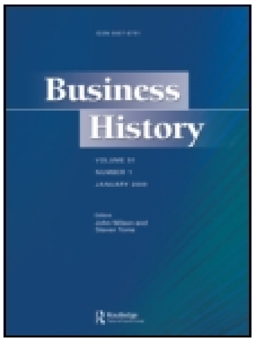

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Ownership Responsibilities and Corporate Governance: The Crisis at Rolls Royce, 1968–71

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A recurrent theme in the economic history of the UK is that of the under-performing firm. The issue is not any scarcity of evidence, be it relative productivity levels and growth rates, market shares at home and abroad or profitability. The literature abounds with such evidence. The problem is how the fortunes of such firms are turned round. Two aspects apply. The first is that of responsibility; who, and in what sense, is ultimately responsible for correcting under-performance? The orthodox model of the owner-managed firm would place that responsibility on the individual as both owner and manager. The growth of the publicly quoted firm, however, has led to a separation of ownership from management and, with it, problems on the nature of responsibility.[1] The second is that, despite the growing literature and contemporary debate on best practice,[2] the application of the analysis of systems of regulation and control to the problems of firm performance has not figured in economic and financial history, despite the wealth of primary source material available. As a result, the contemporary debate has not been informed by the insights which recent economic and financial history might offer.

This article makes a contribution to assessing corporate governance in the recent past. Previously under-exploited primary source materials are used to assess the internal and external mechanisms of governance. The article is based on a case study of governance at Rolls Royce. Section II assesses theoretical approaches which predict ownership behaviour. The performance of Rolls Royce is analysed in section III. Section IV assesses shareholder behaviour to test the validity of each of the theoretical propositions, finds value in each but questions whether, for a company in crisis, they have real relevance. This section moves away from standard approaches of shareholder behaviour which rely on market price data. Market price data reflect the sum total of all transactions; they cannot and do not allow us to identify the transacting parties and their individual behaviour. In order to identify how specific institutions behaved, we assess individual transactions behaviour. We have used previously under-exploited primary source

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materials: the company's share registers which contain, on an annual basis, a record of the holdings and transactions of each named shareholder in the company. From this we identify how named shareholders behaved.

Sections V to VII access a previously unused official report on events at the company. The report was not written as a study of corporate governance; it was a detailed exposition of events. From the wealth of evidence contained in the report, however, we can discern how corporate governance was interpreted and exercised. The information provides a unique insight into how ownership responsibility was carried out (and by whom) at a time of crisis. Section V considers how corporate governance operated in practice at the company through an examination of the company's systems of accounting, regulation and control. The exercise of responsibility in a crisis situation is examined in section VI, which highlights the part played by the banking institutions, and section VII, which considers how government policy influenced the behaviour of all the parties and suggests that responsibility may be traced to the legal ramifications of fiscal liability for trading under conditions of insolvency. Section VIII draws conclusions and considers the implications for the long run evolution of corporate governance in the UK.

II

There are many views of 'City'–industry relations which predict behaviour in the event of company under-performance. For exposition purposes, we use a four-way classification scheme, whilst recognising that there may be some overlap.[3] All four build on the dilution of ownership resulting from the diffusion of ownership among thousands of shareholders. The difference lies in their predictions as to how (and why) shareholders will behave in the event of company under-performance. The residual rights hypothesis predicts heavy selling as shareholders leave a company which threatened current and future income streams and asset values to whom they felt no ownership responsibilities; the property rights hypothesis stresses transferable rights where ownership may be transferred to the highest bidder in the market-place; the bi-partite hypothesis predicts loyalty and communication from larger shareholders and the public policy hypothesis predicts inertia from existing shareholders in anticipation of public ownership. In this section we discuss the dilution of ownership and then each of the four interpretations of shareholder behaviour in turn.

During the twentieth century, the structure of share ownership in the UK had witnessed a switch in equity holdings from the private to the institutional investor, made possible by the growth of the pension and insurance industry. The divorce of ownership from control, which dated from the emergence of the publicly quoted firm in the nineteenth century, was characterised by the mid-1960s by a highly skewed share distribution, whereby the equity in any one company was shared between thousands of shareholders.[4] The diffusion of ownership among thousands of shareholders in any one company has led to a dilution of ownership responsibility. Where there is no clear owner, there is no clear duty on any one individual or institution to assume those duties. Dispersed ownership creates free-rider constraints on any one shareholder incurring the costs of intervention on behalf of all other shareholders; shareholders perceive the cost of communication with other shareholders and companies as higher than that of constant trading.[5]

Where the responsibilities of ownership are not regulated (as in the UK) and where ownership is diluted, the emphasis passes to the exercise of the rights of the shareholder. These rights have been defined by Grossman and Hart as the rights to the residual.[6] This, in turn, as shareholders seek to maximise their own income from equity ownership, has exaggerated any latent tendency among shareholders to stress their residual rights and to trade shares in order to maximise income.[7] Ownership, according to the residual rights hypothesis, becomes the right to accrue income, both from dividend returns and from trading in shares on the stock market.

The second view stresses property rights.[8] This interpretation stresses the tendency of shareholders to treat equity ownership as conferring property rights which may be transferred at any time to the highest bidder. Whilst the residual rights hypothesis stresses the rights of the shareholder and hence the propensity to trade equity to maximise income, the property rights hypothesis treats ownership as a transferable commodity, which may be traded on the stock exchange. Managerial failure is corrected not by intervention by shareholders to exercise ‘voice’, since no one shareholder has sufficient equity to constitute a real influence, but rather through support for mergers and takeovers. Thus the market in property rights becomes a market for corporate control. Rather than engage in costly activities to influence current management, shareholders will support merger or takeover as a way of replacing current under-performing managers.

The structure of shareholding may mitigate against the realisation of ownership responsibilities. According to both the above interpretations of the behaviour of the financial markets, the emphasis is on ownership rights: owners concentrate on maximising their income and managers are left unaccountable. Rights to the residual may be shared between the diffuse owners, but rights to responsibilities are problematic because they are shared collectively between numerous shareholders. Thus incentive structures are for owners to exit the company and to transfer equity to the highest bidder if and when the company encounters difficulties. This creates two problems: an on-going pressure on management to protect market values at the cost of allocating resources to long term investment and second a vacuum of responsibility if and when the company is under-performing. The hypothesis from the above would be that in the event of under-performance, shareholders would either adopt an exit option by selling their shares and closing their accounts with the company or would support takeover. This, of course, is one view of the operation of the financial markets – a view not universally endorsed. The counter-argument would claim that markets are efficient on average – but clearly not in all cases.[9]

The third 'bi-partitite' interpretation believes that both the property and residual rights hypotheses ignore the possibility of differential behaviour. First, it is argued that, in practical terms, shareholding in any one company is highly skewed, ranging from a few financial institutions owning large numbers of shares in given companies to the many smaller financial institutions and private shareholders who own small equity stakes in particular companies. The skewed distribution leads to different behaviour patterns. Shareholders have been described as falling into one of two types – hence the bi-partite theory of shareholder behaviour.[10] The first type concentrates its portfolio on fewer stocks, has larger stakes in individual companies, develops close communication with the companies in which such investments are made, demonstrates a high loyalty factor to those companies, engages in few dealings in those shares, has less freedom to deal with the whole stakes because of the effect on the market, and has a general interest in corporate governance matters in general.[11] Large insurance companies and pension houses, it is argued, fall into this type. The argument is that, given their stakes in a limited number of companies, these institutions have a disproportionate effect on the market. Selling by these institutions would be picked up by the market and could trigger wider selling. These institutions, given their stakes, could suffer a decline in their own asset values. Over 20 years ago, it was noted that signals sent by the major institutional holders were assigned greater weight than that of smaller holders, such that they 'could not sell without turning the market against them'.[12]

The second group of shareholders includes private individual, small insurance companies and pension houses, unit trusts and nominee companies, all of which have widely diversified portfolios with small numbers of shares in a large number of companies, and have only superficial communication with them. This second group fulfils the exit hypothesis. They are characterised as being mainly interested in short term influences on prices, and feel no loyalty to any one company. As a result, they are likely to engage in frequent dealing and have no interest in corporate governance issues.[13] Signals sent by this group have little weight in the markets and they have freedom to trade at will. The residual rights hypothesis thus appears to fit this particular group. Equally, their lack of interest in corporate governance, their superficial contact with companies and their primary concern with short term prices would fit the market in property rights hypothesis.

Our final interpretation looks to the influence of systems of public policy in determining how shareholders behave. This approach stresses that most analyses of 'City'–industry relations have operated in a political vacuum,[14] despite the self-evident truism that the political climate in which institutions operate will have ramifications for governance mechanisms.[15] Recent research has suggested that systems of regulation as well as perceptions of government regulation and intervention did determine the options available to 'City' institutions, their equity holdings of under-performing companies, and how they perceived their ownership responsibilities.[16] This is especially the case in the UK, where legal regulation of the external and internal mechanisms of corporate governance are weak.[17] Roe has argued that corporate governance in this country has always been determined by perceptions of public policy with respect to public ownership,[18] whilst recent research has shown that where public ownership is *perceived* to be a real policy option, shareholders may feel they are relieved of ownership responsibilities. If a third party offers the promise of a transfer of ownership, namely in circumstances where public policy favours greater government intervention through regulation or even public ownership, this may act to deter owners from pursuing their own ownership responsibilities.[19] The public policy hypothesis would thus predict an abrogation of ownership responsibilities by shareholders, but would trace this to prevailing policy regimes.

Abrogation may, however, become a self-fulfilling prophesy. Where responsibilities are translated and expressed in terms of exit and where the firm is deemed strategically important (be it for its export earnings, defence implications or employment) the government may be forced, by default, to assume the responsibilities of ownership. When ownership is shared among thousands of shareholders and in a world of imperfect information and transactions costs, it may be easier for shareholders to allow government to assume those responsibilities if and when public policy favours government intervention in industry. The government may be drawn into dealing with under-performing firms, not because it has specific policy commitments to do so, but because no other body will accept the responsibility.[20] The likelihood of government intervention will depend, of course, on the strategic importance of the firm/industry in question (in terms of output, exports, employment).[21]

There are four views of 'City'–industry relations which predict behaviour in the event of company under-performance. Both the residual rights and the property market hypotheses would predict heavy selling in the event of under-performance, whilst the bi-partite hypothesis would limit such behaviour to only those institutions with small stakes in under-performing companies. Only the bi-partite hypothesis would predict any evidence of voice in the event of under-performance. The public policy hypothesis would anticipate abrogation of any responsibility during periods of active government intervention in industry. The vacuum of responsibility may follow a satisficing model, with no individual or institution assuming responsibility until or unless crisis occurs and the firm is threatened with liquidation. We consider the validity of each approach to corporate governance through a case study approach.

III

A case study approach yields rich insights which aggregate analysis cannot always identify. The criticism, of course, is how representative a case study may be. There is a danger that the case study may be unique. Throughout this article and again in the conclusion this question is addressed and the findings of this case study placed in their wider context. By examining the behaviour of 'owners' in relation to a company which did experience severe financial problems and by utilising primary source materials which allow us to identify the transactions and 'voice' behaviour of named parties in the enfolding events, we can assess how ownership responsibilities were exercised.

The case study is that of Rolls Royce Ltd, a major engineering company specialising in the design, development and manufacture of power units and other equipment for aviation, marine and industrial uses. Its main activity was in the aviation industry. In the mid-1960s Rolls Royce was one of the top 25 companies in the UK, recording healthy increases in its post-tax profit. Although the continued development of civil engines without supporting military contracts placed a strain on the company's financial resources, shareholders had little to be concerned about: the dividend rate was nearly doubled in a five-year period, the dividend yield[22] improved considerably and the earnings on shares increased substantially (Table 1). In the mid-1960s, the *Stock Exchange Gazette* provided actual and potential investors with quarterly surveys of share returns by sector. Rolls Royce compared well with companies in the same industrial sector (Table 2) both in terms of current and future expectations.

On 29 March 1968, Rolls Royce signed a contract with the Lockheed Aircraft Corporation to construct and deliver an advanced technology engine, the largest and most complex engine the company had ever undertaken, designated the RB.211.[23] This was announced as 'an

TABLE 1
ROLLS ROYCE: FINANCIAL RESULTS, 1961–70

Year	Post-tax Profit £m	Production Costs £m	Research & Development Costs £m	Dividend Rate %	Dividend Yield %	Earnings per Share (£)
1961	2.5	112.4	6.3	6.4	3.7	0.05
1962	1.8	99.7	4.7	4.8	2.6	0.04
1963	4.0	90.7	4.6	8.0	4.2	0.07
1964	3.7	95.2	4.6	10.0	5.0	0.16
1965	4.6	113.5	5.4	11.0	5.1	0.18
1966	5.3	153.9	6.8	11.0	4.2	0.16
1967	7.6	241.3	5.7	11.4	5.2	0.15
1968	9.0	291.3	6.4	11.8	4.9	0.15
1969	4.3	276.0	10.3	6.0	2.8	0.06
1970	-9.0	266.9	10.9	0	0	0

Source: Department of Trade and Industry, Rolls Royce Limited, Investigation under Section 165 (a)(I) of the Companies Act 1948 (London, 1973), Appendix 1, Guildhall Library Archive.

TABLE 2
SHARE EVALUATION: MOTORS, AIRCRAFT AND COMPONENTS, 1967

	Dividend Yield %	Price-Earnings Ratio
Associated Engineering	5.00	13.80
Automotive Prods. Ass.	3.10	15.80
Avon Rubber	5.60	11.20
Bristol St. Group	5.10	21.80
Brit. Motor Hldgs.	1.00	1.00
Caffyns.	5.60	13.80
Clayton Dewandre	5.50	15.80
Dowty Group	4.80	16.70
Dunlop Rubber	5.00	15.40
Hawker Siddeley	5.60	13.70
Henlys	1.00	1.00
Kenning Motor Corp.	1.00	1.00
Leyland Motor Corp.	5.10	11.90
Lucas. J.	4.60	11.10
Rolls Royce	4.60	18.40
Simms Motor & Elec.	7.10	14.10
Smiths Industries	5.50	13.00
Vandervell Prods.	7.00	n/a
Westland Aircraft	3.90	11.70
Wilmot-Breeden	5.90	13.00
Woodhead (Jonas)	6.10	10.80
Average (mean)	4.67	12.25

Notes: The dividend yield is the dividend payable per share expressed as a percentage of the market price per share. This ratio reflects the stock market's views of the current expectations of the company.

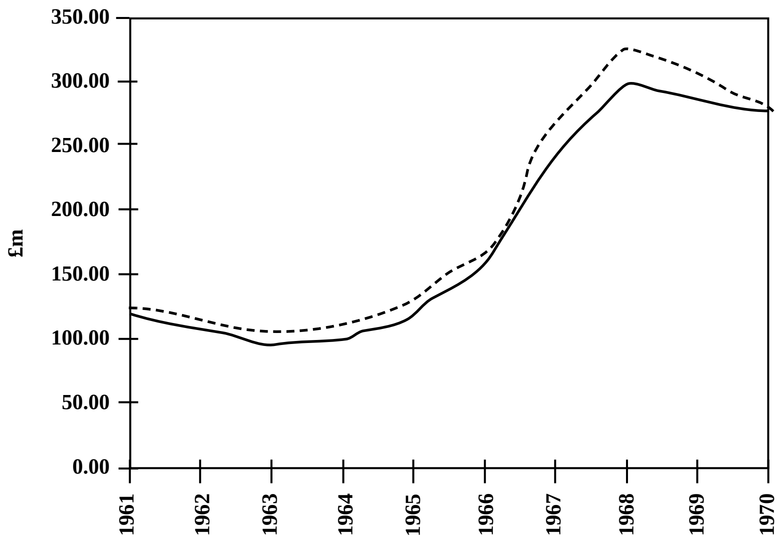
The price/earnings ratio is the market price of an equity share divided by earnings per share. This ratio reflects the stock market's expectations of the future earnings of the company. The higher the number, the greater the expectations.

Source: *Stock Exchange Gazette*, 16 June 1967, p.966.

outstanding encouragement for the skills and technology of British industry [which] constitutes a foothold in the American civil aircraft market far bigger than anything which we have achieved before',[24] to which the government contributed launching aid.[25]

Amidst the general enthusiasm and applause for the contract, few appreciated the massive exposure of the company: both in banking its entire future on one contract and, in its eagerness to win the contract, its failure to carry out adequate project work prior to signing. The markets appear to have been oblivious to the exposure the company was building up, generally applauded the company and looked forward to good times ahead.[26] But the company had under-estimated the extent of the problems it faced. It under-utilised experienced staff on the project, with the result that development costs spiralled out of control as the company tried to grapple with the technological complexities of building the RB.211 (Table 3 and Figure 1). The proposed RB.211 engine was a 'paper engine' which 'had never been built or tested'.[27] A later investigation by the Department of Trade and

FIGURE 1
ROLLS ROYCE: COSTS AND REVENUES, 1961–70



Key

Total Revenue
Production plus research and development costs.

Source: Department of Trade and Industry, *Rolls Royce Limted: Investigation under Section 165 (a) (1) of the Companies Act 1948* (London, 1973, Report by R.A. MacCrindle and P. Godfrey, London Guildhall Library Archive.

Industry was to suggest that 'the commitment to Lockheed embodied in the contract of March 1968 was 'too much of a speculation to be regarded as a responsible commercial decision'.[28] It added:

> The whole future of the company was hazarded on one contract. It is not always wrong for a business to put all its eggs in one basket. Nor is it always wrong for a business to undertake a speculative project. But for a business to combine the two is to court disaster. In the case of the RB.211 this was not adequately appreciated.[29]

Costs continued to rise, forecasts were continually amended and the company struggled in vain to contain the escalating financial and technological problems of building the RB.211.[30] Constant revisions led to an upward spiral of the launch costs estimates from £89.3 million to £99.6 million by June 1969 and £135 million in March 1970 (Table 3).[31]

When the half-yearly statement was issued on 11 November 1970, the company was reporting a post-tax profit loss of £3.1 million and anticipating future losses of £35 million on RB.211 engines against its

TABLE 3
ROLLS ROYCE LTD, RB.211 LAUNCH COST ESTIMATES (£m)

Date of issue	Launch cost to 2 years in service: Engine (a)	Thrust Reverser & Pods	Total	Continuing Development	Total Launch Costs
1968					
Sept. (b)	74.9	7.3	82.2	7.1	89.3
1969					
June	84.1	6.1	90.2	9.4	99.6
1970					
Jan.	91.5	6.9	96.4	9.4	107.8
March	119.1	6.2	125.3	9.4	134.7
April	119.1	6.2	125.3	26.5	151.8
July	136.7	6.3	143.0	26.2	169.2
Sept. (c)	137.5	6.6	144.1	26.2	170.3
1971					
18-Jan	160.3	8.3	168.6	34.1	202.7
25-Jan (d)	154.2	6.9	161.1	34.1	195.2

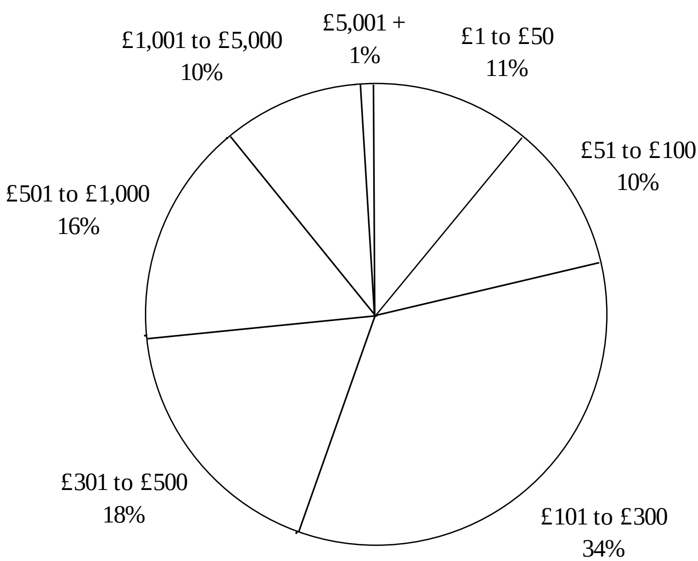
Notes: (a) In the case of the RB.211 engine, only costs classified in the table as engine launch costs were eligible for launching aid from the government.
(b) The original RB.211 launch cost estimate submitted to the government.
(c) Submitted to the government in connection with grant of £42 million additional launching aid.
(d) Assumed a six month delay in the programme.

Source: Department of Trade and Industry, Rolls Royce Limited, Investigation under Section 165 (a) (I) of the Companies Act 1948 (London, 1973), Report by R.A. MacCrindle and P. Godfrey, Appendix 9, Guildhall Library Archives, London.

contracted prices.[32] The 1970 accounts, had they been published at the time, would have shown a £9 million deficit as production plus research and development costs exceeded revenues by over £3 million, with forecast costs still rising. By 4 February 1971 it was obvious that the costs and liabilities facing the company were wholly beyond its financial resources, and the receiver was called in.[33]

The history of the company's difficulties in relation to the design, production and manufacture of the RB.211 have been well documented, not least as a result of the DTI's inquiry.[34] The case of Rolls Royce, however, has never been subjected to corporate governance analysis. The role of the owners has never been assessed. If rights and responsibilities do accrue from ownership, then owners were involved in the difficulties of the company. Two sources of information can be used to identify any such involvement: the DTI inquiry and the company's own shareholder registers. These sources enable us to test the reaction of shareholders and to test the hypothesis predicted by the main theories of shareholder behaviour and to determine who, in practice, exercised ownership responsibilities.

FIGURE 2
ROLLS ROYCE: CONCENTRATION OF STOCKHOLDINGS IN 1968



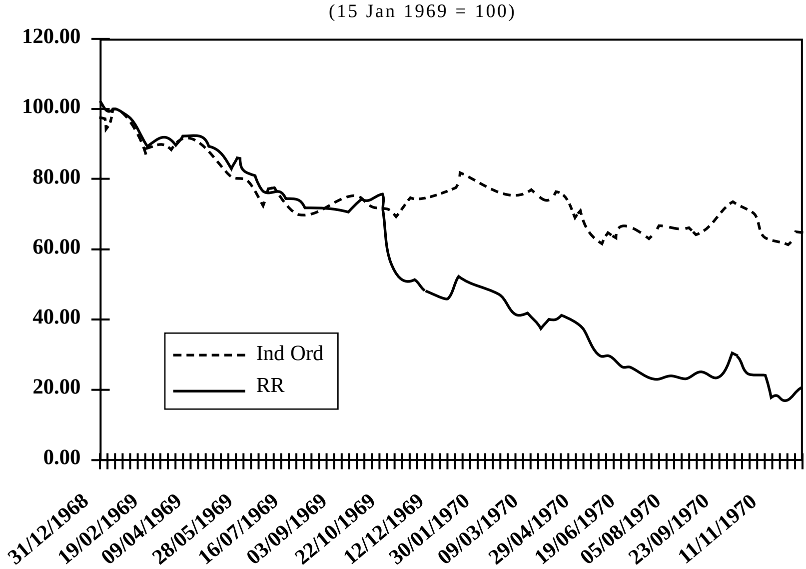
Source: Rolls Royce Ltd, *Annual Report and Accounts*, for year ended 31 Dec. 1968, p.31. The diagram shows the distrtibution of holdings by affiliation, defined as the number of shares held by each category as a percentage of the total number of ordinary shares.

IV

Shareholders are concerned to protect current and future dividend income and to protect the asset value of their shares. Under-performance by a firm thus constitutes, in shareholder value terms, poor returns on dividends and reductions in the market price of shares. The performance of Rolls Royce during the first half of the 1960s suggests that the firm would not be construed as under-performing (Table 1). The same cannot be said from the autumn of 1969, when the share price fell dramatically. In the accounts for the year 1969, the dividend rate was halved (Table 1). Although the market was falling generally, the extent of the collapse in the Rolls Royce price far exceeded that of the market (Figure 2). Shareholders had good reason to be concerned.

Our first concern is the structure of shareholding and the identity of the principal shareholders. Ownership of Rolls Royce in 1968 was shared amongst 59,712 shareholders, comprising 50,742 private individuals, 218 insurance companies, 948 banks and 134 pension funds.[35] The concentration of holdings mirrored that of most publicly quoted companies at that time – small holdings by large numbers of shareholders (Figure 3). In 1968, the issued share capital of Rolls Royce was £66.3 million. Of this, the 50,742 private individuals held 45 per cent. Together, the financial institutions (that

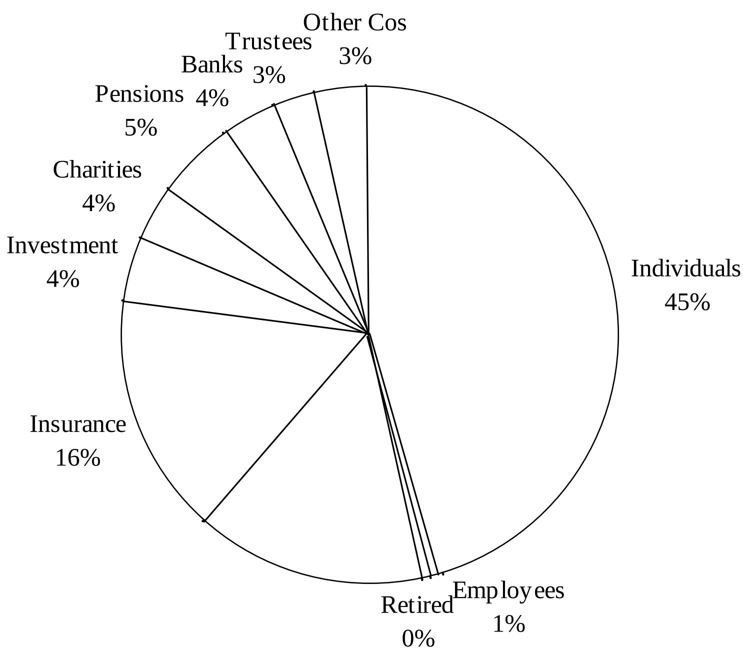
FIGURE 3
INDEX OF SHARE PRICES
(15 Jan 1969 = 100)



is, the banks, insurance and pension companies, investment trusts and nominee companies) owned 44 per cent.

The insurance and nominee companies had the largest presence, holding 16 and 15 per cent of the value of the company's issued share capital respectively (Figure 4). This shared dominance of financial holdings by insurance and nominee companies was to be significant. The former was representative of the 'old' 'patrician' institutions. Nominee companies, which took off in the 1960s alongside unit and investment trusts, have been labelled as 'mass-market investment vehicles'.[36] Lohnro, Goldsmith and Slater represented a new form of aggressive, short-termist financiers.[37] As was demonstrated in the merger and takeover boom of the mid-1960s, the new breed of 'City' institutions exercised exit: not only when given companies under-performed, but also if they believed other companies

FIGURE 4
DISTRIBUTION OF ISSUED SHARE CAPITAL IN ROLLS ROYCE IN 1968 (£)



Source: Rolls Royce Ltd, *Annual Report and Accounts*, for year ended 31 Dec. 1968, p.31. The diagram shows the distrtibution of holdings by affiliation, defined as the number of shares held by each category as a percentage of the total share capitalisation of the company. The share capital for 1968 was £66,264,452. Rolls Royce Ltd, *Accounts*, p.22..

promised better returns. Nominee companies exemplified a 'short-termist' approach with their emphasis on market prices and dividend returns and propensity to express the exit option.[38]

Given the diffusion of ownership, the residual and property rights hypotheses would predict exit. In the event of any difficulties, ownership responsibilities had to be shared among nearly 60,000 individuals and institutions. Given the diffuse nature of stockholding in the company, the incentives were weak for one institution, or indeed any group of institutions, to intervene. In common with other limited liability companies, no one institution or individual had sufficient equity in Rolls Royce to affect the market price and, as such, to influence management either through voice or by trading shares. The incentive structures were such that exit would be the most likely reaction to the company's difficulties.

Two sources of evidence may be used to test these views. The first is the market price for Rolls Royce shares. If shareholders in particular and the 'City' in general were concerned, then one would expect to see sharp falls in the firm's market price from 1968. The market price for Rolls Royce stock collapsed from the winter of 1968 (Figure 2). *Prima facie* evidence appears to support the residual rights and property rights hypotheses.[39]

The bi-partite hypothesis would predict exit behaviour by those institutions with small numbers of shares. Our evidence indicates that the shareholdings held by banks, other companies, investment trusts and nominee companies fell, indicating exit activity by these institutions. All of these institutions rapidly off-loaded shares once problems started to appear. Insurance companies, by contrast, increased their holdings: as did the pension trusts. The 'buyers' may have been expressing loyalty – or behaving as counter-cyclical buyers (buying when the price fell). The latter presumed a belief that the company's fortunes would be restored. In 1968, 27,528 transfers were recorded; by 1970 this had risen to 40,335.[40] The difference in institutional behaviour is marked. Overall, 'loyalty' is associated with old established institutions, and 'exit activity' by the new institutions such as nominee companies.

What then of the behaviour of named institutions? Shareholdings and transactions by named institution are recorded in company share registers. We first deal with non-bank financial institutions. Our analysis of the share registers shows that in 1967 15 such institutions held in excess of 12,000 shares, whilst nine of these had holdings of over 130,000. The 15 institutions are listed in Table 4. By far the largest was the Prudential, which held nearly 2.1 million Rolls Royce shares. Of the 15, only six exercised the exit option. Of these, the closure by the Prudential was the most spectacular, wiping about £3.7 million off the company's share register.[41] Ten institutions, however, did not pursue an exit strategy. Their behaviour contradicts the assumptions of the residual and property rights hypotheses: not only did they not sell shares, but they actually increased their holdings – and in certain cases by a significant amount – as indicated by the increased equity holdings of the Co-Op, Royal Insurance, Legal & General, Norwich, Pearl and Eagle Star during both 1969 and 1970 (Table 4). These institutions behaved in line with the predictions of the bi-partitite hypothesis.

How do we interpret this behaviour? Our evidence suggests this behaviour was counter-cyclical, insofar as the company went to great lengths to hide from shareholders the extent of its financial difficulties. There was a distinct tendency on the part of the company to limit its own responsibilities to shareholders by withholding information.[42] On 19 June 1969 the group's accounts for the year to 31 December 1968 were circulated to shareholders. The shareholders were assured that 'these projects [Concorde and the RB 211] should be major contributors to a period of growing sales and corresponding profits'.[43] The chairman's statement for the following year failed to alert shareholders to the gravity of the situation.[44] The chairman assured shareholders that his Board was 'satisfied that, with the banking facilities available the company has sufficient working capital' at the very time that the company faced rapidly increased costs in both the production and development costs of the RB.211.[45] The statement made to the shareholders on 21 July 1970 again reassured them that the company was in good shape.[46] Shareholders were not warned that recent figures indicated that the RB.211 project would result in a substantial loss. Nor

TABLE 4
SHAREHOLDING (NUMBER OF SHARES HELD) OF THE MAJOR FINANCIAL INSTITUTIONS IN ROLLS ROYCE, 1967–70

	1967	1968	1969	1970
Prudential	2,076,942	2,076,942	0	0
Co-Op	356,077	451,256	625,000	625,000
Commercial Union	206,000	323,585	407,961	410,203
Equity & Law Life	194,365	248,000	300,000	300,000
Eagle Star	191,519	237,000	276,498	279,832
Prudential Nominees	182,291	182,291	212,672	212,672
Scottish Amicable	182,291	182,291	0	0
London Assurance	156,250	335,100	60,000	60,000
Scottish Life	132,187	194,218	0	0
Royal London	94,931	94,931	0	0
Legal & Geneal	81,185	95,005	475,000	475,000
Norwich Union	76,000	76,000	229,994	375,374
Pearl	22,500	22,500	468,280	477,520
Royal Insurance	14,742	14,742	205,129	276,587
Provident Life	12,861	12,861	17,199	0

Source: Rolls Royce Ltd, *Annual Register of Shareholders*, 1967–70, Companies House, London.

TABLE 5
MARKET VALUATION OF STOCK HELD BY MAJOR NON-BANK FINANCIAL SHAREHOLDERS IN ROLLS ROYCE (£)

	Pru	Co-Op	Com Union	Equity & Law Life	Eagle Star	Legal & General	Norwich Union	Pearl	Royal Insurance
31 Dec. 1968	5,062,546	1,099,937	788,738	1,922,550	816,80	695,005	76,000	54,844	35,934
31 Dec. 1969	0	757,813	494,653	599,766	72,750	475,000	229,994	567,790	248,719
31 Dec. 1970	0	296,875	194,846	92,552	28,500	475,000	375,374	226,822	131,379

Notes: Market Valuation estimated as the number of shares held (Roll Royce, Annual Register of Shareholders) multiplied by the share price quoted on the London Stock Exchange (*Investors' Chronicle*).

Pru is the Prudential and Comm Union is Commercial Union.

were they told of the massive cash shortages the company faced.[47] When later questioned, Sir Denning Pearson was to agree that the word 'satisfied' was an 'unfortunate' but not a 'misleading' word.[48] Shareholders who did not exit may have been behaving counter-cyclically rather than naively – but at the cost of a marked reduction in the market valuation of their shares (Table 5).

What then of the banks? Traditionally, the literature assumes that the City fulfils two main functions in relation to industry. The first is that of the provision of long- and short-term capital through loans, with merchant banks specialising in the former and clearing banks the latter.[49] The second is via the stock market, which provides the mechanisms whereby companies sell shares to investors to finance capital expansion (a primary market) and a forum in which investors can buy and sell outstanding shares (a secondary market).[50] Our analysis of the share registers, however, has revealed a third role. Our analysis shows that the clearing banks, by the late 1960s, had developed a strong profile in equity management. In this respect, Rolls Royce was not unique. Large equity shares by clearing banks have been identified in other major companies, particularly in the engineering sector at this time.[51] By 1967, Barclays and the Midland managed more Rolls Royce shares than all of the major non-bank financial institutions, with the exception of the Prudential.[52]

The Rolls Royce shares controlled by the banks, actively and on behalf of individuals, were substantial.[53] As such, banks had a powerful presence both as providers of working capital and as managers of equity portfolios. Their ability to fulfil any principal role in relation to the latter, however, was constrained by the diffuse nature of their ownership and their ability to influence portfolios they managed on behalf of third parties.[54] A bank would be less likely to have control over executor and trustee accounts but more likely to have control over nominee accounts. The bulk of Barclays' shares in Rolls Royce were held in nominee accounts (91 per cent in 1967), whereas most of the Midland stock was in executor and trustee accounts (82 per cent in 1967).[55] In 1967, no shares were transacted in the named and numbered accounts administered by Barclays, whereas nearly 23 per cent of the total stock in its nominee accounts was traded.[56] Nine per cent of the Midland's stock held in executor and trustee accounts in 1967 was traded.[57] Two years later, Barclays was to dispose of 18 per cent of the Rolls Royce shares it held in nominee accounts.[58] The London branch of the Royal Bank of Scotland took an even more extreme exit action, closing down and disposing all of its shares. This research indicates that when and if clearing banks had some control over the shares they administered they sold shares: again *prima facie* evidence in support of the exit hypothesis.

Finally, our analysis of the share registers has identified nominee companies as the source of significant exit behaviour. In 1969, for example, Princes Street Nominees disposed of 20.3 per cent of its equity holdings and a further five per cent the following year. During 1970, Lombard Street Nominees disposed of 20.1 per cent, Fenchurch Nominees 32.5 per cent and Pensmann Nominees 13.9 per cent of their shares (number of shares) in Rolls Royce. This finding gives substantial support to the claim that, from the mid-1960s, equity trading by 'City' institutions had been transformed by the emergence of aggressive 'new mass market investment vehicles' who had no qualms about treating equity as a property right to be transferred to the highest bidder.[59]

The implications of the structure and transactions behaviour for ownership are complex. It is self-evident that ownership responsibilities could not be easily shared between 59,712 shareholders in 1967. It is equally apparent that the residual rights, property rights and bi-partite hypotheses all receive partial support from an examination of the Rolls Royce share registers. The evidence suggests that many shareholders interpreted their roles in terms of their rights, most noticeably their right to sell shares and transfer ownership. In these terms the residual rights and property rights hypotheses receive support from a detailed analysis of Rolls Royce shareholders. By exiting the company in full, such shareholders abrogated any ownership responsibilities and asserted instead their right to trade shares. But Charkham's bi-partite hypothesis also receives some support from those shareholders who did not express the exit option. Ownership in the case of Rolls Royce was used by the majority of equity owners to protect their residual rights to income. In these terms, Rolls Royce appears to fulfil the stereotypical view of owners (and in particular City institutions) in the UK prioritising their property and residual rights.

V

Corporate governance is concerned not only with the transactions behaviour of shareholders, but also with internal systems of control, accounting and regulation. It is concerned with the rights and responsibilities of management. We utilise a report written shortly after the crisis at the company to assess internal mechanisms of governance. That document was written as a report on events at the company; it was not written as a case study in corporate governance. Within its detailed dissection of events, however, is evidence which we have used to assess how the internal mechanisms of corporate governance were exercised. This section and those that follow use this information to analyse what ownership responsibility meant in practice.

The internal mechanisms of corporate governance stress the role and responsibilities of the main board and the presence of non-executive directors to protect the interests of shareholders.[60] Asymmetric information constrained the ability of the main board to identify and deal with the escalating financial costs of the RB.211. The main board was only called on to note certain items presented for main board meetings.[61] Narrative explanations of the adverse financial results were minimal and never dealt with the root causes.[62] Financial information was optional rather than compulsory reading.[63] Two explanations were given as to why the financial information was not prioritised for reading and discussion. The first was that the information presented was voluminous and non-executive directors did not have the time to go through all the material. This could have been overcome had important topics been highlighted.[64] The second was that 'the material supplied to board members was defective in that it failed to inform effectively where the impact of vividly presented information could have been dramatic'.[65]

It is evident from the report that crucial topics were never discussed by the main board. In July 1969 a damning indictment of the exposure created by RB.211 was written by the head of the DED division, Metcalfe.[66] This became known as the Metcalfe Report. Many board members later claimed never to have seen the report or to have been made aware at the time of the state of affairs it revealed. They included the Company Financial Controller, who claimed to have been unaware of this report before November 1970.[67] Was this deliberate? The DTI inquiry was cautious in its comment, merely noting that 'in every case where we have put this suggestion to a witness closely concerned with this matter it has been denied that this was so'.[68] Failure to report and discuss the report was in fact a symptom of a wider failure to discuss significant divisional and financial matters. From 3 September 1969 divisional board papers ceased to be available at main board meetings[69] and financial information occupied very little of the main board's time.[70]

If the main board did not have relevant information or were not sufficiently informed of crucial topics, then this might suggest that the problem lay in communications between the main and the divisional boards or in the composition and role of the divisional boards. The evidence suggests that both were problematic. The DTI enquiry was later to criticise the DED board as being ineffective as a management forum for discussion. This was partly due to the unwieldy size and composition of the board and partly because its members regarded it as a vehicle for discussion and reporting rather than as a body which took decisions leading to action.[71] It had no real authority:

> None of that responsibility was vested in the board as a group ... [The board was used] as a management communication and advisory group rather than the main board of a company. ... The atmosphere was never created where any of the directors felt that they had an enormous responsibility for the functioning of the division.[72]

And one of its members claimed that 'I am quite sure that if I had started demanding what are you going to do about it, I would not have had very much support; and I would have been hushed up because we as a board did not have any authority'.[73] The result was that although the DED board was fully aware of the mounting difficulties posed by the RB.211 as early as July 1969, reports of their discussions were not conveyed to the main board.[74]

But were there other bodies which may have linked the divisional committees with the chief executive's committee and held responsibility for financial control and monitoring? Again, a dissection of the report identifies two such bodies. The body which linked the divisional and the main board was the chief executive's committee, which received divisional meeting reports and decided which information resulting from those reports and meetings should be placed before the main board.[75] Thus responsibility for communicating important topics from the divisional to the main board rested with this committee. The problem was that this body was constituted too late in the day – 11 November 1970[76] – and did not meet for the first time until 17 November 1970, by which time the crisis at Rolls Royce was unsalvageable[77] (see section VI below for who instigated this committee, and why).

The second body identified from the report which might be presumed to have responsibility for communicating the escalating financial crisis to the main board was the finance committee. This committee was established on 28 January 1969,[78] largely in response to outside criticism of the need for a strengthening of the basic management weakness in financial control and the need for greater forward planning in the company.[79] Non-executive directors on the main board might plead ignorance of the escalating financial crisis. The plea sounds weak given the fact that two non-executive directors sat on the finance committee, all other non-executive directors were *ex officio* members, and the non-executive members of the committee were all regular attendees.[80] It was this body that ultimately bore responsibility for reporting key financial information to the main board, and hence for presenting information which 'was not adequate for effective management'.[81] From July 1969, this body was aware of the escalating financial difficulties of the RB.211, but insufficient was done to ensure that the main board as a whole was kept fully informed.[82] The record thus shows that the ability of non-executive directors to challenge management at Rolls Royce constrained by problems of asymmetric information.

Was any director (executive or non-executive) held accountable? Personnel did resign (on health grounds) and managerial changes were introduced.[83] But no individual was held accountable: 'our conclusion in no way questions the integrity, either individually or collectively of members of the board. We believe they acted throughout in what they considered to be the best interests of the company, its employees and its shareholders.'[84]

VI

Who then exercised responsibility? Who forced through managerial changes and the creation of the finance and chief executive's committees? Our analysis shows that pressure for managerial change, for improvements in financial control and reporting and for the creation of the financial and chief executive's committees derived not from management or from shareholders, but from the banking community. The real exercise of 'voice' derived not from shareholders, but from a three-pronged attack from a merchant bank, two clearing banks and the Bank of England.[85]

The merchant bank, Lazards, was involved initially in a consultative role on the company's funding requirements.[86] Lazards, however, was more than an outside 'arm's-length' consultant. It became an active insider. Its leverage derived from its 'large degree of responsibility to the acceptance credit syndicate and the Joint Stock Banks'.[87] Its bargaining strength derived from the company's need to find additional financial support. Its incentive to intervene derived from the increasing role and specialisation of merchant banks as investment advisors to pension, trust and endowment funds.[88] In return, the information contained in the DTI report suggests that Lazards demanded – and got – managerial changes as well as information and participation in decision making.

From May 1968 there were regular meetings between Lazards and senior executives, with Lazard representatives being present at meetings of the Rolls Royce main board.[89] At these meetings, Lazards exercised real influence on the company through the 'voice' mechanism. The record of events catalogues significant developments in the role and influence of the bank. Lazards applied strong pressure on the company's senior management to form an executive committee which should 'meet often' to deal with 'these extremely urgent problems' and 'be given power to take immediate decisions'.[90] It also insisted that the committee should include at least two non-executive directors, one of whom should be a Lazards representative, instructed Denning Pearson to show a copy of its letter to his principal colleagues and outside directors 'so that they are all aware of how we feel this difficult situation should be handled'[91] and told senior management in no uncertain terms that it had to be 'in a position to be positively involved in the very difficult policy decisions which have to be taken'.[92]

The executive committee Lazards demanded was not to be formed until September 1970, by which time the crisis at Rolls Royce was escalating. The delay between the demand being made and the committee being formed suggests that Lazards alone could not force the company to change. Lazards had to have allies elsewhere. The record makes it clear that support came from the clearing banks and the Bank of England. In September 1970, the Midland and Lloyds banks agreed to provide facilities of £5 million each, subject to an immediate study of the future viability of Rolls Royce.[93] The two banks insisted, as part of the agreement, that they had the right to designate a representative to sit on the main board, 'such person to be fully informed about the Company's position and to report as he thinks necessary to the banks'.[94]

In the same month, the Governor of the Bank of England was approached 'for his advice upon the maintenance of the company's bank facilities'.[95] A month later, the Governor informed Denning Pearson that 'if financial help was to be forthcoming from HMG or the private sector there would have to be changes in the management'. That requirement was made specific: a new named chairman and chief executive.[96] Voice had been expressed: managerial changes were demanded and implemented. By the autumn of 1970 a non-executive presence with real leverage and bargaining strengths was present on the main board and committees of Rolls Royce. The non-executive directors represented the banks and the government. The non-executive directors had real voice. They demanded and received up-to-date and comprehensive financial information.[97]

Pressure for managerial change derived not from shareholders but from the banking community. In a three-pronged concerted action, the company's principal merchant and clearing banks, together with the Bank of England, applied real pressure on the company for managerial change, the leverage being that without such change financial aid would not be forthcoming.[98]

The active involvement of the banking community in the problems of Rolls Royce disputes any view of arm's-length anonymous relations between the 'City' and British industry. Access to information, presence on decision making 'two-tier' board systems and demands for managerial change are all evidence of a voice which is more characteristic of the continental than the UK model. There is, however, a *real* difference between the continental system and that revealed at Rolls Royce. Active involvement in the company's difficulties came *after* the signing of the RB.211 contract. Had the continental system been in operation then maybe the terms of the contract would have been very different.[99] 'Voice' was a reaction to crisis rather than an on-going part of normal governance practices.

VII

Our fourth interpretation of ownership responsibility is the public policy hypothesis. This predicts that active involvement by shareholders in the UK is negated by public policy, especially when the government assumes an active role in industry, either by promoting merger or by pursuing public ownership.[100] It further predicts a satisficing strategy by management, based on the assumption of government assistance in the event of crisis. The public policy hypothesis has two strands. The first claims that shareholders in the UK do not intervene because they believe that in the final analysis the government will assume ownership responsibilities either by providing financial assistance or by taking the company into public ownership. The second claims that financial markets are reluctant to force liquidation, especially of high profile companies because they do not want to prompt tighter government regulation of the financial markets.[101] The first hypothesis is a satisficing explanation which relates inertia to a belief that ownership responsibilities can be abrogated to government. The second hypothesis emphasises a negative reaction and fear of provoking government retaliation.

We tested the validity of such views by examining the records to see whether interested parties did believe the government would intervene. There is no evidence to suggest that the management of Rolls Royce assumed that ultimate responsibility might pass to the government or that in a worst case scenario the government would bail them out.[102] Senior directors never considered a worst case scenario. They never believed there was any risk of insolvency. It was not until the meetings of 10 and 12 August 1970 that the Ministry first heard of the gravity of Rolls-Royce's financial position.[103] This was not complacency born of the belief that if the worst came to the worst the government would help, but one born of the conviction that the worst would never occur.

To what extent were shareholders and other interested parties influenced by a perception of government involvement? Shareholders were never consulted. Their propensity to exit the company suggests that they did not believe the government would bail the company out. Other interested parties did, however, believe the government had a role to play: largely and initially through the expectation of government financial assistance. The original contract was signed on the assumption of launching aid from the government. From there on there was a belief from other key players (notably the merchant and clearing banks) that financial assistance might be forthcoming from government.

There is no sense that the Labour government (until June 1970) or the Conservative government (from June 1970) behaved in a way which indicated that it favoured public ownership. Nor was there ever any discussion of merger. Both governments did, however, indicate a willingness to become involved: both through the instigation of meetings with the company and through financial assistance. Both involved a degree of information sharing and communication absent from the relations between shareholders and the company. Both, however, were constrained by the quality of information made available.

Direct government involvement initially derived from the Industrial Reorganisation Corporation.[104] The IRC never presumed the company would be taken into public ownership; nor did it believe that its remit included the promotion of merger as a possible solution. In this respect, the approach of the IRC in relation to Rolls Royce mirrors its transition from the instigator and enabler of mergers from its inception through 1968 and 1969 to a new role as a quasi development bank by 1970, advising the government on capital shortfalls, assessing the validity of financial requirements and monitoring financial loans.[105] In its role as a government agency development bank, the IRC was to be constrained by the quality of the information made available and by the constant upward revisions in the company's capital shortfalls. The IRC had difficulty in keeping track of the extent of the company's financial problems; much of its time was spent trying to ascertain the true nature of the exposure. Nor did it have representation on Rolls Royce's executive committee until January 1971, by which time influence was limited to the timing of the announcement of the decision to call in the receiver. As with the banks, active involvement was a defensive reaction to a crisis situation.

Initially, the government's expectation was that financial aid from the IRC would be the limit to its involvement with Rolls Royce. From the summer of 1969, the government instigated a series of meetings between the Ministry of Technology and the senior executives of the company.[106] These were continued by the Heath government from June 1970.[107] The meetings centred on the technical difficulties of building the RB.211 rather than the liquidity crisis facing the company.[108] It was not until the autumn of 1970 that the extent of the financial crisis was made known to the government.[109] From then on the Ministry was to be 'better informed in depth and breadth both in financial and technical terms than many of the company's own senior officials'.[110] By this time the question of responsibility had assumed legal ramifications.

Responsibility for the company rested on financial liability in law.[111] Under Section 332 of the Companies Act 1948, 'persons who are party to trading by a company at a time when there is no reasonable prospect of its creditors being paid may incur both criminal liability for the company's debts if the company is wound up'.[112] If the government were to provide additional launching aid, it could itself incur some liability for the company's debts,[113] could make it responsible to all the company's creditors and obligations[114] and thus liable to any Lockheed claim.[115] The government was advised that if it made any money available to the company it might be considered a party to the company carrying on business.

In the final analysis, those who took ultimate responsibility were ministry representatives, together with representatives from Lazards and the Midland Bank.[116] It was this group which met on 25 January 1971 to agree that the receiver should be called in. By this time, responsibility had been taken out of the hands of Rolls Royce directors. The decision making had passed to the ministry in concert with Lazards and the clearing banks, working in conjunction with the Bank of England. No Rolls Royce director was at that meeting.[117] For many of the company's main board members it was not until the board meeting of 26 January 1971 that they 'first heard of the real gravity of the company's difficulties and that receivership was first mentioned even as a possibility'.[118]

By early 1971 responsibility had clearly shifted to the banks and to the government; but that responsibility was executed in terms of realising that the company was now insolvent (by the former) and avoiding any liability for that insolvency (by the latter). The government could not commit itself to the unspecified sums which might have been necessary to enable the company to meet its current and future liabilities. It had been advised that 'should it provide some form of bridging finance it might be said to be a party to the carrying on of a business in a way which would normally involve contravention of the section'.[119] 'No-one else had a purse which was big enough.'[120] But, more to the point, no one could commit itself to legal liability for the debts of and potential claims of the company.

The relations between the government and Rolls Royce questions key tenets of the public policy hypothesis. Nowhere was there any sense from company directors, the government, shareholders or financial advisors that public ownership or merger was a policy option. Public policy concentrated on financial assistance, which the financial community assumed would be forthcoming, the IRC provided, and both Conservative and Labour governments supported.

Financial assistance could not be forthcoming because financial assistance involved exposure to financial claim if that assistance was made available when the company was, technically, trading whilst insolvent. For policy makers, the Rolls Royce saga appears to have marked a realisation that the vacuum of responsibility had to be addressed before similar crises occurred. One such lesson was that government had to assume greater responsibility by becoming better informed on industry and company performance. It is no coincidence that the Rolls Royce crisis precipitated a series of quarterly meetings between civil servants at the Department of Trade and Industry and leaders of industry.[121] From this time on, the DTI effectively assumed the role of principal and fulfilled, in part, the ownership responsibilities which the 'City' had been unwilling or unable to do. For many companies, this was the first time they had been subjected to rigorous review.[122] The DTI took more interest than either the banks or shareholders, subjected companies to regular meetings at which 'penetrating' questions were asked, answers demanded and outspoken comments were made about the companies' inadequacies.[123]

VIII

The case of Rolls Royce provides support to the advocates of the residual rights and property rights hypotheses of institutional and private shareholder behaviour. At no time did shareholders behave in a way which indicated they felt any responsibility to the company. In these terms, the behaviour of Rolls Royce shareholders mirrors the stereotypical view of how owners in general and financial institutions in particular behave in the UK. Responsibility was to rather than of the shareholders, although here there is evidence to suggest that the company was not forthcoming in informing and warning shareholders of the difficulties it was experiencing.

Critics of the internal mechanisms of corporate governance receive ample support from Rolls Royce. Given the constitution and role of the main and the divisional boards, directors could not fulfil their responsibilities. Problems of imperfect and asymmetric information made their job difficult, if not impossible. Non-executive directors were outnumbered and did not have full access to the information which might have alerted them to the problems the company was building up. In this, Rolls Royce was hardly unique.

Given the structure of shareholding in Rolls Royce, ownership of the company negated the fulfilment of ownership responsibilities; the incentive was for shareholders to exit the company. This, in turn, created a vacuum of ownership responsibilities. Where ownership constitutes no responsibility, other parties assume that role. Responsibility passes to others with direct financial involvement: namely merchant and clearing banks, which have a duty to protect their financial commitments to the company. This the banks, and Lazards in particular, did. It was Lazards which first warned the company of the exposure it was building up, which insisted on an executive committee and which demanded non-executive representation on that committee. It was the merchant and clearing banks working together which pressurised management, demanded representation, managerial change and access to information. This behaviour has more in common with the continental than the stereotypical view of governance models in the UK, the significant difference being that the former is on-going whilst in the latter governance responsibilities were prompted only by crisis. The behaviour of the banks is more characteristic of the continental than the UK model, but could only operate in crisis conditions as a reaction to the escalating problems of the company rather than as part of the on-going process of governance. Therefore, responsibility by the banking community in the case of Rolls Royce also involved the necessary step of calling in the receiver.

Public policy influenced events, not because there was any expectation of public ownership, but because the vacuum of responsibility meant there was no one else capable of mounting a financial rescue. Ultimate responsibility was defined in legal terms: in terms of liability if the company was trading under conditions of insolvency. Had interested parties known earlier, remedial action might have been taken which could have avoided the crisis; but that would have involved a more thorough questioning of the original contract made with Lockheed in 1968. By the time the government was aware of the financial exposure, it was too late. The lessons may have been that greater government involvement was needed and that, in future scenarios, rescue attempts should be instigated before the legal implications of insolvency applied.

Events at Rolls Royce throw into sharp focus the inability of standard external and internal mechanisms of corporate governance to assign ownership responsibilities in the UK. The behaviour of shareholders fulfils stereotypical views of how shareholders react. Residual and property rights were exercised and ownership responsibility abrogated. That behaviour, however, created a vacuum of responsibility. Responsibility then ceded to those with direct financial interests: namely merchant and clearing banks. The active and forthright involvement of the former is one of the most striking aspects of this case study and suggests a research agenda which prioritises the advisory role played by merchant banks. Their role as providers of investment funding to industry in general and as managers of equity portfolios for many City institutions gave them a unique role to influence management. This, however, is a role which appears to be absent from the current literature.

The Rolls Royce case study also underlines the importance of incorporating public policy regimes into any analysis of corporate governance in the UK. The behaviour of City institutions as equity managers and providers of capital cannot be explained without explicit acknowledgement of the interplay between government, industry and the ‘City’. Ownership responsibilities may be abrogated if and when there is an assumption of government assistance. That assumption may in turn create an incentive to abrogate responsibilities: a vicious circle that creates a self-fulfilling prophesy of arm’s-length relations between ‘City’ and industry. The research agenda now must be to trace how and why perceptions of public policy have determined the course of ‘City’–industry relations in the UK.

The case study reported here is that of a company in crisis. However, only by investigating a company in crisis can ownership be truly investigated, for only under such conditions can the source and exercise of those responsibilities be fully revealed. The crisis at Rolls Royce may stand in the annals of economic history as a worst case scenario of industrial decline, but the investigation of corporate governance under such conditions underlines the weaknesses of external and internal mechanisms of corporate governance in this country. The crisis at Rolls Royce may have been unique; but the ill-defined nature of corporate governance and the incentive of owners to exit if and when under-performance was revealed were not.

NOTES

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1. A.A. Berle and G.C. Means, *The Modern Corporation and Private Property* (New York, 1933); O. Hart, ‘Corporate Governance: Some Theory and Implications’, *Economic Journal*, Vol.105 (1995), pp.678–89; idem, *Firms, Contracts and Financial Structure* (Oxford, 1995); J. Parkinson, ‘Company Law and Stakeholder Governance’, in G. Kelly, D. Kelly and A. Gamble (eds.), *Stakeholder Capitalism* (London, 1997).
2. Kelly *et al.*, *Stakeholder Capitalism*; J. Parkinson, A. Gamble and G. Kelly, *The Political Economy of the Company* (Portland, 2000).
3. My thanks to a referee for pointing this out. Thus, those with property rights may have residual rights. We use the four type classification as shorthand to address the key issues of this case study.

4. The growth of the institutional investor resulted from the growing presence of pension houses and insurance companies. The growth of insurance and pensions led to a massive inflow of funds into their accounts which to a widening and deepening of their company share portfolios. Between 1963 and 1975 the proportion of shares held by persons fell from 54 per cent to 37.5 per cent. Committee to Review the Functioning of Financial Institutions, *Progress Report on the Financing of Industry and Trade* (London, 1977), para.69, p.20. G. Clayton and W.T. Osborn, *Insurance Company Investment: Principles and Policy* (London, 1965); W.A. Thomas, *Finance of British Industry, 1918–1976* (London, 1978); Committee to Review the Functioning of Financial Institutions, *Written Evidence by Insurance Company Associations*, pp.1–48; Committee to Review the Functioning of Financial Institutions, *Progress Report*, paras.69–71, pp.20–21; G.P. Stapleton, *Institutional Shareholders and Corporate Governance* (Oxford, 1996).
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10. Charkham, *Good Company*; Stapleton, *Institutional Shareholders*. Similar claims are made in relation to the US. See A. Schleifer and R.W. Vishny, 'Large Shareholders and Corporate Control', *Journal of Political Economy*, Vol.94 No.3 (1986), pp.461–88.
11. A behavioural pattern also identified by Gaved. See M. Gaved, *Ownership and Influence* (Institute of Management, London School of Economics, 1995).
12. Committee to Review the Functioning of Financial Institutions, *Progress Report on the Financing of Industry and Trade*, para.87, 26.
13. Charkham, *Good Company*, p.102.
14. See Marsh, *Myths*.
15. M.J. Roe, *Strong Owners, Weak Managers: The Political Roots of American Corporate Finance* (Princeton, NJ, 1994).
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18. Roe, *Strong Owners*.
19. Bowden, 'Corporate Governance: The Impact of Public Policy Regimes'; Bowden, 'British Leyland'.
20. As, for example, the Labour government's plans for influencing shareholding behaviour and stakeholding relations in the mid-1960s. See Bowden, 'British Leyland'.
21. See Bowden, 'British Leyland'.
22. The gross dividend payable per share expressed as a percentage of the market price per share.
23. Department of Trade and Industry (hereinafter DTI), *Rolls Royce Ltd and the RB 211 Aero-Engine* (Jan. 1972), Cmnd. 4860, p.5.
24. DTI, *Rolls Royce Limited, Investigation under Section 165 (a) (I) of the Companies Act 1948* (London, 1973), Report by R.A. MacCrindle and P. Godfrey, Guildhall Library Archive, p.166.
25. *Hansard* (Commons), Official Report, Fifth Series, Debate on Rolls Royce (11 March 1971), pp.655–8.

26. *Investors Chronicle*, 14 Feb. 1969, p.528; 5 April 1969, p.5.
27. DTI, *Investigation*, 'Summary and Conclusions of Investigation', para.532, p.330.
28. Ibid., para.552, p.344.
29. Ibid., para.548, p.341.
30. DTI, *Investigation*, 'Engine Development and Cost Estimating; Development Costs and Estimates', pp.179–94.
31. DTI, *Rolls Royce and RB 211*, para.3, p.5, para.6, p.6.
32. DTI, *Investigation*, 'Financial Control and Forecasting', para.100, p.73. The original agreement specified the delivery of 100 engines to be supplied at a fixed price of £354,000, which included adjustments for customer demanded modifications (DTI, *Rolls Royce and RB 211*, para.2, p.5).
33. Appointment of a Receiver, Board Statement published 4 Feb. 1971, quoted in DTI, *Investigation*, Appendix 14, p.1.
34. DTI, *Investigation.*
35. Rolls Royce Ltd, *Annual Report and Accounts, 1960–1969*, Companies House, London, Company File Reference: 87989. The structure of shareholding in Rolls Royce mirrored that of other UK quoted companies in the post-war decades as institutional investors increased their share of equity: L. Hannah, *The Rise of the Corporate Economy* (London, 2nd edn, 1983); W.A. Thomas, *The Finance of British Industry, 1918–1976* (London, 1978). For Rolls Royce, by far the largest institutional group was that of the insurance companies, which increased their share of the company's shareholding from 13.1 per cent in 1960 to 16.3 per cent by 1969. They were closely followed by nominee companies, which accounted for 13.4 per cent by 1969. The 1960s were also characterised by increased holdings by banks (from 2.4 per cent in 1960 to 3.6 per cent of the nominal value of shareholdings by 1969) and pension funds (2.4 per cent to 3.6 per cent). But for Rolls Royce, as for other quoted companies in the 1960s, the individual investor still accounted for the largest share of the company's equity (Table 3), although their share fell from 55.9 per cent to 47 per cent between 1960 and 1969.
36. A. Brummer and R. Cowe, *Weinstock; The Life and Times of Britain's Premier Industrialist* (London, 1999), p.118.
37. See Bowden, 'Corporate Governance: The Impact of Public Policy Regimes', pp.185–6.
38. S. Bowden, 'Troubles in an American Era: State and Financial Maladjustment to New Technology in the British Engineering and Defense Industries, 1940s to 1970s' (mimeo, 2001).
39. The first week of November, the end of January to the beginning of April, the end of April to the beginning of June and the last weeks of 1970 were particularly active months for trading in Rolls Royce stock. The announcement of an IRC loan in May 1970 did nothing to alleviate the concerns of shareholders: on the contrary, many saw this as sufficient cause to dump Rolls Royce stock. The half-yearly statement issued on 11 November 1970 announcing a post-tax deficit and anticipating large future losses on the RB.211 against contracted prices prompted many owners to exercise the exit option. However, the price did seem to stabilise in the first month of 1971, i.e. just prior to receivership. The DTI reported that there had been extensive purchasing by Guaranty Nominees on behalf of buyers of American Depository Receipts in the USA and that by the time the share register was finally closed nearly 25 million shares had been bought in this way. We have no way of knowing who Guaranty Nominees really bought the shares for, whether this was an attempt to shore up the market price, or what this being really represented. DTI, *Investigation*, 'Miscellaneous Matters', para.507, p.321.
40. Ibid., para.506, p.320.
41. We do not know the actual date when the Prudential sold its shares and cannot thereby ascribe a precise market valuation to the shares it sold. The £3.66 m figure is estimated taking the average share price for the year. If the Prudential sold at the peak price for the year, then just over £5 million would have been wiped off the register.
42. Shareholders were not involved until the Royal Exchange Assurance Ltd, acting as trustee

for the debenture holders, was notified on a confidential basis at the beginning of February 1971. DTI, *Investigation*, para.484, p.303.
43. Chairman's statement to shareholders, 19 June 1969, quoted in DTI, *Investigation*, 'Events leading to Interim Statement', para.356 p.190.
44. Circulated to shareholders on 22 June 1970. Ibid., para.406, p.232.
45. Ibid., para.406, p.232. This was despite the fact that Lazards had already warned Sir Denning Pearson that he had a responsibility to his shareholders to warn them of the likelihood of 'pessimistic results' for 1970–72 and to 'qualify certain comments made in his published statement' in the light of the revised financial estimates recently made available to the board. Ibid., para.411, p.240.
46. Ibid., para.412, pp.240–43.
47. Ibid., para.412, p.244.
48. Ibid., para.406, p.233.
49. The term 'merchant bank' was a current term in the 1970s, but not a term used today. Today, such banks call themselves investment banks. My thanks to the referee for pointing this out.
50. See Marsh, 'Market Assessment'.
51. For example, in British Leyland Motor Corporation and in GEC. For a discussion of the extent to which banks actively controlled the share accounts, S. Bowden and J. Maltby, 'Under-Performance, Short-Termism and Corporate Governance: The "City" and the British Motor Corporation, 1952–1967', *Financial History Review*, Vol.5 No.2 (1998), pp.179–201.
52. In 1967, Barclays administered 1,103,933 shares, Martins 56,627 shares and Midland 763,681 shares in Rolls Royce. Rolls Royce Ltd, 'Annual Register of Shareholders, 1967–1970', Companies House, London, Company File Reference: 87989.
53. The existence of nominee, named, numbered, executor and trustee accounts for each of the main banks, makes it difficult to assign responsibility and identify precise control of the shares in each account. In many instances, it may be assumed that the bank acted on behalf of and on the instruction of anonymous individuals and exercised little or no control.
54. A problem which applied to their holdings in other companies. See Bowden and Maltby, 'Under-Performance'.
55. Rolls Royce, 'Share Registers', 1967–69.
56. Ibid.
57. Ibid.
58. Rolls Royce, 'Annual Register for 1969', pp.393–401.
59. Brummer and Cowe, *Weinstock*, p.118. It was these institutions, illustrated most spectacularly by the infamous Slater-Walker company, which fuelled the hostile takeover boom of the late 1960s: ibid., p.10.
60. See M. Conyon and D. Leech, 'Top Pay, Company Performance and Corporate Governance', *Oxford Bulletin of Economics and Statistics*, Vol.56 (1994), pp.229–45, and M. Conyon, P. Gregg and S. Machin, 'Taking Care of Business: Executive Compensation in the United Kingdom', *Economic Journal*, Vol.105 (1995), pp.704–14.
61. Two sets of papers were presented: a green folder containing the agenda, minutes and further reports. The green folder comprised the main items for board discussion. The red folder consisted of financial plus narrative reports.
62. Management Structure, DTI, Investigation, para.57, p.37; para.58, p.39; para.61, p.40; para.75, p.46.
63. The financial information was in the red folder. DTI, *Investigation*, 'Financial Control and Forecasting', para.113, p.72.
64. Ibid., para.113, p.72.
65. DTI, *Investigation*, 'Management Structure', para.66, pp.42 and 43.
66. This was the divisional board responsible for the RB.211 project.
67. DTI, *Investigation*, 'Management Structure', para.66, p.2; Events leading to the interim statement, DTI, *Investigation*, para.360, p.193.
68. Events leading to the interim statement, DTI, *Investigation*, para.360, p.193.
69. Management Structure, DTI, *Investigation*, para.68, p.44.

70. DTI, *Investigation*, ‘Financial Control and Forecasting’, para.113, p.72.
71. Ibid., para.71, p.45. The main board had 22 members.
72. DTI, *Investigation*, ‘Miscellaneous Matters’, para.556, p.346.
73. Interview with member of the DED Board, quoted in DTI, *Investigation*, ‘Events leading to the Interim Statement’, para.361, p.194.
74. Ibid., paras.364 and 365, p.196.
75. DTI, *Investigation*, ‘Management Structure’, para.60, p.40.
76. Ibid., para.59, p.40.
77. DTI, Investigation, para.437, p.261.
78. DTI, *Investigation*, ‘Management Structure’, para.59, p.40 and para.115, p.72.
79. *Rolls Royce Ltd: Summary Report of the Industrial Reorganisation Corporation*, para.8, p.2 and para.9, p.3.
80. DTI, *Investigation*, Financial Control and Forecasting, para.116, p.73.
81. Ibid., para.157, p.93.
82. DTI, *Investigation*, ‘Events Leading to the Interim Statement’, para.354, p.189; para.360, p.195.
83. David Huddle, the managing director of the DED division, who held responsibility for the RB.211, was preoccupied with other matters (notably in America negotiating with Lockheed) for most of the time, and ultimately collapsed in June 1970 due to ill-health under the pressure of events. Sir Denning Pearson resigned as Chief Executive and was appointed a non-executive Deputy Chairman. He was replaced as Chairman by Lord Cole. The responsibility previously delegated by the Board to the Chief Executive was taken over by an Executive Committee consisting of the Deputy Chairman, the two Group Managing Directors of Gas Turbines and the Automotive and Subsidiary Companies and the Deputy Chairman. Responsibility for the day to day operational management of the company was divided between the two Group Managing Directors.
84. DTI, *Investigation*, ‘Summary and Conclusions’, para.552, p.344.
85. The other group which became increasingly alarmed and pressed management for action was the company’s auditors who by April 1970 were expressing concerns about the recoverability of the RB.211 research and development costs. DTI, *Investigation*, ‘Events Leading to the Interim Statement’, para.400, p.225.
86. Lazards was given revised company forecasts from early May 1968. Given the group’s existing heavy borrowings, Lazards warned the company that new financing had to be sought: from new equity and from an IRC loan. DTI, *Investigation*, ‘Events Leading to the Interim Statement’, para.333, p.171. The proportion of Rolls Royce funds provided by borrowed money stood at 50 per cent in 1967. DTI, *Investigation*, ‘Engine Development and Cost Estimating’, para.95, p.58.
87. DTI, *Investigation*, ‘Events Leading to the Interim Statement’, para.397, p.220.
88. *Committee on the Working of the Monetary System, Report* (Aug. 1959), Cmnd. 827, para.196, p.70.
89. For example that of 11 March 1970 which accepted the IRC loan offer (DTI, *Investigation*, ‘Events Leading to the Interim Statement’, para.392, p.216) and that of 17 April 1970 which discussed the revised group five year forecasts. DTI, *Investigation*, ‘Events Leading to the Interim Statement’, para.396, p.218.
90. Ibid. para.397, p.219.
91. Ibid. p.221.
92. Ibid. p.220. The letter from the chairman of Lazards to Sir Denning Pearson, 20 April 1970, is reproduced in full in the 1973 DTI Report.
93. At the same time, £8 million was to be provided by the Bank of England. DTI, *Investigation*, ‘Events Leading to the Interim Statement’, para.428, p.254.
94. Ibid., para.443, p.265. The terms of agreement are set out in full in the DTI Report.
95. Ibid., para.418, p.248.
96. Ibid., para.426, p.252.
97. Maurice Laing was appointed on 28 May 1968. He was deputy chairman of John Laing &

Son Ltd. Maurice Laing may have been appointed for his business experience, but it is notwithout significance that he was also a member of the Court of the Bank of England and acted as link between the Governor of the Bank and the company. Lord Beeching was appointed as non-executive director to the main board on 1 August 1970 to represent the interests of the IRC. Ibid., para.411, p.239.

98. This message was be reinforced by a personal communication from the Prime Minister's office to Lord Cole on 3 November 1970, which insisted that the government had to be satisfied that 'steps were being taken to put the management of the company on a proper footing' (ibid., para.427, p.253). The letter from the Prime Minister's secretary to Lord Cole of 3 November 1970, summarised the meeting Cole had had with the Prime Minister on 30th October. The letter is reproduced in full in the DTI Report.
99. 'Once the contract was signed no system of financial control could have significantly altered the course of events' (DTI, *Investigation*, 'Miscellaneous Matters', para.566, p.357). Later analyses spoke of responsibility in terms of the main board in general and the senior executives in particular: the main board for failing to consider contingencies and worst case scenarios at the time the contract with Lockheed was signed (ibid., para.567, p.358), and the two senior executives in the company for failing to 'recognise the awesome dangers of the venture ... they were equipped to recognise and warn against its imprudence ... in omitting to do so they failed properly to discharge the responsibilities of stewardship which rest upon the directors of a public company' (ibid., para.567, p.359).
100. Roe, *Strong Owners*.
101. Ibid.
102. DTI, *Investigation*, 'Miscellaneous Matters', para.548, p.341.
103. DTI, *Investigation*, 'Events Leading to the Interim Statement', para.414, p.245.
104. In May 1968, Lazards pressed Rolls Royce to seek new financing through an Industrial Reorganisation Corporation loan. (Ibid., para.333, p.171). Established in 1966 by the then Labour government, part of its overall policy objective of improving the competitiveness of British industry. Eighteen months later, the IRC carried out an investigation to advise government on the level and form of existing government support to the aero-engine industry. D. Hague and G. Wilkinson, *The IRC – An Experiment in Industrial Intervention; A History of the Industrial Reorganisation Corporation* (London, 1983), p.201.
105. A policy of encouraging mergers and takeovers does not appear to have figured in the case of Rolls Royce (Hague and Wilkinson, *IRC*). There was no obvious candidate willing and able to take over the company. By this time, the late 1960s fashion for mergers had abated.
106. DTI, *Investigation*, 'Events leading to the Interim Statement', para.369, p.200.
107. Ibid., para.410, p.239.
108. Ibid., para.412, p.244.
109. *Hansard*, 11 March 1971, pp.633–5.
110. DTI, *Investigation*, 'Events Leading to the Interim Statement', para.415, p.245.
111. Ibid., para.478, p.299; para.481, p.301.
112. DTI, *Rolls Royce and RB 211*, para.24, p.11.
113. DTI, *Investigation*, 'Events Leading to the Interim Statement', para.429, p.255.
114. Ibid., para.484, p.302; para.493, p.310 and para.494, p.311.
115. Ibid., para.495, p.312.
116. Ibid., para.484, p.302.
117. Ibid., para.484, p.304.
118. Ibid., para.488, p.307.
119. DTI, *Investigation*, 'Miscellaneous Matters', para.565, p.355.
120. DTI, *Investigation*, 'Events Leading to the Interim Statement', para.503, p.319.
121. The impetus for DTI involvement derived from its on-going interests and concerns with the balance of payments implications of the country's export performance, as well as the employment implications of the problems of British industry, and from its assumption, from 1971, of the duties of the Industrial Reorganisation Corporation. The winding up of the IRC transferred responsibility for the administration of its loans to the DTI. DTI

interview, 27 Aug. 1997; Committee to Review the Functioning of Financial Institutions, *Volume 4, Oral Evidence by the National Enterprise Board* (22 Nov. 1977).

122. Notes of an interview between R. Stormonth-Darling (former non-executive Director of BMC and BLMC and G. Owen; our thanks to Geoffrey Owen for giving us access to the transcript of this interview; Notes of interview by the author with John Barber, former Finance Director of BLMC (from 1968) and Managing Director of BLMC (until 1975), London, 27 Aug. 1997; DTI interview. The DTI interview refers to an interview conducted by the author on 17 October 1997 in London with one of the senior civil servants involved in these meetings. Our source wishes to remain anonymous and the confidentiality has been respected.
123. Barber interview, London, 27 Aug. 1997.