

⁴⁰ Paddy Ireland, Ian Grigg-Spall and Dave Kelly, 'The Conceptual Foundations of Modern Company Law,' (1987) 14(1) *Journal of Law and Society* 149, 153.

exercise of managerial discretion. In particular, the short-term interests⁴¹ of current investors superseded the orthodox focus of directors' duties, namely the long-term interests of the company.⁴² This part examines how the short-term focus of the 'market'⁴³ managed to become an 'entrenched feature'⁴⁴ of corporate decision-making and thus became the prevailing focus of the corporate fiduciary ladder, discussed in part three.

(i) Shareholder wealth maximisation as a proxy for rentier shareholders

The reification of the corporation had a transformative impact on the shareholder demographic and behaviour. In particular, the changing nature of the share (from an ownership interest to a financial instrument) saw a rise in the late twentieth century⁴⁵ of institutional investors, who had dramatically different governance perspectives to their predecessors.⁴⁶ The outcome of this changing profile is that investors largely evaluate corporations by reference to the company's share price (and more specifically earnings

⁴¹ Namely, a focus on short-term results at the sacrifice of concern for long-term value creation, see: CFA Centre for Financial Market Integrity/Business Roundtable Institute for Corporate Ethics, 'Breaking the Short-Term Cycle: Discussion and Recommendations on How Corporate Leaders, Asset Managers, Investors and Analysts Can Refocus on Long-Term Value,' (2006), 3 < http://www.corporate-ethics.org/pdf/Short-termism_Report.pdf> accessed 16 May 2013.

⁴² Considered in part two, section two.

⁴³ The 'market' being the representation of the aggregate opinion of investors. See: Department for Business Innovation and Skills, *The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report*, July 2012, para 2.18 (the 'Kay Review.')

⁴⁴ Sir George Cox, 'Overcoming Short-termism within British Business: The Key to Sustained Economic Growth,' 26 February 2013, 6 < http://www.yourbritain.org.uk/uploads/editor/files/Overcoming_Short-termism.pdf> accessed 10 September 2016 (the 'Cox Report.')

⁴⁵ This change largely manifesting from the 1960s and culminating in the 1990s. See the Kay Review (n 43), 29 and P Myners, 'Institutional Investment in the United Kingdom: A Review,' (2001) (the 'Myners Review'), chapter 1, 27-38.

⁴⁶ The largest institutional investors are pension funds and insurance companies (see Kay Review (n 45) chapter 3 and the Myners Review (n 45), 5). Mutual funds (companies that issue shares to an individual and then invest in a diverse portfolio, enabling smaller investors to participate in a range of companies) also play an important part in shareholder behaviour and, in particular, the promotion of short-termism. For a helpful definition of the various types of institutional investors see: Lori Verstegen Ryan and Marguerite Schneider, 'Institutional Investor Power and Heterogeneity,' (2003) 42 *Business & Society* 398, 400 - 404.

per share)⁴⁷ rather than the underlying value of the business. In adopting this approach, shareholder conduct and the concomitant market response is driven, in part, by short-term fluctuations in share price, with the effect that managerial attention is similarly focussed.

The increase in institutional investors influenced the predominance of short-termism in three important ways.⁴⁸ First, institutional investors are financial intermediaries who owe a duty to their own investors (for example, the pension fund holder). Thus, the ultimate beneficiary of the investment sits at the end of a chain of interests, involving fund trustees and managers, each of whom have their own priorities. This chain of interests creates a system of ‘ownerless capitalism,’⁴⁹ whereby the corporation and its beneficial owner are abstracted from one another. Secondly, but related to this fiduciary position, the fund managers who make the investment decisions within the chain are constrained by an obligation to ‘enhance the value of the assets entrusted to [them] by [their] clients.’⁵⁰ This is a very distinct, although not always analagous, duty to that of a director. For fund managers, their primary concern is to increase the performance of their fund, which can involve a necessity to sell their holdings and a disincentive to

⁴⁷ For a helpful definition of earnings per share (‘EPS’) see: Marc Moore and Edward Walker-Arnott, ‘An Alternative View of Corporate Short-Termism,’ (currently unpublished), 8: ‘As the name suggests, this figure is essentially calculated by dividing the company’s total earnings or net income (minus total fixed dividends payable to preference shareholder) over the period by the number of its ordinary shares that are in circulation. Accordingly, where a company’s net quarterly income is £10 million, and the company has 2 million ordinary shares in circulation, then its quarterly EPS will be £5. In the hypothetical example, this £5 figure will (theoretically at least) be representative of the amount of earnings accruing to each individual ordinary share of the company over the period. In this way, the EPS figure (theoretically) enables the shares of companies with often radically differing business characteristics and growth profiles to be compared by investors in a like-for-like manner, on the basis of a unifying objective criterion of perceived shareholder wealth (or ‘value’) creation.’

⁴⁸ The holdings of institutional investors have reduced in recent years although they still represent an influential proportion of investors and therefore remain the focus of corporate governance reform, such as the Financial Reporting Council’s UK Stewardship Code (July 2010) <<http://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Stewardship-Code-September-2012.aspx>> accessed 10 September 2016.

⁴⁹ Cox Report (n 44), 21.

⁵⁰ BlackRock, cited in PIRC, ‘Stewardship and the Stakeholder Economy: Perspectives on the Role of Shareholder Engagement in the UK Economy,’ 18.

pursue the costs of active corporate governance, informed by a perspective that passivity by fund managers is a 'safer' option to activism.⁵¹

Finally, this obligation to increase the fund value is evaluated in relative, not absolute terms; provided a fund outperforms its competitors then the fund managers have discharged their duties.⁵² This measurement of success is often undertaken against short-term timescales, notably financial reporting deadlines.⁵³ The culmination of these three factors is that institutional investors operate within an environment that is pervaded by a short-term imperative. This imperative is further accommodated by technology that enables high frequency trading, designed to make profit on short-term price fluctuations rather than the substantive value of the firm.⁵⁴

This dispersed and detached cohort of shareholders, comprising a significant number of institutional investors who are bound by their own fiduciary duties, gives rise to particular behavioural consequences. Specifically, it creates collective action issues and engenders rational apathy. That is, from a governance perspective the influence of any one shareholder's vote (or even a collection of them) is likely to be minimal. Thus, the cost of actively engaging with corporate management outweighs the economic benefit, making active governance economically irrational. Adopting this economic analysis, the rational action for disgruntled shareholders is to sell their shares on the now liquid market rather than exercise their voice through governance mechanisms.⁵⁵ The result of

⁵¹ Bernard Black, 'Shareholder Passivity Reexamined,' (1990) 89 Michigan Law Review 520, 533. See also the Kay Review (n 43), para 6.39.

⁵² On this see the outcome of the empirical work undertaken by Hendry *et al* (n 20), 1110, and 1116 identifying the 'obsession' of fund managers with 'relative performance.' See also the Cox Report (n 46), 21 and the Kay Review (n 43), para 6.34.

⁵³ Corporate reporting for quoted companies is mandated by the Financial Conduct Authority's Disclosure Rules and Transparency Rules. In particular, see DTR 4.1-4.2.

⁵⁴ Kay Review (n 43), paras 2.22 and 5.15. See also Lynne Dallas, 'Short-Termism, the Financial Crisis, and Corporate Governance,' (2011) 37 Journal of Corporation Law 265, 297-302.

⁵⁵ F. Easterbrook and D. Fischel, 'The Corporate Contract,' (1989) 89 Columbia Law Review, 1416, 1443: 'investors are rationally uninterested in votes, not only because no investor's vote will change the outcome of the election but also because the information necessary to cast an

such rational apathy is important. Not only do shareholders abandon a governance role but it means that shareholders generally only communicate with the board through market activity; promoting the response of the market as the primary form of communication to the board. This pre-eminence of the generic 'market' was identified in the empirical study undertaken by Hendry *et al*⁵⁶ who found that managerial attention was focussed on investor relations and in this regard, their reference was consistently to the 'market in general, rather than to the company's investors in particular.'⁵⁷ The implication for corporate management is that the board is not concerned about the (low) risk of shareholder activism but the more likely threat of share sale and the concomitant market response. Thus, shareholder interests (and the focus of directors' duties) come to be represented by a homogenous market norm of wealth maximisation, which is largely determined by reference to an earnings per share calculation.

Importantly for managerial behaviour, this market pressure to promote short-term share valuation is reinforced by a number of direct personal repercussions. From a financial perspective, directors' remuneration structures are increasingly linked to market performance, either through contingent bonus arrangements or stock options.⁵⁸ Moreover, significant share sales will eventually engage the market for corporate control, leaving the corporation at risk of a takeover, which ultimately undermines its directors' job stability.⁵⁹ This relationship between personal incentives and short-termism was found to be prevalent by the Cox Report, which concluded that

informed vote is not readily available.' See also: F. Easterbrook and D. Fischel, 'Voting in Corporate Law,' (1983) 26 *Journal of Law & Economics* 395, 402 (on the relationship between collective action issues and shareholder passivity).

⁵⁶ Hendry *et al* (n 20).

⁵⁷ *Ibid* 1120.

⁵⁸ On the relationship between directors' remuneration and corporate performance see: Michael Jensen and Kevin Murphy, 'Performance Pay and Top-Management Incentives,' (1990) 98(2) *The Journal of Political Economy* 225. On the relationship between executive remuneration and executive risk-taking see: Lucian Bebchuk, Alma Cohen and Holger Spamann, 'The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008,' (2010) 27 *Yale Journal on Regulation* 257.

⁵⁹ Henry Manne, 'Mergers and the Market for Corporate Control,' (1965) 73(2) *Journal of Political Economy* 110, 113 (see also the description of 'earnings per share' based bonus payments in practice at pp 266-267).

management behaviour 'is focussed on short-term delivery, reinforced with remuneration schemes with powerful incentives based on short-term results.'⁶⁰ From an operations perspective, this short-termism is also fuelled by the rigorous financial reporting requirements that a listed company is under. However, the board is motivated not simply by personal incentives that are tied to market performance but an understanding that 'just as managers' compensation suffers if they miss their internal targets, CEOs and CFOs know that the capital markets will punish the entire firm if they miss analysts' forecasts.'⁶¹ Thus powerful, and pervasive, incentives exist for directors to manage the market, rather than the long-term value of the corporation, such that 'earnings management'⁶² is 'considered an integral part of every top manager's job.'⁶³

The consequences of this changing demographic combined with a conceptual shift in our understanding of share functionality are significant. The function of shares, and with it the expectations of share ownership, became purely financial and increasingly short-term. Thus, short-termism becomes 'pervasive in business decision making'⁶⁴ and the market (not long-term value) dictates corporate strategy.

(ii) Distorting fiduciary duties; the changing status of the 'company' beneficiary

This predominance of the homogenous 'market' serves to distort the operation of directors' fiduciary duty to 'promote the success of the company.'⁶⁵ Specifically, this market focus narrows directors' managerial discretion to the pursuit of a pure profit

⁶⁰ Cox Report (n 46), 23. Job security and reputation are also closely aligned with achieving financial targets, see: John Graham, Campbell Harvey and Shiva Rajgopal, *The Economic Implications of Corporate Financial Reporting* (2005) 40 *Journal of Accounting and Economics* 3, 12.

⁶¹ Michael C. Jensen, 'Agency Costs of Overvalued Equity,' (2005) 34 *Financial Management* 5, 7.

⁶² That is, undertaking actions that 'smooth' the financial reports of the company thereby meeting the expectations of investors. Examples include deferring losses/costs to subsequent reporting periods. See: Moore and Walker-Arnott (n 47), 11-12; Dallas (n 54), 278-281.

⁶³ Jensen (n 61), 8.

⁶⁴ Dallas (n 54), 269.

⁶⁵ s 172 Companies Act 2006.

maximising objective, without regard for broader interests.⁶⁶ In doing so, it provides the paradigm that underpins creative compliance, pursuant to which directors are 'justified' in treating compliance as a pure pricing exercise.

As introduced in chapter four, the duty to promote the success of the company is, primarily, a duty to increase the long-term value of the corporation for the benefit of its members.⁶⁷ Nevertheless, when the Companies Act 2006 codified directors' duties it introduced the concept of 'enlightened shareholder value' that is, in discharging this duty directors are required to have 'regard' to a range of broader stakeholder interests (such as the impact of any decision on corporate reputation as well as employee and community interests).⁶⁸ Thus, notwithstanding the overarching profit focus of this duty, directors do have a discretion, indeed obligation, to have regard to wider interests when setting corporate strategy. This discretion is supported by judicial treatment that has made it consistently clear that the court will not, in the absence of *mala fides*, interfere with directors' decision making.⁶⁹ Moreover, it is important to recall that in the context of this obligation, directors owe their fiduciary duties to the corporation,⁷⁰ which is generally accepted to mean the benefit of all shareholders⁷¹ both present and future.⁷² Thus at law, directors are seemingly able to take into account a relatively wide range of factors when setting corporate strategy. It is at this juncture, that we return to the impact of the corporation's normative environment on decision-making. Whilst directors are not mandated to pursue creative compliance strategies, it is the extra-legal

⁶⁶ Werner (n 33), 389. See the empirical study of David Collison, Stuart Cross, John Ferguson, David Power and Lorna Stevenson in which the majority of corporate respondents felt that s 172 Companies Act 2006 required 'maximising share price in the short term.' Association of Chartered Accountants, *Shareholder Primacy in UK Corporate Law: An Exploration of the Rationale and Evidence*, (Research Report 125), 8.

⁶⁷ Lord Goldsmith, Lords Grand Committee, 6 February 2006, column 255, cited in: Ministerial Statements, *Companies Act 2006, Duties of Company Directors*, June 2007, 7. <<http://www.berr.gov.uk/files/file40139.pdf>> accessed 10 September 2016.

⁶⁸ s 172(1) (a-f) Companies Act 2006.

⁶⁹ *Carlen v Drury* (1812) 1 Ves & B 154

⁷⁰ s 170 Companies Act 2006 and *Percival v Wright* [1902] 2 Ch 421.

⁷¹ *Greenhalgh* (n 13), 291.

⁷² *Gaiman* (n 14), 330.

pressures of market behaviour (and the interpretation of section 172 of the Companies Act 2006) that have encouraged this approach.

The transition of directors' attention from the legal requirement to increase the long-term value of the company, to the market demands of increasing short-term earnings per share, has a powerful practical impact. A 2005 survey, cited by Dallas, found that over 80% of the 401 US financial executives interviewed would reduce discretionary spending to meet targets whilst over 50% would delay starting a new project, even at a cost to the company, if this would meet earnings expectations.⁷³ Moreover, it becomes clear how this perception of directors' fiduciary duties supports creative compliance strategies that may undermine the long-term stability of the company but nevertheless increase its' short-term value (an approach adopted by Enron in its use of off-balance sheet special purpose vehicles). In contrast, a board taking into account the long-term interests (and viability) of the corporation may eschew immediate gains to promote longer-term success.

Thus, the change in focus of the corporate beneficiary, whilst ostensibly subtle, has significant ramifications.⁷⁴ Even so, it could be argued that the fact that the corporation acts by individual agents means that the personal 'ethics' of these agents will curtail otherwise egregious behaviour. This is where the importance of the structurally predicated corporate decision making hierarchy comes in. As part three explains, the separation of ownership and control considered in the first two parts of this chapter precipitate a decision making hierarchy that effectively insulates individual decision makers from moral responsibility. As such, the motivations of the market (reflected in

⁷³ Dallas (n 54), 280.

⁷⁴ Kay Review (n 43), para 4.15. Also, Sir Roger Carr, when describing his position as chairman of Cadbury during the Kraft takeover bid, explained that the board felt it could not reject a high bid (reflecting the full value of the company) even if they considered the long term success of the company may be best achieved if it remained independent (cited by the Kay Review at para 3.5).

personal benefits and that are perceived to be legitimised by company law) are nevertheless able to dictate corporate strategy.

PART THREE: THE CORPORATE FIDUCIARY LADDER

This part considers how the structure of the corporation facilitates a decision making hierarchy, which this thesis terms the ‘fiduciary ladder.’ It is this fiduciary ladder that enables the profit-maximising interests of the ‘market’ to displace the personal ethics⁷⁵ of individuals within the corporation. We have seen that at the highest level the corporation is premised on a fiduciary duty, which is owed by the directors to the company.⁷⁶ This part explores how this duty transcends the corporation through the fiduciary ladder (predicated on an internal command and control structure) in such a way that enables the corporation to operate free from the substantive, colloquial, connotations of ‘personhood.’

(i) The structure of the fiduciary ladder

Ronald Coase first identified the internal corporate power hierarchy in his seminal work *The Nature of the Firm*.⁷⁷ In his article, Coase defines the firm as a centralised system of management, governed by an entrepreneur-coordinator (in a modern corporation, the board of directors) who directs a subordinate workforce.⁷⁸ In this regard, Coase

⁷⁵ In broad terms, the non-legal behavioural constraints that restrict individuals from acting in a self-serving manner.

⁷⁶ Sections 170-177 Companies Act 2006. For academic literature on this relationship see: P Finn, *Fiduciary Obligations*, (The Law Book Company Limited (1977); Robert Cooter and Bradley Freedman, 'The Fiduciary Relationship: Its Economic Character and Legal Consequences,' (1991) 66 New York University Law Review 1045 (for an economic analysis of fiduciary duties); John Lowry, 'The Duty of Loyalty of Company Directors: Bridging the Accountability Gap Through Efficient Disclosure,' (2009) 68(3) Cambridge Law Journal 607 (for a review of the policy decisions underlying the codification of directors' duties).

⁷⁷ (1937) 4 *Economica* 386.

⁷⁸ This can be contrasted with the origins of the firm itself, being a vehicle designed to reduce the transaction costs that would otherwise arise each time a particular market input was required. Thus, it has been suggested that a corporation would more accurately be described as a nexus *for*

contrasted the centralised, internal organisation, of the firm with the operation of the economic system of the market exchange, which was not subject to central control. Rather, the market operates by itself, governed by the price-mechanism pursuant to which supply adjusts to demand and production to consumption.⁷⁹

In adopting a ‘real world’⁸⁰ analysis of the firm, namely one that did not perfectly reflect the economic system of the market, Coase importantly identified the inherently subservient role of firm employees. That is, the essence of relationships *within* the firm was control, not exchange.⁸¹ In doing so, Coase argued that a defining characteristic of the firm was that the central entrepreneur could direct the employees within it, subject only to broad limitations detailed in the employment contract; that a workman does not change departments because of relative prices, he transfers ‘because he is ordered to do so.’⁸²

In his analysis, Coase recognised the internal command and control structure that the modern corporation operates on (and that supports the fiduciary ladder detailed below). That is, Anglo-American employment relations are premised on a historical master and servant relationship, in contrast to the contractual legal origins of employment relationships in continental Europe.⁸³ The master and servant roots of the British employment relationship are pervasive and profound, notwithstanding their repeal in 1875.⁸⁴ They inform both the express and implied duties of the employment contract,

contracts, rather than the more popular nexus *of* contracts. See John Armour *et al* (eds) *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford University Press, 2nd edn, 2009), 6.

⁷⁹ R. H. Coase, ‘The Nature of the Firm,’ (1937) 16(4) *Economica* 386, 387.

⁸⁰ *Ibid.*

⁸¹ *Ibid.*, 393.

⁸² *Ibid.*, 387.

⁸³ This can be contrasted with the contractual legal origins of employment relationships in continental Europe On which see Simon Deakin, ‘Legal Origin, Juridical Form and Industrialisation in Historical Perspective: The Case of the Employment Contract and the Joint-Stock Company,’ (2009) 7 *Socio-Economic Review* 35.

⁸⁴ For an analysis of modern authorities on the ‘master and servant’ nature of employment relationships see: *Geys v Société Générale, London Branch* [2012] UKSC 63.

granting to the employer full direction and control over the employee.⁸⁵ Moreover, this foundation underpins the psychological contract⁸⁶ between the parties and drives the perception that the 'intent of employment law seems to be to make the employee as much as possible an extension of the employer.'⁸⁷

Critics of this master/servant analysis suggest that employees, like other contracting parties, may simply withdraw their services; that the worst that an employer can do is litigate or terminate the employee's contract.⁸⁸ However, this is where the importance of Coase's 'real world' model of the employment relationship is important. In reality, there is a significant gulf between the contractual entitlements of the employee/employer relationship and the reality of the means available to employees. In particular, the entrenchment of employees both within their employer firm and their industry more generally, significantly restricts employee mobility. Thus, the employment relationship is one of high dependency and the labour market, particularly in periods of economic difficulty, can be static. The effect of this command relationship is that regardless of the contractual right of exit that employees have they are often constrained to stay within their employment and do as they are instructed (the next section considers the psychological dependency within the hierarchy in more detail).

The decision-making fiduciary ladder operates across this corporate command structure as follows. A legal entity necessarily has to operate through agents⁸⁹ and for a large listed corporation this entails a vast network of individuals, the most senior of which are

⁸⁵ Marc Moore, *Corporate Governance in the Shadow of the State*, (Hart Publishing, 2013) 47.

⁸⁶ That is, the employee's perception as to their complete obligations to their employer. See: D Rousseau, 'The 'Problem' of the Psychological Contract Considered,' (1998) 19 *Journal of Organizational Behaviour* 665; Sam Middlemiss, 'The Psychological Contract and Implied Contractual Terms: Synchronous or Asynchronous Models?' (2011) *International Journal of Law and Management* 32.

⁸⁷ Scott Masten, 'A Legal Basis for the Firm,' (1988) 4 (1) *Journal of Law, Economics and Organization* 181, 188.

⁸⁸ Armen Alchian and Harold Demsetz, 'Production, Information Costs, and Economic Organization,' (1972) 63 *American Economic Review* 777, 777.

⁸⁹ *Aberdeen Railway Co v Blaikie Bros* (1954) 1 Macq 461, 471

the board of directors; occupying the Coasean position of co-ordinator entrepreneur (although it will be seen that this centralised system is nevertheless supported by decentralised loci of power).⁹⁰ As the previous section demonstrated, directors are bound by their fiduciary duty to promote the success of the company (a duty that is applied in practice to mean the interests of the market), which includes an uncompromising obligation of loyalty to the beneficiary. In discharging this duty the board has primary responsibility for setting corporate strategy,⁹¹ which given the distortion of directors' duties from 'company' to 'market' interests, and concomitant personal incentives, generally prioritises profit maximisation.

To achieve these strategies, a typical structure that is adopted is that the board sets broad objectives for senior management,⁹² although it leaves the operational decisions of how to actually achieve these objectives to the management teams. Therefore, senior executives have the autonomy to operate as decentralised centres of management (an autonomy that is important when considering director responsibility in the next section).⁹³ In turn, senior management directs employees on how to implement the minutiae of these strategies. Thus, decision-making within the corporation is exercised via a hierarchy, starting with the interests of the market and filtering through the subordinate stages of the corporation. In this regard, a corporate fiduciary ladder is created; the shareholders (expressed now as the market) sit at the top of the ladder as corporate beneficiaries. Next are the directors who owe a fiduciary duty to the corporation. Beneath the directors are the semi-autonomous senior management teams

⁹⁰ The modern corporation operates through a complex network of business units, specialisms and divisions. This chapter considers the normative impact of operating across a corporate hierarchy more generally and therefore does not engage in a detailed organisational analysis of managing corporate conglomerates. On this see: Joseph Bower, 'Planning Within the Firm,' (1970) 60(2) *The American Economic Review* 186.

⁹¹ Article 3 Model Articles.

⁹² A fiduciary is not able to delegate his responsibility, save with express authority. Directors have such authority pursuant to Article 5 Model Articles. See also: *Ex parte Belchier* (1754) 27 ER 144; *Dovey and the Metropolitan Bank (of England and Wales) v John Cory* [1901] AC 477.

⁹³ Werner (n 33), 399.

and thereunder are the 'rank and file' corporate employees, situated at the bottom of the ladder.

This hierarchical structure creates an edifice of fiduciary obligations, supported by the internal contractual command and control structure.⁹⁴ In this way, directors' duties (driven by market norms) become verticalised and are embedded throughout the corporation; that is, from the board to managers and managers to employees. Action is undertaken by each rung of the ladder simply because the rung above them directed them to do so. Thus, the broad fiduciary duty that binds directors (and has, arguably, been distorted by them) extends down a hierarchical ladder premised on the internal command and control structure first identified by Coase. The beneficiary of the ladder, which effectively dictates the actions of the firm, is now the faceless 'market' interested in one outcome: earnings per share. The consequence is that the corporation, the most significant economic actor of our time, is governed by a decision-making hierarchy premised on a resolutely market driven, profit-maximising norm.⁹⁵

Notwithstanding the profit focus of the ultimate corporate beneficiary, the fiduciary ladder is nevertheless comprised of individuals. It would therefore be reasonable to expect that, at some point, personal ethics would intervene to stop egregious behaviour. Regrettably, numerous corporate scandals exist to demonstrate that this is not the case.⁹⁶

⁹⁴ Herbert Simon describes a hierarchy as 'a system that is composed of interrelated subsystems, each of the latter being, in turn, hierarchic in structure until we reach some lowest level of elementary subsystem.' See Herbert Simon, 'The Architecture of Complexity,' (1962) 106(6) *Proceedings of the American Philosophical Society* 467, 468.

⁹⁵ Note that organisations that adopt a more horizontal or decentralized structure still act, ultimately, within the parameters of an authority structure. Further, the autonomy that such horizontal organizational models grant tends to relate to decisions concerning product or service design (and delivery) rather than cultural, compliance or fiscal policies.

⁹⁶ See for example, the decision of Manville executives to conceal the risk of asbestosis from their employees, notwithstanding the fatal consequences. On which see: Ronald Sims, 'The Challenge of Ethical Behaviour in Organizations,' (1992) 99(7) *Journal of Business Ethics* 505, 506; Marc Weingarten, 'Asbestos Litigation from an American Perspective,' (2009) 4 *Journal of Personal Injury Law* 253.

The next section explains the psychological impact of the fiduciary ladder and why it is able to displace personal moral norms so absolutely.

(ii) The relationship between the fiduciary ladder and personal conduct

The previous section demonstrated how the fiduciary ladder created a hierarchy of control, a hallmark of which was the ability of the board to direct the conduct of subordinate employees. Moreover, earlier parts of the chapter identified the pervasive and homogenous corporate objective of profit maximisation. This section considers how these two characteristics coalesce to cause otherwise law-abiding individuals to engage in illegal or otherwise unethical behaviour. In particular, it draws on the findings of the Milgram 'electric shock' research to demonstrate why it is that 'behaviour that is unthinkable in an individual who is acting on his own may be executed without hesitation when carried out under orders.'⁹⁷

In brief, Stanley Milgram's famous 'shock study' was structured to identify the point at which people would defy authority notwithstanding a clear moral imperative. The experiment involved three participants: the subject (referred to as the 'teacher' and who is the only genuinely naive participant in the research), the learner (an actor) and the administrator/researcher (also an actor) who wore a white laboratory coat as a symbol of authority. The learner was strapped into an electric shock machine, in full sight of the teacher. The teacher is then taken to a different room, from which the learner is no longer visible, and asked by the administrator to inflict a series of electric shocks of increasing severity each time the learner answers a question incorrectly. The shocks were indicated to increase to a potentially fatal voltage. The insight given by the

⁹⁷ Zygmunt Bauman, *Modernity and the Holocaust*, (Polity 1989), 154. Bauman is, of course, writing in a very different context. However, his insights into the application of the findings of the Milgram experiment are highly instructive and applicable to individual behaviour within an organisational setting.

research was the willingness of the teachers to inflict shocks marked as ‘danger - severe shock’ simply because the authority figure, the administrator, had asked them to do so, regardless of the audible screams of the learner and their pleas for release.⁹⁸

The salient finding of Milgram's work is that it is a person's relationship with authority, not their character (for example whether they are aggressive or passive), which is determinative of their transgression of personal ethics within an organisation.⁹⁹ Specifically, when an individual operates within a hierarchy, several important consequences occur. The individual voluntarily¹⁰⁰ becomes part of a legitimate chain of command, implicitly agreeing to achieve (and therefore be measured against) the objectives of the ultimate authority within the hierarchy.¹⁰¹ In doing so, the individual's immediate commitment is to the authority (regardless of the impact of his actions on a third party) and his role is simply to undertake the specific tasks assigned to him to achieve the authority's objective. The profound outcome of this chain of command is that responsibility for the morality of any activity is outsourced to the authority; the individual does not evaluate the ethics of his conduct but is simply responsible for obeying¹⁰² orders (a position that Milgram described as an agentic state, which is discussed further below).

⁹⁸ See Stanley Milgram, *Obedience to Authority: An Experimental View*, (first published Tavistock Publications 1974, rev edn, Pinter & Martin 2010), a detailed explanation of the experiment is at pp 9-10.

⁹⁹ Milgram (n 98), 168. In coming to this conclusion, Milgram rebuked suggestions that his experiment simply facilitated the realisation of people's inner (suppressed) desire to engage in violent conduct, the so-called ‘aggression theory,’ see: Milgram (n 98), 166-178.

¹⁰⁰ This voluntary participation is psychologically important as it creates a ‘sense of commitment and obligation which will subsequently play a part in binding the subject to his role (Ibid 142).

¹⁰¹ The legitimacy of authority is important (Ibid 140). When Milgram varied the experiments so that another apparent member of the public (who was in fact an actor) instructed the subject to administer the shock every participant refused (ibid 106). Within a corporate structure, the legitimacy of authority is clear and supported by regulatory norms. Moreover, the corporate authority's instructions adhere to a legitimate overarching ideology of profit maximisation, which is also reflected in corporate regulation. On the importance of a justifying ideology, see: (Ibid 143).

¹⁰² Milgram notes that ‘the essence of obedience [is] that the action carried out does not correspond to the motives of the actor but is initiated in the motive system of those higher up in the social hierarchy,’ (Ibid 167).

How is it that a hierarchy (such as the fiduciary ladder identified in the previous section) has this transformative impact on individual behaviour? In the first instance, the hierarchy creates social distance between individuals within the firm and the repercussions of their actions, which has two important consequences. First, and more obviously, the distance insulates the actor from the causal impact of their actions and the further the distance, the greater the insulation.¹⁰³ In contrast, if an individual is directly involved in causing harm to another, that individual is 'denied the comfort of unnoticing the causal link between his action and the victim's suffering.'¹⁰⁴ Secondly, this social distancing causes the individual to have greater alignment with, and loyalty to, the authority figure (in the corporate environment an individual's manager). Thus, the hierarchy leads to 'an ever-more profound and unbridgeable chasm between the actors (i.e. members of the organization) and the objects of action.'¹⁰⁵ Notably, this chasm arose in the extreme conditions of the Milgram experiment, a situation where the authority relationship was temporary (no subject was present for more than one hour) and the consequences of the individual's actions severe. The impact of these psychological phenomena is even more profound when arising in a corporate environment, where the relationship is long-term and the harm caused perceived to be merely fiscal.

This alignment between an individual and the organisational hierarchy is the first step in transforming individual behaviour. Once embedded within the hierarchy, an individual is then subsumed within a command and control structure, whereupon individual decision-making is simply concerned with whether to obey or disobey instructions, not whether the instructions are morally right or wrong. As such, the individual's self-image

¹⁰³ Ibid 37-41. Milgram tested this theory by undertaking a series of modified experiments that varied the proximity between the subject and the 'victim.' The original research placed the subject and the victim in different rooms (remote-victim) whereas variations had them, *inter alia*, in the same room (proximity) and also required the subject to force the hand of the victim onto the shock plate (touch-proximity). Ibid 33-35.

¹⁰⁴ Bauman (n 97), 155.

¹⁰⁵ Ibid 156.

has transformed from evaluating the morality of autonomous conduct to becoming an ‘instrument for another person's wishes.’¹⁰⁶ In simply carrying out the wishes of another, conduct that is ‘psychologically, of a profoundly different character than action that is spontaneous,’¹⁰⁷ individuals within the hierarchy achieve what Milgram described as an *agentic* state.¹⁰⁸ In this state an individual, unburdened by moral responsibility, ‘becomes something different from his former self, with new properties not easily traced to his usual personality.’¹⁰⁹ That is, an individual feels ‘responsible *to* the authority directing him but feels no responsibility *for* the content of the actions that the authority prescribes.’¹¹⁰ This comprehensive outsourcing of moral responsibility ‘is the most far-reaching consequence of submission to authority,’¹¹¹ leading Bauman to conclude that ‘collective perpetuation of cruel acts is made all the easier by the fact that responsibility is essentially ‘unpinnable.’¹¹² Importantly, this complete lack of autonomy (and concomitant lack of moral responsibility) creates not simply an after-the-event excuse but the very condition that enables the blind pursuit of authoritative instructions without engaging in a broader ethical analysis.¹¹³

Several examples of the consequences of this outsourcing arose from the Milgram research. During the electric shock experiment, individuals who questioned the morality of the request were easily satiated by the managers' response that ‘no permanent harm would be caused,’ there was no further individual analysis as to the ethics of temporary harm or the affliction of pain. Moreover, the acceptance of personal responsibility (or otherwise) was determinative as to whether an individual ‘disobeyed’ the researcher by refusing to continue with the experiment. Generally, ‘disobedient’

¹⁰⁶ Ibid xviii.

¹⁰⁷ Ibid xvii.

¹⁰⁸ Ibid 162 and Milgram (n 98), 134 – 136.

¹⁰⁹ Milgram (n 98), 145.

¹¹⁰ Ibid 147.

¹¹¹ Ibid 10.

¹¹² Bauman (n 97), 163.

¹¹³ Ibid 163.

subjects accepted full, personal, responsibility and refused to assign any responsibility to the learner or the researcher.¹¹⁴ This can be contrasted with the 'obedient' subjects who continued the experiment until the end, including one who, questioning the ethics of continuing, asked the researcher whether he 'accepted all responsibility.' On being reassured that this was the case the subject proceeded to administer the maximum (and potentially lethal) amount of volts.¹¹⁵

Thus, the hierarchy enables the creation of an agentic state, which in turn creates the psychological condition necessary for individuals to eschew moral responsibility for their actions. In a corporate setting, this abrogation of moral responsibility is further reinforced through reward structures that generally recognise obedience, not disobedience.¹¹⁶ A position supported by the view that, particularly in a time of crisis, individuals will 'respond to what they are measured on,'¹¹⁷ namely achieving the authority's objectives. Furthermore, individuals occupying an agentic state are concerned not with the broader implications of their actions but rather the recognition of the authority. What matters is 'how smartly and effectively the actor fulfils whatever he has been told to fulfil by his superiors.'¹¹⁸ As such, the authority not only dispenses rewards and metes out punishment but it also passes moral judgment.¹¹⁹

This outsourcing of responsibility to the hierarchy is further, cognitively, legitimised by the perception that by operating within a chain of command each individual is simply one component part of the organisation's operations. That is, each level within the

¹¹⁴ See the transcripts of the experiment involving 'Mr Renseller' as the subject, Milgram (n 98), 52 and Gretchen Brandt (p 87), both of whom accepted personal responsibility for their conduct and both of whom refused to carry on.

¹¹⁵ See Fred Prozi's transcripts: Milgram (n 98), 77 and those of an unnamed subject at 162. The majority of 'defiant' subjects considered themselves responsible for their conduct whereas for 'obedient' subjects the majority considered the researcher to be responsible: see Milgram (n 98), 205.

¹¹⁶ On the role of rewards more generally see Milgram (n 98), 139-140.

¹¹⁷ Bower (n 90) 190.

¹¹⁸ Bauman (n 97), 159.

¹¹⁹ Ibid.

chain can claim a lack of information with which to analyse the impact of their actions making it ‘psychologically easy to ignore responsibility when one is only an intermediate link in a chain.’¹²⁰ Importantly, each level of command can, ostensibly, rely upon this justification. For example, even directors rely on the fact that specific management decisions are made by the decentralised senior management teams (to whom directors delegate responsibility).¹²¹ It is at this juncture that we see the further importance of the transition of the corporate beneficiary to the faceless ‘market.’ Not only are corporate decisions driven by a pure profit maximising norm but the ultimate point of authority within the fiduciary ladder is no longer a natural person, constrained by 'human' values. Rather it is the faceless market, concerned simply with financial performance.

The existence of the market beneficiary is also important in providing a clear, unchallenged objective to individuals within the hierarchy. Milgram was conscious that his experiment created a monolithic chain of command whereby a single researcher directed the subject and thus Milgram wanted to test the impact that a plurality of directions had on subjects' behaviour.¹²² To do so, Milgram undertook a further experiment during which two ‘researchers’ (sources of authority) would argue in front of the subject, disputing the course of action to be taken. In all cases this pluralism ‘completely paralysed’¹²³ the subject's activity.¹²⁴ The unchallenged adoption of the market as the ultimate corporate beneficiary replicates this unitary authority. In doing so, the risk of plurality is removed, recreating the single authority reflected in Milgram's

¹²⁰ Milgram (n 98), 12. See also: Bauman (n 97), 161.

¹²¹ John Coffee, ‘No Soul to Damn: no Body to Kick’: An Unscandalized Inquiry into the Problem of Corporate Punishment,’ (1980) 79 Michigan Law Review 386, 398. For example, the management of GE when facing price fixing charges pointed to a directive that its executives were required to sign expressly forbidding violations of anti-trust rules. However, the targets and incentives set by management created an environment where such collusion was, at best, highly likely. See Bower (n 90), 193.

¹²² Milgram (n 98) 107 - 114 and Bauman (n 97), 163.

¹²³ Milgram (n 98), 109.

¹²⁴ Bauman (n 97), 165.

original experiments. Importantly, within Milgram's work other 'victim-led' attempts designed to interrupt the continuation of the experiment, such as screams and pleas to stop, were ineffective. It was the break in authority, the disruption to the clear line of hierarchy generated by the disagreement between the two researchers that caused subjects to discontinue with the research, not the presentation of evidence that they were inflicting pain.

The outcome of this hierarchy is not that it removes moral norms but that it repositions them.¹²⁵ The objective of individuals within the chain, who have so easily become 'an instrument of authority,'¹²⁶ becomes pleasing the system of authority. Importantly, in doing so the fiduciary ladder operates to 'shift' responsibility at all levels of the ladder, with the effect that each rung of the ladder can look to another level within the firm as being morally responsible for the decision made. In removing personal responsibility in this way, the fiduciary ladder enables individuals to pursue the wishes of the hierarchy (profit maximisation achieved through creative compliance) free from ethical analysis. This insulation also removes the powerful impact of stigma¹²⁷ and another key driver of compliance, namely 'the mere feeling that some action would be so outrageous that one's fellows would not tolerate it.'¹²⁸

(iii) Responding to the fiduciary ladder

Understanding the behavioural impact of corporate structure in this way provides both an ethical imperative for corporate reform together with a deeper understanding of the changes needed if we are to respond to the problem of creative compliance. The GAAR seeks to manage corporate compliance by simply focussing on restricting the

¹²⁵ Ibid 160.

¹²⁶ Milgram (n 98), 174.

¹²⁷ Coffee (n 121), 389.

¹²⁸ F Hayek, *Law, Legislation and Liberty*, (Routledge Classics, 1973), 92.

compliance strategy itself. However, as this chapter (and chapter four) have sought to demonstrate, corporations' compliance strategies are borne from the norms, and unintended protections, which arise from the broader corporate regulatory framework. Thus, if we are to achieve any substantive reform in this field we need to challenge the deeper causes of the problem.

Milgram drew an analogy between the agentic state and being asleep.¹²⁹ That is, an interruption can reverse the insulation offered by the hierarchy (as it can wake someone from sleep). Within his experiments Milgram identified that this interruption can come from, *inter alia*, peer dissent, plurality of instructions and distancing the source of authority. Within a corporate structure replicating these interruptions is unlikely: peers within the firm are subject to the same agentic state, the unitary profit maximising norm within a clear hierarchical structure is unlikely to be subject to realistic challenge and the nature of a corporate environment is such that the authority structure is ever-present. Instead, where we can introduce challenge is to undermine the ability to outsource moral responsibility at all stages of the chain. The most credible stage of the corporate hierarchy at which to do so is the board of directors.

In particular, we have seen how the distortion of fiduciary duties has facilitated 'unethical' corporate compliance strategies. Thus, the interpretation of these duties within the current normative landscape needs to be revisited and, importantly, implemented to address current behaviours.¹³⁰ Chapter six builds on this necessity but, in brief, it is necessary to introduce a stronger imperative to appreciate the legitimacy of, and functional requirement to uphold, the rule of law: an imperative that is theoretically premised on the normative harm caused by creative compliance and the

¹²⁹ Milgram (n 98), 157.

¹³⁰ Gunther Teubner, 'Corporate Fiduciary Duties and Their Beneficiaries A Functional Approach to the Legal Institutionalization of Corporate Responsibility,' in Klaus Hopt and Gunther Teubner (eds) *Corporate Governance and Directors' Liabilities: Legal, Economic and Sociological Analyses on Corporate Social Responsibility* (Walter de Gruyter & Co, 1984), 167

legitimacy of requiring a regulatory response to ameliorate the (arguably unintended) consequences that corporate law, theory and architecture can cause.

PART FOUR: CONTRASTING OTHER ACTORS

This chapter suggests that public corporations are uniquely predisposed to adopt creative compliance strategies on the basis that the structure of their decision-making mechanisms insulates the corporation and their employees from responsibility. This section responds to the potential objection to this theory, namely that such corporations are no different to other significant economic actors or organisations. In particular, it considers the position of high net worth individuals, private companies and partnerships.

In contrasting these other actors, the key point of distinction is that none of them are protected by the operation of the fiduciary ladder. That is, in all cases there is a human decision-maker to ultimately take responsibility for the act or omission complained of. In the case of an individual acting in their personal capacity they are, of course, easily identifiable and therefore responsible for their decisions. In the event that they transgress moral norms or breach regulation, the individual is clearly identifiable to both the public and enforcement agencies.

That said, the case of the individual entrepreneur or high net worth individual (acting in a purely personal capacity) is rare. The very necessity of the corporation arises as its objects 'are beyond the reach of the members as individuals,'¹³¹ and thus individual capitalists ordinarily act through a corporate vehicle. As such, creative compliance rarely involves an individual acting *qua* individual. Moreover, when acting in a

¹³¹ A. Chayes, 'The Modern Corporation and the Rule of Law,' E Mason (ed) *The Corporation in Modern Society* (Harvard University Press, 1961), 34.

personal capacity (without the protection of the corporation) the fiduciary ladder does not exist as the individual concerned cannot use the corporate architecture, or decision making hierarchy, to shield themselves from moral culpability. A similar argument applies to private or closely held companies, which are often ‘owner-managed’ meaning that the shareholder and director are usually the same person. As a consequence, the shareholders are legally but not economically emancipated from the corporation. Again, this ‘human’ presence has a dramatic impact on the risk profile of the company and also the responsibility for transcending social norms; the ability to outsource moral responsibility for corporate decisions simply does not exist.

The difference between corporations and partnerships is more nuanced although premised on the same distinction that the decision-makers within the partnership remain visible from a reputational perspective. Historically, only general partnerships were available,¹³² which meant that all partners were jointly and severally liable for the obligations of the firm.¹³³ This personal liability precluded the operation of the fiduciary ladder as ownership and control remained unified and ensured that partners’ personal risk appetites were reflected within the decision making process. The high visibility of individual partners, both in terms of risk and reputation meant that the firm decision making process was nevertheless imbued with the personal traits that are often missing from the corporate one. The personal nature of the partnership is powerfully demonstrated by the fact that traditionally the partnership could be dissolved on notice by one partner¹³⁴ or upon the exit of a partner through death or bankruptcy.¹³⁵

As partnerships developed, they started to emulate the desirable characteristics of the

¹³² Partnership Act 1890.

¹³³ Section 9, Partnership Act 1890.

¹³⁴ Section 32 Partnership Act 1890.

¹³⁵ Section 33 Partnership Act 1890.

corporation, culminating in the creation of the limited liability partnership ('LLP').¹³⁶ An LLP has separate legal personality¹³⁷ and the members' liability is limited to the extent set out in the LLP deed entered into between them.¹³⁸ Part one of this chapter demonstrated the importance of separate personality and limited liability on the creation of the corporate fiduciary ladder and thus it would be a natural conclusion to suggest that the LLP shares this decision making structure. However, there is one important difference: LLPs rarely have the concomitant separation of ownership and control. The partners of the LLP are invariably the managers of the LLP (for example, large law firms).¹³⁹ Thus the fiduciary ladder does not exist to shield the owner/managers from reputational damage, either within the firm or from external scrutiny. In this sense the historical development of partnership principles continue to influence the use and operation of partnerships and the attempted emulation of the corporate form is insufficient to define the LLP within the same class as a corporation.

In briefly contrasting other significant economic actors in this way, we can understand the powerful impact that the existence of the internal fiduciary ladder, combined with a 'faceless' beneficiary, has on corporate behaviour. Moreover, this distinction provides an ethical imperative to subject corporations, in contrast to other actors, to regulatory reform in this field.

¹³⁶ Limited Liability Partnerships Act 2000.

¹³⁷ Section 1 Limited Liability Partnerships Act 2000.

¹³⁸ Section 5 Limited Liability Partnerships Act 2000.

¹³⁹ The traditional requirement that law firms operate as partnerships are premised on the exact notions of the fiduciary ladder that exists within large corporations. That is, by operating through a partnership there was an identifiable ownership structure of individuals who were bound by professional ethics (and regulatory oversight). A discussion of this principle can be found in: Sir David Clementi, *Review of the Regulatory Framework for Legal Services in England and Wales: Final Report*, (December 2004), 113.

CONCLUSION

This chapter has sought to demonstrate how understanding the existence of the corporate fiduciary ladder can help address the concerns that society has with current standards of corporate compliance. The answer, in high-level terms, is that it helps to explain why it is that the corporate person lacks the substantive attributes that we expect of natural ‘personhood’ and why the ethics of individuals within the firm are so readily displaced. Moreover it demonstrates that by repositioning our understanding of personality in a corporate context, namely as the product of legal rights and duties, we can identify the impact that those regulatory provisions have on individual behaviour.

By understanding the influence of the regulatory system in this way, we are better positioned to structure a holistic approach to creative compliance; one that addresses the causes of this behaviour, not simply its effects. Single-issue regulation that responds to specific concerns will, no doubt, have some impact on current compliance scandals. However, creative compliance is, by its very nature, a complete disregard for the normative value of regulation; it simply views compliance as a pricing exercise. Thus, if we are to achieve any substantive reform in this field we need to challenge the deeper causes of the problem. As this chapter (and chapter four) have sought to demonstrate, one of those causes is the powerful normative impact of both corporate law and architecture, which coalesce to both legitimise creative compliance and insulate corporate decision-makers from the reputational consequences of their actions. The result of such impunity is that the dominant shareholder wealth maximising norm, which informs personal benefits (such as remuneration and, for directors, job security) is able to determine corporate strategy.

The reality is that corporate compliance responsibility is reaching a critical point. Corporate scandals are dominating the headlines and have now been met with a

regulatory response. Chapters one to three of this thesis set out the normative basis for reform, whilst chapters four and five explored those aspects of company law and governance that both legitimise creative compliance and act as impediments to reform. The following chapter concludes the substantive parts of this thesis by examining how the corporate normative landscape can be influenced to support, rather than resist, the implementation of spirited compliance, including the requirements of legislation such as the GAAR.

CHAPTER SIX

TOWARDS A NEW CORPORATE INTEGRITY:

THE OVERARCHING COMPLIANCE OBLIGATION

*'A corporation exists, not of natural right, but only by license of law and the law if we look at the matter in good conscience, is responsible for what it creates.'*¹

*'It is not the court's role to correct the uneven spread of avoidance opportunities and the implicit unfairness that avoidance represents. That is Parliament's role.'*²

INTRODUCTION

Corporate law is at a pivotal stage in its development. As has often been observed, it is in response to a crisis that a window for reform develops and this is certainly the case for modern company law.³ Significantly, the opportunity that has arisen following the recent corporate scandals is, potentially, a substantial one. These cases have generated a public response that is not limited to the 'severe criticism'⁴ of the discrete issue of corporate tax compliance but a broader rejection of the abuse of corporate privilege. Moreover, this public response has been met with similar consternation from, and commitment to reform by, national and international governments together with powerful global institutions.⁵ Nevertheless, the claim made by this thesis is that the UK response, in the form of the GAAR, does not go far enough to address the causes of creative compliance, instead limiting itself to the effects of the practice. More

¹ Woodrow Wilson, Governor's Inaugural Address, Minutes of Assembly of New Jersey, 17 January 1911, 65 reprinted in *The Public Papers of Woodrow Wilson* (Ray Stannard Baker and William E. Dodd eds.) (Harper 1925) vol. II, 273-5.

² Malcolm Gammie, 'Moral Taxation, Immoral Avoidance – What Role for the Law,' (2013) *British Tax Review* 577, 581.

³ On which see John Coffee's discussion of the regulatory sine curve: John C. Coffee, 'The Political Economy of Dodd-Frank: Why Financial Reform Tends to be Frustrated and Systemic Risk Perpetuated,' in Eilís Ferran, Niamh Moloney, Jennifer G. Hill and John C. Coffee (eds.) *The Regulatory Aftermath of the Global Financial Crisis* (Cambridge University Press 2012), 301-320.

⁴ Judith Freedman, 'Lord Hoffman, Tax Law and Principles,' Oxford Legal Studies Research Paper No. 14/2015, 15.

⁵ Most notably the Organisation for Economic Co-operation and Development's Base Erosion and Profit Shifting ('BEPS') initiative.

importantly, the GAAR fails to utilise this unique window of opportunity to make truly meaningful reform to our expectations of the role and responsibilities of the modern corporation in civil society.

This chapter concludes the substantive parts of the thesis by setting out a proposal that corporations should be subject to an overarching compliance obligation. Enshrined within the Companies Act 2006 itself, this overarching obligation would act as a statutory overlay, which effectively serves to constrain, rather than repeal, the objective of the firm as one of pure shareholder wealth maximisation. Positioning this overarching obligation within the Companies Act 2006 is crucial. It ensures that, unlike the GAAR, the overarching obligation utilises the expressive function of law to make a clear statement that it occupies a higher normative status than the shareholder wealth maximising norm enshrined within, *inter alia*, section 172 of the Companies Act 2006. In this way, the overarching compliance obligation fulfils a normative ordering function,⁶ making it clear that, in the event of conflict, the requirements of the compliance objective take priority over the shareholder wealth maximisation norm.

In putting forward this proposal for reform, the chapter proceeds as follows. Part one explores (and rejects) the claim that to reduce creative compliance liability should be imposed on corporate gatekeepers, with a particular focus on corporate lawyers. In repudiating this argument, part one explains how the imposition of liability (and by implication, responsibility) onto a third party would do little to change the perception, which is the root cause of creative compliance, that corporations do not have a responsibility to adopt spirited compliance standards. That said, it should be made clear from the outset that part one does not deny that restraining legal advice and practice would be instrumentally effective. Rather, it suggests that a gatekeeper restriction

⁶ In the same way that culture can perform a similar function. On which see: Charles O'Reilly, 'Corporations, Culture, and Commitment: Motivation and Social Control in Organizations,' (1989). *California Management review* 31(4), 12.

should flow from a primary (and mandatory) duty that is imposed on the corporation. It is this primary duty that then necessarily restricts the advice that a lawyer can provide, whilst nevertheless retaining the important expressive function that the duty is that of the corporation, not its counsel.

Having explained why the thesis rejects a primary gatekeeper responsibility, part two then introduces the proposal to implement an ‘overarching compliance obligation’ within the Companies Act 2006. It expands upon the claim outlined above, namely that the position of the compliance objective within the Companies Act 2006 itself (as opposed to, for example, the Articles of Association or UK Corporate Governance Code) is crucial if we are to properly engage the expressive function of law to change the corporate normative environment. By providing statutory legitimacy to this new injunctive norm, it can then start to counteract the market norms and pressures that coalesce to influence corporate decision-making. It is this normative influence that serves, in part, to distinguish the overarching compliance obligation from its tax-specific counterpart, the GAAR.

Thereafter, part three considers the crucial, although somewhat nuanced, role that enforcement plays in enhancing the expressive function of the overarching compliance obligation. Drawing on Tom Tyler’s work, which was considered in chapter one, it explains how the equal and fair application of the overarching obligation is crucial not only to maintaining the rule of law, but also to enhancing the legitimacy of the provision and, as a consequence, corporations’ compliance behaviours towards it. As to the mechanics of enforcement, the part outlines why it is essential that the overarching obligation be enforced by the state, rather than operate as a shareholder remedy, to avoid the collective action problems that would otherwise arise (and the potential lack

of inclination by shareholders to bring a claim to restrain creative compliance).⁷ Nevertheless, the question of enforcement is a nuanced one. Any enforcement policy needs to balance the proper enforcement of the overarching obligation (to realise its expressive function) with the equally important concern that it is not used in inappropriate circumstances or in an unduly politicised way.⁸

Part four concludes the substantive parts of the chapter by addressing the key challenge that arises with a proposal such as this. In particular, it responds to the criticism that the overarching compliance obligation is too ambiguous (a charge that is made against the GAAR). Whilst acknowledging that uncertainty is, clearly, an issue with proposals such as this, the part explains how, in due course, the overarching compliance obligation can actually reduce uncertainty and support judicial interpretation. Furthermore, the part explains how the existence of an overarching compliance obligation helps to reduce uncertainty for those directors who are subject to its provisions. By imposing a mandatory rule such as this, directors are able to implement spirited compliance strategies without risking an allegation of a breach of their general duty of loyalty under section 172 of the Companies Act 2006.

The overarching compliance obligation is an ostensibly bold claim, subject to understandable concerns (which are considered in part four). However, as the previous chapters have demonstrated, creative compliance is a problem of legitimacy, one that is predicated on the norms that are inherent within (and therefore further legitimised by) the Companies Act 2006 itself. Understood in this way, meaningful reform needs to challenge these norms in a clear and unequivocal manner. Without such a robust response, the recent tax scandals and the concomitant introduction of the GAAR will simply become another example of a corporate scandal being met with a limited

⁷ Collective action problems were discussed in more detail in chapter five.

⁸ Judith Freedman, 'Designing a General Anti-Abuse Rule: Striking a Balance,' (2014) 20(3) Asia-Pacific Tax Bulletin 167, 167.

regulatory solution.⁹ As a consequence, and much like Enron and SOX before it, creative corporate tax compliance and the GAAR will merely be a precursor to the next corporate scandal. The suggestion put forward in this chapter is that we utilise the current disposition for reform to introduce a provision that seeks to readdress a corporation's relationship with, and responsibility to, the legal and market institutions that it depends upon.

PART ONE: WHY GATEKEEPERS ARE NOT THE (ONLY) ANSWER

Lawyers play two significant roles in creative compliance. First, as chapter four (part four) explained, they serve to further legitimise a narrow interpretation of the corporate objective and, as a consequence, the compliance standards that fall within that objective. Secondly, and more functionally, they play a crucial role in implementing the tax structures that serve to reduce a corporation's tax base. These structures are highly complex, nuanced and, by their very nature, legally technical transactions. As a consequence, they are the product of collaboration between large, and often international, teams of accountants, tax advisers, solicitors and, depending on the transaction, sometimes barristers.¹⁰ Taking these two factors together, it is perhaps not surprising that a common proposal to restrict creative compliance is to implement reforms that either prevent, or dissuade, corporate lawyers from implementing these transactions in the first instance.¹¹

⁹ Whilst the GAAR meets one political objective of securing a 'quick win' (on which see: Freedman Hoffman (n 4), 3) it does not provide the level of reform needed to make a material change to creative compliance.

¹⁰ Barristers are involved either to provide an opinion on a particularly risky transaction or to undertake the necessary advocacy if a court procedure is involved. For example, if the structure includes a court approved reduction of capital sections 645-649 Companies Act 2006) or a scheme of arrangement (sections 895-901, Companies Act 2006)

¹¹ Arthur Laby reviews some of the literature in this regard, noting that the perception is that if we increase gatekeeper liability 'we will avoid such debacles in the future.' See: Arthur B. Laby, 'Differentiating Gatekeepers, (2006) 1 Brooklyn Journal of Corporate, Financial & Commercial Law 121, 121.

In putting forward a proposal for lawyers' liability, and drawing on the Lehman Brothers' collapse as a case study, Kershaw and Moorhead raise the question as to whether transactional lawyers should bear responsibility if they facilitate unlawful (or, more accurately, as they acknowledge 'probably'¹² unlawful) client conduct.¹³ In particular, Kershaw and Moorhead look at the implementation of a financing structure known as 'Repo 105' to examine the potential tension between a solicitor's duty to zealously defend their client's interests and their position as a 'custodians of the rule of law.'¹⁴ The Repo 105 was one example of an otherwise common (and often used) repurchasing structure. In general terms, these repurchasing (or 'repo') transactions involve a bank 'borrowing' short-term funds from a 'lender.' However, these transactions, which appear to be a secured loan, are structured as sale and buyback transactions. Namely, the borrower 'sells' an asset such as a bond to the lender, with an agreement to repurchase it (less a fee). These sale and repurchase agreements are common features of the tax structures that the GAAR seeks to restrict (for example, stock 'loans' also work on this basis).

The Lehman's Repo 105 operated in a slightly different way to the traditional repos. To avoid disclosing how much it was borrowing, as part of the 'sale' Lehmans accepted less cash than the actual worth of the asset that was transferred. Indeed, the name of the structure is derived from the fact that the asset was worth at least 105% of the money received. This, Lehmans argued, allowed the bank to register the Repo 105 as a true sale on its books, rather than a secured loan (which is how the relevant accounting standards would typically require it to be provided for),¹⁵ thereby shielding the amount of its borrowing. In brief, the reason Lehmans claimed it could account for the Repo

¹² David Kershaw and Richard Moorhead, 'Consequential Responsibility for Client Wrongs: Lehman Brothers and the Regulation of the Legal Profession,' (2013) 76(1) *Modern Law Review* 26, 27.

¹³ *Ibid.*

¹⁴ *Ibid.*

¹⁵ *Ibid.* 29.

105 in this way is that the reduced consideration received on the sale is such that the transaction did not meet the control test that would characterise the structure as a loan rather than a sale. That is, it allowed the bank to argue that it was ‘not able’ to repurchase the assets and that therefore it no longer ‘controlled’ them for the purposes of the relevant accounting standard.¹⁶ Once the ‘sale’ had occurred, Lehmans would use the funds to service other debts and then borrow more money to ‘repurchase’ the asset that was the subject of the repurchasing structure (resulting in the difficulties that Lehman’s later found itself in).

The question of legal professional responsibility arises as Linklaters gave a crucial opinion that classified the (clearly circular) transaction as a genuine sale and purchase, thereby enabling Lehmans to proceed with the structure on that basis (and account for it as such). Without that opinion the transaction would not have been able to proceed. The relevance of this to creative compliance is that the Linklaters’ opinion was, as a question of English Law, ‘clearly correct.’¹⁷ However, the practical effect of the transaction was, arguably also equally clearly, that of a secured loan. Thus the question arises as to whether Linklaters should bear any responsibility for their role in the losses that arose as a consequence of the structure that they helped to facilitate?

In their article, Kershaw and Moorhead argue that transactional lawyers, who are commonly subject to ‘fewer rules and significantly less scrutiny’¹⁸ than their trial counterparts should be subject to limits on the ‘zealous pursuit of client interests ... where their actions generate a *real, substantial and foreseeable* risk of client action that is unlawful or ‘probably unlawful.’¹⁹ Specifically, they refer to the trust that society

¹⁶ This is explained in more detail in Kershaw and Moorhead, *Ibid*, 33. Demonstrating the relationship between bright line rules and creative compliance, the accounting standards set the level of overcollateralization at 102%.

¹⁷ *Ibid*, 36.

¹⁸ *Ibid*, 26.

¹⁹ *Ibid*, 27.

places in the legal profession to be faithful to both ‘the letter and spirit’²⁰ of the law. The instrumental role that solicitors play in implementing tax avoidance structures is such that Kershaw and Moorhead’s proposal seeks to impose consequential responsibility on solicitors, predicated on a principle of foreseeable wrongdoing. In explaining the justification for this restriction, although acknowledging the limits of the analogy, the comparison is drawn between the liability of a taxi driver who unwittingly drives a robber to the jewellery store and that of a ‘get away driver’ who performs the same function but in full knowledge of the events that are to unfold.²¹

Kershaw and Moorhead are not alone in their view that we should look to the professions to restrict creative compliance. John Coffee is an advocate of such ‘gatekeeper’ responsibility²² although recent UK proposals also plan to fine the accounting firms that design such structures.²³ This focus on the legal industry is not surprising. Lawyers are ‘key players in the corporate tax shelter industry’²⁴ and the pursuit of zealous advocacy has been identified as one contributing factor to abusive tax avoidance practices.²⁵ There is no doubt that imposing restrictions (or sanctions) on the team of advisers that are necessary to implement these structures is, to a degree, instrumentally effective. However, whilst this may be one element of a holistic response to creative compliance it is submitted that it cannot, and should not, be the focus of the government’s response.

²⁰ Ibid, 47.

²¹ Ibid, 41.

²² John C. Coffee, ‘The Attorney as Gatekeeper: an Agenda for the SEC,’ (2003) Columbia Law and Economics Working Paper No. 221. See also: Robert W. Gordon, ‘A New Role for Lawyers?: The Corporate Counselor After Enron,’ (2003) 35 Connecticut Law Review 1185, who suggests that the participation of lawyers in implementing the transactions that were pivotal to Enron’s collapse justifies a reconceptualization of the role of the lawyer. In particular, Gordon recommends the creation of an ‘Independent Counselor, with a distinct ethical orientation,’ (at 1210).

²³ HM Revenue & Customs, *Strengthening Tax Avoidance Sanctions and Deterrents: Discussion Document*, 17 August 2016.

²⁴ William H. Simon, ‘After Confidentiality: Rethinking the Professional Responsibilities of the Business Lawyer,’ (2006) 75(3) Fordham Law Review 1453, 1453.

²⁵ Doreen McBarnet, ‘It’s Not What you Do but the Way You Do it: Tax Evasion, Tax Avoidance and the Boundaries of Deviance,’ in D. Downes (ed.) *Unraveling Criminal Justice: Eleven British Studies* (Macmillan, 1982), 247.

As the earlier parts of this thesis have demonstrated, the problem with creative compliance, both the initial decision to creatively comply and the challenge with subsequent attempts at reform, is that corporations in general do not see any normative harm in this approach to compliance. In particular, adopting a ‘spirited’ approach to compliance is not considered to be a corporate responsibility. Earlier chapters have demonstrated that to achieve meaningful reform, what is needed is a change in how corporations define compliance (thereby shaping the way in which they ‘fill the gaps’ of regulation, as well as how they choose to comply with any specific mandates). As a consequence, to change the perspective that corporations are not responsible for complying with the spirit of the law, the primary duty to constrain creative compliance must be on the corporation itself, rather than ‘outsourcing’ responsibility to a third party. To return to the taxi analogy, the individual robbing the bank is clearly liable for the principal crime of robbery. The problem, as chapters one and three explained, is that this is not (ordinarily) the case for corporations that creatively comply.

Nevertheless, a claim that reforms should render the corporation primarily responsible does not ignore the role that advisers play in implementing these structures. By imposing a statutory obligation on corporations to constrain creative compliance (rather than simply apply a best practice requirement), then this serves to also constrain the advice that corporate gatekeepers can provide. That is, a solicitor cannot ‘advise’ a client to act illegally, or provide the documentation (or opinion) that enables them to do so.²⁶ However, this subtle distinction is crucial. By structuring the restriction in this way, the responsibility is clearly that of the corporation, whilst the restriction on corporate gatekeepers is a consequence of (or derived from) that primary obligation.

²⁶ SRA Handbook, Principle 1.

PART TWO: THE OVERARCHING COMPLIANCE OBLIGATION

As earlier parts of the thesis have explained, the problem of creative compliance is one of construction, which is itself a product of a corporation's normative environment. In particular, the expressive function of section 172 of the Companies Act 2006 is such that corporations (and arguably also their advisers) interpret it to advocate, in practice, a largely unfettered pursuit of shareholder wealth maximisation. As a consequence any meaningful attempts at reform necessitate a significant incursion into this widely held belief as to the legitimate objective of the firm. The question that necessarily arises, and that this part considers, is how this can be achieved.

As a preliminary matter, if a government wishes to change, or influence, a social norm there are a number of devices available to it. These options span a continuum as to the level of intrusion that is engaged and include education (the provision of simple facts), persuasion (the use of rhetoric to actively change attitudes), incentivisation (through taxes or subsidies), specific restrictions (time and place prohibitions, such as smoking bans in public places) or absolute prohibitions (regulatory bans).²⁷ However, the motivation for creative compliance is such that, whilst less coercive tools (such as education) may form part of the requisite response, they will be insufficient to change current practices.²⁸ Moreover, and perhaps needless to say, the use of incentives to amend a 'pricing' approach to compliance serves to utilise the problem rather than address it. Rather, a regulatory (or 'absolute prohibition'²⁹ to use Sunstein's taxonomy) is required. Accordingly, the proposal for reform put forward in this part is a mandatory

²⁷ See: Cass R. Sunstein, 'Social Norms and Social Roles' (1996) 96(4) Columbia Law Review 903, 938-940.

²⁸ Of note is that significant corporate scandals, from Enron to Amazon and the concomitant regulatory mandates have to date failed to change the corporate perception that creative compliance is simply clever compliance. Therefore, an education only programme is unlikely to make material inroads into this perception.

²⁹ See: Sunstein, (n 27), 940.

compliance requirement that is, for reasons that are explained further below, included within the Companies Act 2006 itself.

(i) The rationale for codification

Crucially, the codification of a claim for spirited compliance seeks to capitalise on the expressive function of law, which was discussed in more detail in chapter four. That is, in addition to providing an enforceable claim, it is designed to utilise the symbolic power of the law to express normative approval for spirited compliance and, as a consequence, disapproval for creative compliance. Nevertheless, this suggestion for reform gives rise to two immediate and preliminary questions. First, isn't this proposal otiose given that the GAAR has already put this obligation on a statutory footing? Secondly, where should the duty be codified?

Turning to the question of duplication, and as set out in section two, the proposed duty is designed to have a broader remit than its GAAR counterpart. As noted in chapter one, the GAAR is a single-issue, discrete piece of legislation with limited scope and, as a consequence, limited application. However, that is not the primary justification for proposing a Companies Act 2006 provision, notwithstanding the implementation of the GAAR. The GAAR is operating within a wider regulatory and governance environment that tacitly, if not expressly, endorses a wealth maximising norm that conflicts with the GAAR's claim to constrain creative compliance. This dominant norm is then reinforced by, *inter alia*, the perceived ethos of a capitalist market economy. The difficulty that the GAAR faces is that against this backdrop it fails to make the normative impact that is necessary to achieve its objective of fundamentally reforming corporate conceptions of their compliance responsibility, necessitating a more robust approach. That said, this lack of normative impact is perhaps not surprising, given the striking acknowledgment in the Aaronson Report, which examined whether the UK should introduce a GAAR,

that a critical consideration of the study group considering the GAAR was whether a GAAR ‘might erode the attractiveness of the UK’s tax regime to business.’³⁰

It is the need to effectively utilise the expressive function of the law (to change corporate norms) that answers the second question, namely where to codify the duty? Three options readily arise: the Model Articles of Association, the UK Corporate Governance Code or the Companies Act 2006 itself. There is something intuitively attractive about enshrining a spirited compliance obligation in the Articles. They effectively comprise the ‘rule-book’ of the company and go to the heart of the relationship between the board and its members. In terms of embedding a cultural change into the DNA of the organisation, the Articles of Association would seem to be a sensible place to do so. However, there are several, ultimately insurmountable, difficulties with this proposal. First, and most obviously, is the ability of shareholders to amend the articles. Even if the provision was an entrenched one,³¹ the mere ability to amend the provision undermines the authority of its status. Secondly, the articles are only enforceable by the shareholders; faced with the usual collective action problems and the fact that shareholders may be in favour of creative compliance this again severely undermines the likely impact of any such article. Finally, and as an extension of the first two issues, the articles simply do not possess the normative force of the Companies Act 2006 itself. To challenge the significant suite of provisions in the Act that coalesce to reinforce the shareholder wealth maximising norm it is necessary to include a provision on an equal, if not higher, footing to the Act itself.

It is this last reason that reflects the similar limitations of including a requirement within the UK Corporate Governance Code. Whilst the Code undoubtedly commands respect across the listed corporate community and amongst institutional investors, there are

³⁰ Graham Aaronson QC, ‘GAAR Study, A Study to Consider Whether a General Anti-Avoidance Rule Should be Introduced into the UK Tax System,’ 11 November 2011, para 1.4.

³¹ Pursuant to section 22, Companies Act 2006.

limited examples of action being taken by shareholders in respect of non-compliance.³² Moreover, the requirement to ‘comply or explain’ both lacks the expressive force required (namely an unequivocal admonishment of creative compliance) whilst not being suitable for the objective at hand. Comply or explain is a sophisticated and useful tool for matters where flexibility and discretion is required to reflect the particular circumstances of a company, for example to achieve the appropriate balance between executive and non-executive directors.³³ Creative compliance is not such an issue. As chapters two and three explained, creative compliance causes significant harm to the social order and the objective of reform is to militate against this conduct, not to provide corporations with the discretion to shape their own standard (indeed, this is the very practice that reforms are seeking to prevent).

Therefore, it is by including a provision in the Companies Act 2006 itself that we start to introduce a norm that is perceived to be on the same footing as, if not higher than, those contained elsewhere in the Act. By positing the obligation in the Companies Act 2006, a very clear expression is made as to the meaning and status of the requirement. That is, spirited compliance is an unequivocal corporate obligation, which is a fundamental part of a corporation’s core legislative requirements and duties. It is not limited to a single issue, or otherwise relegated to a limited remit. Rather, it is an overarching obligation that pervades all corporate activity and decision-making.

(ii) The overarching compliance obligation

It is for this reason that the duty is expressed not merely as a meta-rule (put another way, a rule about how to comply with other rules) but as an overarching obligation.

³² The appointment of Stuart Rose as both Chairman and Chief Executive of Marks & Spencer plc being a common example.

³³ Financial Reporting Council, UK Corporate Governance Code, April 2016, principle B.1.

Much like its litigation counterpart,³⁴ it is a principle that applies to and governs all other decisions. It is an objective to be achieved, rather than a rule to be complied with. It is an objective that corporations must ‘give effect to’³⁵ when exercising the powers and privileges granted by the rest of the Act. In this way, it does not repeal shareholder exclusivity, or change the core purpose of the firm. Rather it acts as an overlay, only constraining these principles of shareholder exclusivity where necessary to, effectively, protect the rule of law. Therefore, by adopting an overarching obligation (rather than discrete rule), the reform proposal performs a normative ordering function, making it clear what considerations are to take priority in the event of conflicting norms or where, as is likely, multiple courses of action are available to the corporation and its agents.³⁶

The exact wording of such an overarching obligation is, of course, the remit of statutory draftspersons. However, it is anticipated that such a provision could be structured in the following way.³⁷ It is proposed that this overarching obligation would immediately succeed the current section 7 Companies Act 2006, indicating its status as an inherent part of the incorporation contract:

7A The overarching compliance obligation

7A(1) A public company once so formed shall give effect to the overarching compliance obligation of complying with the spirit, as well as the letter, of the law.

³⁴ Rule 1.1, Civil Procedure Rules.

³⁵ This wording is taken from rule 1.2, Civil Procedure Rules.

³⁶ That is, the challenge of what David Kreps describes as ‘unforeseen circumstances’ and ‘multiple equilibria.’ See: David M. Kreps, ‘Corporate Culture and Economic Theory,’ in J. E. Alt and K. A. Shepsle (eds), *Perspectives on Positive Economy* (Cambridge University Press, 1990), 98 and 103.

³⁷ This proposal incorporates principles and structure from both s 207 Finance Act 2013 and rule 1.1, Civil Procedure Rules.

7A(2) For the purposes of section 7A(1), complying with the spirit of the law includes, so far as is practicable –

(a) maintaining the rule of law and, in particular, the principle of equality before the law; and

(b) ensuring that the substantive results of the company's compliance practices are consistent with:

(i) any principles on which the relevant regulation or provision are based (whether express or implied);
and

(ii) the policy objectives of those provisions.

7A(3) In determining whether a compliance practice complies with section 7A(1) regard may be given to –

(a) whether the conduct in question was intended to exploit any shortcomings in the relevant regulation or provision;

(b) whether the conduct in question involved any contrived or artificial steps.

7A(4) The examples given in subsections (2) and (3) are not exhaustive.

7A(5) If compliance decisions are made in contravention of the

requirement of section 7A(1), an offence is committed by –

(a) the company; and

(b) every officer of the company who is in default.

7A(6) A person guilty of an offence under this section is liable –

(a) on conviction on indictment, to a fine;

(b) on summary conviction, to a fine not exceeding the statutory maximum.

A breach of section 7A would trigger the application of part 36 of the Companies Act 2006, which provides a framework to govern sanctions (and enforcement) under the Act to ensure that an efficient, effective and proportionate regime is achieved.³⁸ Therefore, an officer would be deemed to be in default if he or she ‘permits, participates in, or fails to take all reasonable steps to prevent, the contravention.’³⁹ Subject to the interaction with the UK GAAR (and, in particular the counteraction provisions under s 209 of the Finance Act 2013), section 7A would need to be amended to address the possible counteraction of abusive tax structures that are outside the scope of the GAAR but may nevertheless come within the remit of the overarching compliance obligation (as section 7A, as currently drafted, only provides for a fine in the event of breach).

³⁸ For a discussion of these objectives see: Department of Trade and Industry, Company Law Review Steering Group, *Modern Company Law for a Competitive Economy, Final Report* (26 July 2001), para 15.1.

³⁹ Section 1121(3), Companies Act 2006.

One further sanction to consider would be to enable an application to be made under the Company Directors Disqualification Act 1986 in the event of breach.⁴⁰ This right could be potentially linked to an amended part 32 of the Companies Act 2006 allowing the Secretary of State to investigate the company as a result of a breach of the overarching compliance obligation.

The right for the Secretary of State to investigate a company under part 32 is an important one, even if (as is anticipated) it is not regularly invoked. Acting as a powerful counterbalance to the privilege of incorporation, the mere threat that this right of investigation could be triggered should act as a powerful deterrent. Part 32 provides inspectors with pervasive investigation rights, including the ability to demand documents and assistance from corporate officers (an entitlement that applies not only to the company under investigation but, importantly, extends to its subsidiaries). These investigatory powers are therefore highly relevant to tax structures and serve to act as a meaningful deterrent against breach. An investigation of this nature would be a significant disruption to corporate life and reflects both the seriousness, and consequences, of breach. As a consequence, the risk of investigation, although only pursued in the most egregious or persistent cases of breach, would be a significant deterrence to a corporation and may therefore be an important enforcement tool.

To achieve its aims, the overarching compliance obligation needs to be determined against a fundamentally objective standard. That is, it would be necessary to determine, *inter alia*, the regulatory provision in question, the principles or policy underlying the substantive regulation and ascertain whether they have been breached, or the rules themselves manipulated so that they apply in a manner that was not intended by

⁴⁰ Either under section 8, Company Directors Disqualification Act 1986 (as part of a wider corporate investigation) or as an amended section 3 (persistent breaches of companies legislation), in each case without requiring that the company itself be insolvent for an order (or undertaking) to be made.

parliament. Were a subjective standard to be adopted then we would make very few inroads into the interpretive and expressive challenges that have been the subject of this research. Furthermore, aside from its impact (or lack thereof) on the normative environment, a subjective test would raise significant evidential barriers to enforcement.⁴¹

PART THREE: ENFORCING THE OVERARCHING COMPLIANCE OBLIGATION

A crucial value of including this compliance objective within the Companies Act 2006 goes to the issue of enforcement. Unlike a provision in, for example, the Articles of Association, section 7A is enforceable by the Secretary of State, avoiding the collective action and motivational issues that would arise if enforcement action were limited to corporate shareholders. As to the mechanism, or process, for enforcement this is a matter that would require significant consultation and the exact procedure would need to be set out in a schedule to the Act. Nevertheless, some initial comments can and, of course should, be made here.

At this early stage, it would be tempting to suggest that a specialist panel be commissioned on the same terms as the GAAR Advisory Panel to adjudicate claims under the proposed overarching compliance obligation. However, this would be a potential mistake. In its initial formulation, the GAAR Advisory Panel was envisioned as a ‘forum ... a basis for a ‘regulatory conversation.’⁴² Notwithstanding this intention,

⁴¹ Indeed, it is for this reason that the GAAR adopts a similar objective standard, whilst relying on other safeguards to protect against ‘honest confusion’ on the part of the tax payer. See: Freedman Hoffman (n 4), 4; Judith Freedman, ‘Designing a General Anti-Abuse Rule: Striking a Balance,’ (2014) 20(3) Asia-Pacific Tax Bulletin 167,171.

⁴² Judith Freedman, ‘Creating New UK Institutions for Tax Governance and Policy Making: Progress or Confusion?’ (2013) 4 British Tax Review 373, 378. In this way, the UK GAAR Panel was originally modeled on its Australian counterpart, on which see: Justice G. T. Pagone, ‘The Australian GAAR Panel.’ GAAR Conference London (10 February 2012) available at

the eventual form of the GAAR Advisory Panel has taken on a quasi-judicial function, with both its guidance and decisions becoming a mandatory factor that the court ‘must’⁴³ consider in any subsequent hearing. Further, and arguably as a consequence of this revised status, the Panel is required to be independent (most notably from HMRC). This seemingly laudable suggestion carries with it its own difficulties. Not only does this cause difficulties and forms of attack for the Panel as constituted,⁴⁴ but it acts as a barrier for the ‘regulatory conversation’ that the original Panel was designed to achieve (prohibiting inclusion of HMRC as a key constituent of such conversations).

Perhaps the biggest challenge with this quasi-judicial role that the GAAR Advisory Panel now finds itself in is one of clear identity. It is neither a forum for discussion and development nor a judicial body. As a consequence, it is both constrained by, and open to attack and criticism from, both perspectives. It may be restricted from advocating for certain reform (to protect its neutrality) whilst being open to demands for a right of audience by taxpayers that are subject to a GAAR notice (as a matter of fair procedure).⁴⁵ The unfortunate result is that the GAAR Advisory Panel, as a novel and potentially valuable method of aiding resolution, risks losing legitimacy whilst serving simply to increase the time and costs of adjudication.

An alternative enforcement model would be for all claims to be referred to the relevant court or tribunal, with the attendant protections as to due process and independence that this would provide. In this regard, one model to consider would be the two-stage application that has been adopted for the codified derivative claim.⁴⁶ This process is, of course, the subject of much criticism and commonly the parties agree to conflate the

<http://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Events/conferences/2012/gaar/pa-gone-revised.pdf> last accessed 10 September 2016.

⁴³ Section 211(2), Finance Act 2013.

⁴⁴ An original Panel member, David Heaton was forced to resign in response to criticism that he had provided earlier advice on tax avoidance.

⁴⁵ Freedman, *Creating New UK Institutions* (n 42), 379.

⁴⁶ Section 261, Companies Act 2006.

two stages.⁴⁷ However, in doing so, the original purpose of this procedure is arguably missed. The intention of the first stage is to allow genuinely unmeritorious claims to be rejected and to dispose of cases efficiently. Adopting this model for the overarching compliance obligation would allow a filtering process, which is subject to the rigour of the court process and, in due course, contribute to the development of jurisprudence as to those cases that failed to meet the threshold of the overarching compliance obligation. The challenge with this approach, which we have seen with the derivative claim, is the time and costs that it takes to get to the first-stage of the hearing (with few cases making it that far) and, as a consequence, a scarcity of guidance as to how a *prima facie* case will be established.

Rather, a better model to adopt would be to implement an Advisory Panel that reflects the Australian model, which was the intention for the original GAAR Advisory Panel. That is, a panel that acts as a review board to assist enforcement officers considering whether to bring an action. Operating in this way, the Panel provides oversight by senior officials, which gives some comfort to the public as to how the rule is enforced.⁴⁸ Reflecting this role, the mandate of the Australian Panel is to ‘to assist the Tax Office in its administration of the GAARs in the sense that the decisions made on the application of GAARs are objectively based and there is a consistency in approach.’⁴⁹ Of note is that the Australian Practice Statement as to the application of the Australian GAAR makes it clear that the GAAR is a measure of ‘last resort,’⁵⁰ seeking to provide reassurance to the public as to the use of such an important provision.

⁴⁷ See for example (although many cases under the new regime have adopted this approach): *Franbar Holdings Ltd v Patel* [2008] EWHC 153 (Ch). The key criticism of this two-stage approach is that it creates a ‘mini-trial’ and any adoption of a similar procedure would need to mitigate against this risk.

⁴⁸ Pagone (n 42), 1.

⁴⁹ See: Australian Tax Office, PS LAW 2005/24, [23] available at <<http://law.ato.gov.au/atolaw/view.htm?locid=psr/ps200524/NAT/ATO&PiT=99991231235958>> accessed 10 September 2016.

⁵⁰ PS LAW 2005/24 (n 49). [50].

If this model were adopted, the enforcement procedure would offer a genuine process of internal oversight and review, building up a body of opinion that would help to inform both corporations and those responsible for enforcing the overarching obligation. Crucially, if properly structured, this oversight function reflects a legitimate step within the enforcement process, which should enhance the credibility of the administration procedure. This is in contrast to the ongoing risk and criticisms that a two-stage process (such as that for the derivative claim) can attract as a result of the *ex parte*, but judicial, first-stage test. To preserve the legitimacy of the Panel, it would be essential for it to comprise some external members, providing both expertise but also ‘review and accountability.’⁵¹ To further enhance the integrity of the Panel composition, consideration should be given to termination only for cause (to preserve independence) and also to maximum fixed terms of service (to avoid allegations of undue alignment either between panel members *inter se* or with the Secretary of State).

One further observation must be made about enforcement in this context. As Tyler’s work, which was discussed in part two of chapter one, makes clear, legitimacy is a key element of compliance and legitimacy includes the fair enforcement of legislation. Therefore, it is critical that any provision such as that outlined in this chapter is both rigorously enforced (to give effect to its expressive function and normative impact) but also equally enforced (to enhance its legitimacy and therefore increase the likelihood of spirited compliance with it). In terms of equality of application, this requires both that the provision is not only applied to large corporations that operate within the public eye but also that the provision is not used ‘as a weapon’⁵² in circumstances where it is inappropriate to do so. One protection against this risk is the intervention of the Panel discussed in this section. A further protection is that the burden of proof in making a

⁵¹ Pagone (n 42), 6.

⁵² This was a common concern with the proposal of the GAAR (see: the Aaronson Report, (n 30) para 5.7)

claim for breach should be very clearly on the Secretary of State.⁵³ Moreover, any advice given by the Advisory Panel, and their reasons for such an opinion, should be made publicly available, facilitating both accountability but also a greater understanding of the circumstances that will constitute a breach (or otherwise) of the overarching compliance obligation.

PART FOUR: DIFFICULTIES WITH THE OVERARCHING COMPLIANCE OBLIGATION

The immediate difficulty with the overarching compliance obligation is one of interpretation. How are the courts and, moreover, the corporations bound by the overarching obligation, to determine what it means? Indeed, this was a challenge levied against the GAAR. As discussed in chapter one, certainty is always going to be a concern for principles-based regulation. However, whilst it is trite to observe that ‘looking for the intention of parliament’⁵⁴ is what the courts do with any purposive interpretation, the risk of uncertainty with provisions such as these is an important one.

The overarching obligation can help to mitigate (although by no means eliminate) this uncertainty in several ways. First, the overarching obligation, by acting as a statutory overlay to ‘fill gaps and produce sensible answers,’⁵⁵ provides a framework in which ‘equality’ and ‘spirited compliance’ can be defined in this context. Drawing upon the analysis in chapter three, this duty can be interpreted through a conceptual framework of the rule of law and equality before the law, providing greater guidance and expectation as to how the overarching obligation will be determined. In this way, the interpretive framework is strengthened in comparison to other, similarly broad,

⁵³ Freedman, *Designing a General Anti-Abuse Rule* (n 41), 171.

⁵⁴ *Ibid*, 170.

⁵⁵ Freedman, Hoffman (n 4), 15.

legislative provisions such as ‘abusive,’⁵⁶ ‘unlawful purpose’⁵⁷ or ‘adequate procedures.’⁵⁸

Secondly, and in alignment with the GAAR and other principles-based legislation such as the Bribery Act 2010, it is anticipated that guidance would be issued to support the interpretation of the overarching compliance obligation. The principles set out in the guidance would provide an additional basis on which to interpret the requirements of section 7A and reduce the uncertainty that it produces. It is for this reason that the Aaronson report explained that provisions such as the anti-abuse rule, supported by guidance and a clear interpretive framework, have the potential to reduce uncertainty.⁵⁹ That is, without such a provision, courts may ‘stretch the interpretation of the wording before them’⁶⁰ to achieve a particular result. In contrast, with the existence of an overarching obligation, courts can apply the underlying statute in more concise and straightforward terms, then apply the overarching obligation where necessary.

This discussion of uncertainty does give rise to one indirect benefit of regulatory overlays such as the overarching compliance obligation. Namely, it distils the need for regulation to ‘spell out the policy and principles on which it is based in order to give the courts the tools they need to work out the answers.’⁶¹ That is, the overarching compliance obligation cannot, and should not, operate as a panacea for poor legislation.⁶² Rather, it seeks to uphold the clear principles and policy of the underlying regulation. In this way, it should ‘reinforce the need to produce better ... legislation,’⁶³

⁵⁶ Section 206, Finance Act 2003

⁵⁷ Section 7(2), Companies Act 2006.

⁵⁸ Section 7(2), Bribery Act 2010.

⁵⁹ Aaronson Report, (n 30), para 1.7(iii).

⁶⁰ Freedman, *Designing a General Anti-Abuse Rule* (n 41), 168.

⁶¹ Freedman Hoffman (n 4), 16.

⁶² Malcolm Gammie, ‘Moral Taxation, Immoral Avoidance – What Role for the Law,’ (2013) *British Tax Review* 577, 585-586.

⁶³ Freedman Hoffman (n 4), 17.

encouraging greater articulation of ‘principle, clarity and purpose’⁶⁴ in the underlying legislation. Therefore, one indirect benefit of a provision such as this is that it should be a ‘valuable prompt to encourage’⁶⁵ legislators to ensure that the principles and policies that the legislation is predicated upon are clear.

A critical consequence of the overarching compliance obligation is that it provides certainty to corporate officers, creating a mandatory rule rather than leaving the establishment of ‘responsible’ compliance (including tax paying) to their discretion. It provides guidance as to what ‘responsible’ means in this context, beyond that which the media determines, whilst providing protection against allegations that adopting spirited compliance practices breaches their duties to shareholders.⁶⁶ Thus whilst the overarching obligation does not provide unwavering certainty, it does, as Judith Freedman observed regarding the GAAR,⁶⁷ provide clarity as to the role of the judiciary and, in this context, the statutory entitlement (moreover, responsibility) of directors to pursue compliance practices that may not, directly or in the short term, maximise shareholder returns.

One final potential objection to the overarching obligation, which should be considered here, is why the overarching obligation should apply to compliance and not, for example, social responsibility or human rights more generally. Moreover, (notwithstanding the oxymoron) is there a risk that introducing a corporate overarching obligation opens the floodgates to multiple ‘objectives,’ leading to a proliferation of ‘overarching’ principles, which, clearly, undermine the whole concept? It is at this juncture that we return to the comments made in the introduction to this thesis and also the analysis of equality as a meta-rule (discussed in chapter three). Compliance is not

⁶⁴ Gammie (n 62) 577.

⁶⁵ Freedman, *Designing a General Anti-Abuse Rule* (n 41), 170.

⁶⁶ Judith Freedman, ‘Interpreting Tax Statutes: Tax Avoidance and the Intention of Parliament,’ (2007) 123 *Law Quarterly Review* 53, 86.

⁶⁷ *Ibid*, 87.

simply a tax problem; it is a corporate responsibility problem. If we challenge the way that corporations understand their obligation to the law, to the system that created them and that governs their relationship with civic society, then we challenge their broader perceptions of responsibility across multiple fields.⁶⁸ Ensuring that we get corporate compliance standards right therefore serves to improve a corporation responds to matters as diverse as human rights, transparency, employment law and finance.

CONCLUSION

The problem of creative compliance has been a consistent feature of modern corporate practice, and one that has proven to be elusive to resolve. Notwithstanding judicial⁶⁹ and parliamentary⁷⁰ attempts to curtail this strategy it remains a prevalent feature of corporate decision-making. This thesis has suggested that the reason for the persistence of this attitude towards creative compliance is a normative one. Put simply, legal subjects adopt compliance standards that they consider to be legitimate and corporations, for the reasons considered throughout this research, consider creative compliance to be fundamentally legitimate. Importantly, this view is justified by reference to the norms that are inherent within the Companies Act 2006 itself.

The entrenchment of the shareholder wealth maximising norm is such that any attempts to constrain this norm need to be unequivocal and possess significant expressive and normative force.⁷¹ In particular, in seeking to implement a new injunctive norm (such as spirited compliance) this must, as a matter of fact and perception, constrain the

⁶⁸ A detailed consideration of the interplay between compliance and other regulatory fields is outside of the scope of the present study. However, the point is made here to demonstrate why the introduction of a general overarching compliance obligation should not open the floodgates to multiple claims.

⁶⁹ For example, limited intrusion by *Ramsay Ltd v Inland Revenue Commissioners* [1982] A.C. 300.

⁷⁰ Most recently through the GAAR.

⁷¹ In this regard, and as discussed in chapter one, we can learn from the early experiences of the Bribery Act 2010.

shareholder wealth maximising norm enshrined in section 172 of the Companies Act 2006. This is not an insignificant task and to achieve such an extraordinary change to corporate attitudes requires a similarly substantial proposal, such as that set out in this chapter.

The details of a proposal such as this would, of course, take significant effort to finalise. However, the principles outlined in this chapter are based upon the deconstruction of creative compliance and recognition of the importance of spirited compliance both to the corporation and to wider society. Returning to the definition provided in chapter one, for something to have integrity it needs to be complete. For the public corporation, that completeness requires both a stable and efficient market order, which itself depends on a robust legal framework predicated on the rule of law. The proposal put forward by this thesis is that we maintain corporate integrity, namely corporate ‘completeness,’ by protecting the very essence of legal integrity: that is, the protection of equality before the law through the overarching compliance obligation.

CONCLUSION

Corporate compliance and, more particularly, the need to determine what compliance standards a corporation should adopt, raise a number of fundamental questions about a corporation's relationship with, and compliance obligations towards, regulation. It mandates that we understand not simply why corporations currently adopt creative compliance practices (an explanatory or positive enquiry) but also what standards they ought to adopt (a normative enquiry).¹

The challenge with reconceptualising corporate compliance is significant, and enshrines a broad range of difficulties. This research has sought to deconstruct those issues (commonly conflated into a single criticism of 'corporate greed' or 'profit-driven irresponsibility') in order to understand more fully the action that needs to be taken if we are to embed a more responsible, or spirited, approach to compliance within the UK corporate community.

In responding to a practice that 'thrives' on traditional command and control style regulation, the GAAR has, rightly, adopted a principles based approach to statutory design. However, as chapter one explored, as beneficial as this regulatory architecture is, it too is subject to limitations. That is, in time the 'principle' risks becomes narrowed through interpretation whilst there will, undoubtedly, remain gaps in the legislation that are filled by a corporation's own, narrow, interpretation of acceptable compliance standards. Notwithstanding these issues, the largest difficulty facing the GAAR is the fact that it is being implemented within a normative environment where profit-maximisation is perceived to be the sole objective of the corporation, legitimising creative compliance and undermining attempts to constrain it.

¹ On the distinction between explanatory and normative adequacy (or analysis) see: Christine M. Korsgaard, *The Sources of Normativity*, (Cambridge University Press, 1996, 13.

The first step in addressing this normative challenge was to establish a normative justification for constraining creative compliance. One difficulty with the recent political response to aggressive tax structuring is that it seemingly lacks consistency or a robust conceptual foundation. Again, in this context, as with many others, perception is critical. If the pursuit of creative compliance is perceived to be the persecution of simply ‘undesirable’ or ‘unpopular’ behaviour, targeted at a few high profile corporations, rather than the corporate community more generally, then the wider claim for constraint seemingly lacks the *ex ante* legitimacy that is required to drive more meaningful compliance behaviour. In offering this justification, chapters two and three explored the detrimental impact that creative compliance has on the rule of law and, as a consequence, the legitimacy and stability of the social (including legal and market) orders that the corporation depends upon.

A critical challenge with changing the way in which corporations define compliance, which was explored in chapter four, is the fact that the corporate law and governance framework itself seemingly endorses a singular, profit-maximising norm. Indeed, this perspective was arguably endorsed, rather than truly challenged, by the Company Law Review Steering Group when presented with an opportunity for reform. That said, were this norm only enshrined in section 172 Companies Act 2006, it may not be so powerful. However, this norm is reflected throughout the corporate regulatory environment, from rights of removal and enforcement, to the personal remuneration structures of senior management. Importantly, as chapter five examined, the architecture of the firm then serves to insulate this norm against any conflicting perspectives that natural citizens acting on the corporation’s behalf may hold. As a consequence, we start to understand why individuals can act in a manner within the corporation that is antithetical to their behaviour outside of it.

Notwithstanding these positive and normative enquiries into the reasons why corporations creatively comply and, moreover, the reasons why they should refrain from so doing, the question remains as to how we can challenge this behaviour. Drawing on the insights from chapters four and five, chapter six rejected the common suggestion that the way to mitigate creative compliance is to seek to impose restrictions on corporate gatekeepers. This type of moral outsourcing, whilst effective in discrete examples, fails to achieve the behavioural change necessary for long-term reform. Rather, it is necessary to change corporate responsibility for compliance, which then operates to constrain the advice that lawyers can provide. That is, it is crucial that the primary duty is that of the corporation and it is only as a derivation of this duty that corporate gatekeepers are restricted in the advice that they can provide.

It is for this reason that the thesis recommends embedding spirited compliance within the corporate DNA. It is important to be clear that spirited compliance is a fundamental obligation, contained in the Companies Act 2006 itself, not within a discrete form of regulation, which can be marginalised against the homogenous norm inherent within the entire corporate law and governance framework. The proposal is a bold one but, much like similar (successful) attempts to change corporate perspectives (such as the Bribery Act 2010), it is necessarily so. It is by making a clear and unequivocal statement that corporations are subject, at all times, to an overarching compliance obligation that we can start to meaningfully change corporate compliance behaviours.

This thesis has undertaken both a normative and positive enquiry into the corporate practice of creative compliance. In doing so, it has provided normative support for reform and, predicated on chapters four and five, offered a proposal for reform. Future research can then build on this theoretical understanding by undertaking empirical work to support, and develop, its findings. Such work should examine, *inter alia*, internal corporate structures to mitigate the impact of the fiduciary ladder and to determine how

best to embed within the corporation the cultural change that will be necessary to support any reform proposals. Other avenues of research would include drafting the guidance that would be necessary to support section 7A (in the same manner that guidance has been issued for the GAAR and Bribery Act 2010). Nevertheless, this research has undertaken a critical first step. By identifying the foundation for reform, and the inherent limitations faced by the GAAR, we can now move towards a greater corporate integrity.

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