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Corporate Governance

in the Context of Corporate Restructuring

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Abstract

The purpose of this thesis is to study corporate governance through a holistic approach by reviewing how the interests of shareholders, creditors and employees are protected and constrained throughout the life of a company.

The thesis begins with the view that corporate governance is a control system with both an internal and an external governance scheme. By restructuring the parameters in both schemes, I set up a three-dimensional structure to study corporate governance. I first select shareholders, creditors, and employees as three factors of the axis of subjects. I then group social political issues, contracts, and laws and regulations as factors on the axis of constraints. After that, I define the third axis as the life cycle of corporate governance, parameters on which include corporate governance in the normal life, flotations, takeovers, and insolvency. By setting up this three-dimensional structure, I argue that corporate governance must be studied through a holistic approach integrating both the institutional perspective and the life cycle of corporate governance.

The institutional perspective emphasizes the importance of social political issues in shaping the combination of constraints on the interests of stakeholders. The discussion in this thesis shows that different stakeholders have different combinations of constraints in safeguarding their own interests. On the whole, the current governance institution can provide due protection to stakeholders in different phases of the life cycle of corporate governance. One implication of this discussion is that company law is not the only relevant issue in corporate governance studies. In turn, shareholder primacy is a misleading conception in the institution of corporate governance even if it is a valid argument in the specific coverage of company law.

The dynamic perspective on corporate governance points out that corporate governance also develops in a life cycle pattern. It is important to realize that, similar to the widely recognized path-dependence in corporate governance in comparative governance studies, the development of corporate governance practices in any company is also a continuous process in that existing governance practices and structures may make a difference to the occurrence of the later phases in the life cycle of corporate governance. Moreover, the dynamic perspective accentuates the importance of corporate governance around insolvency compared with that of other phases. Indeed, the solvency criteria which are legally prescribed merely in financial terms can not only exclude any serious consideration of non-financial interests but also reinforce the established finance oriented governance practices.

This study also provides some thoughts on the current reform of corporate governance. In general, corporate governance is a multi-disciplinary issue and reform of corporate governance practices must be carried out with both an institutional and a dynamic approach. Accordingly, corporate governance reform can only be an ongoing and piecemeal process. Any abrupt change to the established system may only do a disservice and is thus inadvisable.

Key words: corporate governance, an institutional perspective, a dynamic view, shareholder, creditor, employee, flotation, takeover, and insolvency.

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CHAPTER 1. INTRODUCTION

The purpose of this thesis is to study corporate governance through a holistic approach by reviewing how interests of shareholders, creditors and employees are protected and constrained throughout the life of a company.

The corporate form is reviewed in this thesis from both an internal and an external perspective.[1] An internal perspective centres on the intra-organization structure and arrangement whereas the external perspective focuses on the business environmental factors. Viewed from this perspective, corporate governance systems can be similarly divided into the internal governance scheme and the external governance scheme.[2] The essence of this approach is that corporate governance study should adopt a holistic approach and the main objective of corporate governance study is to analyze the interrelationship among the components of both the internal and external governance scheme. Accordingly, corporate governance will be defined in this thesis as *a system in which the interests of participants are balanced and orchestrated to pursue the purpose of company*.

The next step is to set up such a holistic approach to the corporate governance study. A further analysis of parameters in both the internal and the external governance schemes is thus necessary. In this context, I follow the institutional approach provided by David and North.[3] For David and North,

> "*The Institutional Environment is the set of fundamental political, social and legal ground rules that establishes the basis for production, exchange, and distribution.*"
>
> And
>
> "*An Institutional Arrangement is an arrangement between*

[1] Pfeffer, J., and Salancik, G., *The External Control of Organizations, A Resource Dependence Perspective*, (2003), Stanford University Press, at 6-10.
[2] Gillan, S., *Recent Developments in Corporate Governance: An Overview*, (2006), *Journal of Corporate Finance*, 12(3):381-402.
[3] Davis, L., and North, D., (with the assistance of Smorodin, C.), *A Theory of Institutional Change: Concepts and Causes, in Institutional Change and American Economic Growth*, (1971), CUP.

> *economic units that govern the ways in which these units can cooperate and/or compete.*"[4]

According to David and North, both markets and organizations are considered as institutional arrangements. However, an organization differs from a market in that the former exists to consciously coordinate firm-specific assets through discretionary rules while the latter consists of rules and conventions that regulate recurrent voluntary transfers of property rights through the competitive price system.

The distinction between the institutional environment and the institutional arrangement and the further division of markets and the organization within the institutional arrangement tell us that factors considered in the control perspective of the governance structure can be divided into three groups, *i.e.*, institutional environment, markets and organization. In detail, the organization in the institutional approach is comparable to the internal governance structure from the control perspective, the institutional environment corresponds to the legal, social and political factors in the external governance structure, and the markets constitute a third group of factors in the external governance structure.

This regrouping thus dispels the complexity and generality in the traditional control perspective of corporate governance. By further reorganizing the factors in the external governance structure, this approach enhances the consistency among factors in the same group while at the same time provides a new perspective to study corporate governance as an organic whole.

I. INTERNAL GOVERNANCE AND SELECTION OF THE SUBJECTS

It is widely accepted that the internal governance scheme is mainly about shareholder control, stakeholder control, and director control. However, the separate legal personality of a company dictates that a company has its own interests, downplaying the priority of the interests of any stakeholders, including those of shareholders. Indeed, the understanding of the director control is strongly hinged on one key concept of the interests of the company, the definition of which reverts to the

[4] *ibid.*, at 6-7.

traditional shareholder and stakeholder debate. Viewed from this perspective, the "conflict" between shareholders and stakeholders is a basic issue of internal governance.

Next, we need to select representative subjects of the internal governance structure. While it is easy to identify shareholders, it may be not to ascertain stakeholders. Indeed, the concept of stakeholder is a rather vague concept.[5] The broadest definition may include "*any group or individual who can affect or is affected by the achievement of the organization's objectives*"[6] while a narrow view of stakeholder includes only those participants who have placed property or other assets at risk in a business firm.[7]

In order to avoid unnecessary complexity and facilitate the discussion, I follow the narrow view of stakeholder preferred by OECD, which states that

> "*With respect to stakeholders as a concept, most agree that an essential component is the degree to which capital (human and physical) and other rights are tied to a given enterprise and therefore subject to possible losses from the action of, inter alia, management.*"[8]

Accordingly, I select shareholders, creditors, and employees, as stakeholders who bear direct and close relationships to the interests of the company, as the representative subjects to be studied in this thesis.[9] These factors represent the first dimension of this thesis.

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[5] Orts, E., and Strudler, A., *The Ethical and Environmental Limits of Stakeholder Theory*, (2002), *Business Ethics Quarterly*, 12(2):215-233. The authors argue that the current stakeholder theories can mainly be divided into two categories—a narrow version and a broad version, the latter of which has been criticized to be "meaningless" and doomed to "collapse", at 218.

[6] A broad view of stakeholders can be read as follows: "*A Stakeholder in an organization is (by definition) any group or individual who can affect or is affected by the achievement of the organization's objectives.*" See Freeman, E., *Strategic Management: A Stakeholder Approach*, (1984), Pitman Publishing, at 64. Another example can be seen in Sheridan, T. and Kendall, N. *Corporate Governance: An Action Plan for Profitability and Business Success*, (1992), London: Pitman, at 27-28. This concept may also include such concerns as the interests of community and environment.

[7] Clarkson, M., *A Stakeholder Framework for Analyzing and Evaluating Corporate Social Performance*, (1995), *Academy Management Review*, 20:92-117.

[8] OECD Report, *Corporate Governance: A Survey of OECD Countries*, (2004), available at *http://www.nhh.no/for/courses/spring/eco420/OECD-04.pdf*, at 70.

[9] But notice that the distinction between the three subjects may however not be as clear-cut as expected due to the creative contractual arrangements. In fact, as will be discussed, shareholders can be creditors through shareholders' loan to the company, creditors can be shareholders by holding convertible securities, and employees can also be shareholders through Employee Stock Ownership Plans. However, such mutation of the dividing line between these three subjects is only a modification of the mainstream categorization and does not provide difficulty to the discussion of the thesis.

II. EXTERNAL GOVERNANCE I AND CONSTRAINTS ON THE INTERESTS OF SUBJECTS

According to the categorization made earlier in this chapter, I will discuss in this section the group of institutional environmental factors, *i.e.*, legal, social and political factors. These are background environmental factors which inform both the markets and the internal governance structure. A comprehensive study of corporate governance as shown in the control perspective of corporate governance necessitates the inclusion of these factors.

For the purpose of corporate governance study, these environmental factors are important constraints on the interests of the subjects we are going to discuss in this thesis. Once we deem institutional factors as constraints on the interests of the subjects, we may have to include another parameter, *i.e.*, contracts. For one thing, contracts are the main way through which subjects establish legal relationships with a company. For another, constraints on the interests of the subjects can almost always be found in the contracts. The inclusion of contracts thus transforms the categorization of institutional environment into the categorization of the constraints of the interests of the subjects. Such a reshuffle of the factors retains all the elements considered in the institutional environment but views such factors from a different perspective. Thus, the inclusion of contracts can be justified for both consistency and inclusiveness.

For the sake of convenience, I combine social and political issues into one group. In other words, I will select three elements, *i.e.*, contracts, laws and regulations, and social-political factors, as parameters on the axis of constraints of the interests of subjects. Such an approach, however, cannot be understood as an effort to disconnect the interrelationship between these three perspectives. Indeed, as Aoki argues, "*actual institutional dynamics appear to involve interactions of economic, organizational, political, and social factors.*"[10] For instance, the interrelationship between 'formal'

[10] Aoki, M., *Endogenizing Institutions and Institutional Change*, (2007), *Journal of Institutional Economics*, 3(1):1-31, available at http://ssrn.com/abstract=918620, at 12.

legal rules and less formal social norms is hard to tell apart.[11] Thus, the categorized discussion can only be understood as an effort to tap the intricacy of the institutional view of corporate governance.

III. EXTERNAL GOVERNANCE II AND THE LIFE CYCLE OF CORPORATE GOVERNANCE

We still have one more group of external factors left untouched, *i.e.*, the group of markets, which includes the production factor markets, the market for the corporate control and the product market. To simplify the discussion we should first see whether some factors can be integrated into the discussion of other two dimensions. It is not hard to see that the labour market can rightly be covered when we discuss employees and the private capital market is an issue which can readily be covered when we discuss creditors. Also, since the director labour market is relevant only to directors, I will leave it aside.

Then, the third dimension emerges to contain the public capital market, the market for corporate control and the product market. A company is exposed to the public market mainly when the company goes through the Initial Public Offering (IPO) process or in the UK flotation.[12] A flotation terminates the life of a company as a private company but at the same time begins a new life of the company as a public listed company. In other words, the public capital market connects the corporate governance of private companies with that of public companies.

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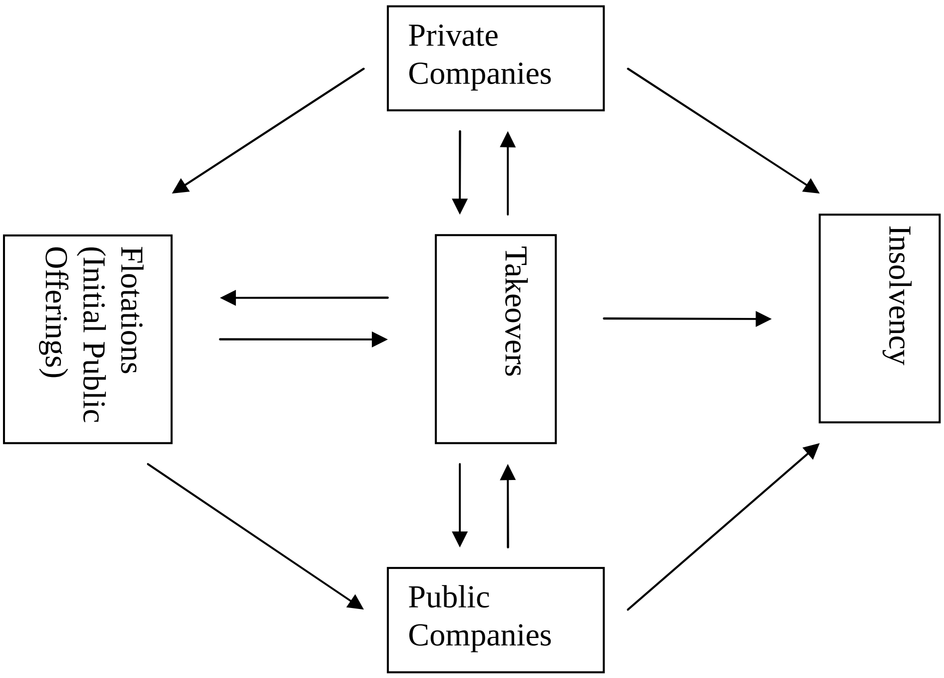
[11] As admonished by Deakin and Ahlering, "*an understanding of more formal institutions, including the legal framework, must be complemented by an appreciation of how they interact with informal norms, social conventions and tacit understandings in shaping behaviour.*" See Deakin, S., and Ahlering, B., *Labour Regulation, Corporate Governance and Legal Origin: A Case of Institutional Complementarity?*, (2005), CBR Working Paper No.312, available at *http://ssrn.com/abstract*=898184, at 4. This view thus corresponds to that of Aoki, who argues that enduring institutions have self-enforcing and self-sustaining characteristics which can not be reduced into formal rules, see Aoki, M., *Toward a Comparative Institutional Analysis*, (2001), Cambridge, Mass: MIT Press at 5.

[12] Flotation is a process through which a private company can be transformed into a public company. However, flotation is not the only method by which a private company can be transformed into a public company. See ss90-96 of Part 7 (Re-registration as a Means of Altering a Company's Status) of the Companies Act 2006 (CA 2006). Another point worth mentioning is that unlisted companies can also go through an Initial Public Offering (IPO) process to raise capital from the public. But unlisted companies will not be subject to the Listing Rules on the London Stock Exchange. Moreover, since an IPO is usually called a floatation in the UK (see Ferran, E., *Company Law and Corporate Finance*, (1999), OUP, at 567), we select *flotation* rather than *IPO* for the purpose of discussion in this thesis.

Alternatively, a company may resort to the market for corporate control for its strategic growth or downsizing purposes. From the perspective of corporate governance, if the growth proceeds smoothly, the growth and mature stages are still covered under the issue of corporate governance either of a private company or of a public company. Once the growth and mature stages are informed with merger and acquisitions and/or divestiture activities, corporate governance may undergo extreme turbulence. Such activities involve a big change to the existing governance structures, either due to the collision of the two existing governance structures of two separate companies, as happens in hostile takeovers, or because of the enhancement of the corporate control into the hands of a group of persons, as occurring in Management Buy Outs (MBOs) or Management Buy Ins (MBIs). In any case, takeovers can appropriately be seen as representing specific junctures in the life of corporate governance. Of course, the end result of takeovers may be a strengthened governance structure or a bad one. If good corporate governance is introduced and enhanced through takeover activities, a new cycle of either the corporate governance of private companies or that of public companies will be initiated. Alternatively, if the result is the latter bad one, we may have to move to the decline and death phases of the life of a company. In other words, the above analyses show that the market for corporate control is an important juncture in the life cycle of corporate governance.

The above analyses thus show that flotation and takeover fit roughly with the birth and the growth or the downsizing phases. Such an understanding links with the life cycle of a company. Since the life cycle of a company is a strategic perspective of the birth, the growth and the death of the company, the inclusion of insolvency is thus necessary. Indeed, both a private company and a public company can become insolvent without going through all these intermediate stages. Also, we understand that the stage of insolvency includes both corporate rescuing efforts and the possible termination of the life of a company. If a distressed company, through reorganization of liabilities and assets, can come back to life, the company is successfully saved and a new life of corporate governance is initiated. If such a rescue process includes a flotation or a division of the company, and/or a taken-over by other companies, we may refer back to the governance around a flotation or that around a takeover. Alternatively, if, unfortunately, the end result is the liquidation and the dissolution, we may reach the end of the life of corporate governance. For that matter, insolvency can be considered either as the end of the life of corporate governance or as the resurrection of a new life of corporate governance. In other words, insolvency is just another juncture in the life cycle of corporate governance.

The above discussion thus tells us that corporate governance can also be studied from a life cycle perspective. Indeed, once we deem the governance of private companies and public companies as standard governance capsules, we may identify flotations, takeovers and insolvency as special junctures of the life cycle of corporate governance. If we further deem corporate governance around flotations, takeovers and insolvency as relatively separate governance capsules, we may draw a diagram of the life cycle of corporate governance as Diagram 1, which for the purpose of facility of discussion can further be reduced into the following linear Diagram 2.



Note: Insolvency includes corporate rescue and the liquidation of a company. If corporate rescue involves flotations (IPOs) and/or takeovers, the corporate governance structure can be seen either as a repetition of some capsules of the above diagram. Also omitted from the diagram are takeovers between private companies and those between public companies. While only takeovers involving public companies are discussed in detail in the thesis, takeovers between private companies will be discussed briefly for the sake of simplicity.

Diagram 1-1 The Life Cycle of Corporate Governance (1)

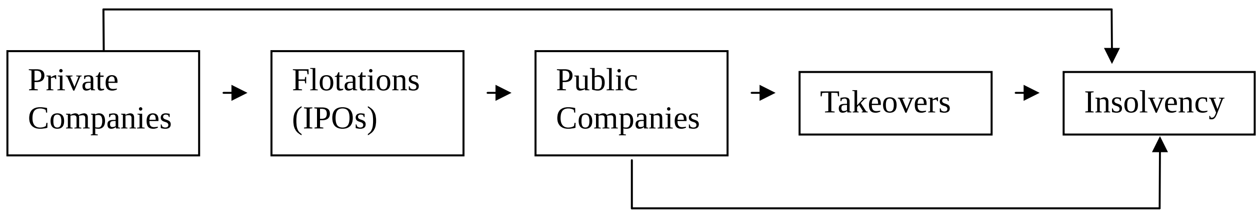


Diagram 1-2 The Life Cycle of Corporate Governance (2)

Once we establish that the life cycle of corporate governance is another dimension of the thesis, we can go back to the product market. Since competition on the product market informs the life of a company, it is an issue which can be covered wherever relevant. As a result, we successfully integrate markets into the life cycle of a company.

It is recognized that the identification of special junctures in the study of corporate governance is not new. For example, Bernstein, when studying the corporate governance in case of insolvency, states that:

> *"Governance decisions have the greatest impact when they are a matter of life and death—or, in the case of a firm, reorganization or liquidation—and that crossroad is therefore an excellent time to test the efficiency of a corporate governance system."*[13]

Indeed, the most relevant study is Filatotchev's study of corporate governance at the thresholds of IPO, takeover and insolvency.[14] For Filatotchev, conflicts of interests among and between stakeholders and shareholders intensify around these thresholds and thus study on corporate governance around these thresholds should deserve more attention from governance scholars. This study echoes Filatotchev's view in accentuating the thresholds in corporate governance but develops it into a life cycle perspective of corporate governance.

[13] Bernstein, E., *All's Fair in Love, War & Bankruptcy? Corporate Governance Implications of CEO Turnover in Financial Distress*, (2006), *Stan. J. L. Bus. & Fin.*, 11(2):299, at 303
[14] Filatotchev, I., *The Firm's Life-Cycle and the Dynamics of Corporate Governance: Overcoming Governance "Thresholds"*, in DTI Economics Paper No.13, *Corporate Governance, Human Resource Management and Firm Performance*, (2005), Papers from a Joint DTI/King's College London Seminar, available at *http://ssrn.com/abstract=881730*.

With the completion of this methodology of the whole thesis, I will give a detailed discussion of flotations, takeovers, and insolvency in the life cycle of corporate governance in the second chapter. Discussion of shareholders, creditors, and employees will be covered in the ensuing three chapters. In those chapters, I will proceed with the discussion along the life cycle of corporate governance and examine the combination of contracts, and laws and regulations in each capsule of the life cycle with a due emphasis on social political issues as background information.

Taking account of these considerations, we can now draw a cube to describe the structure of the whole thesis:

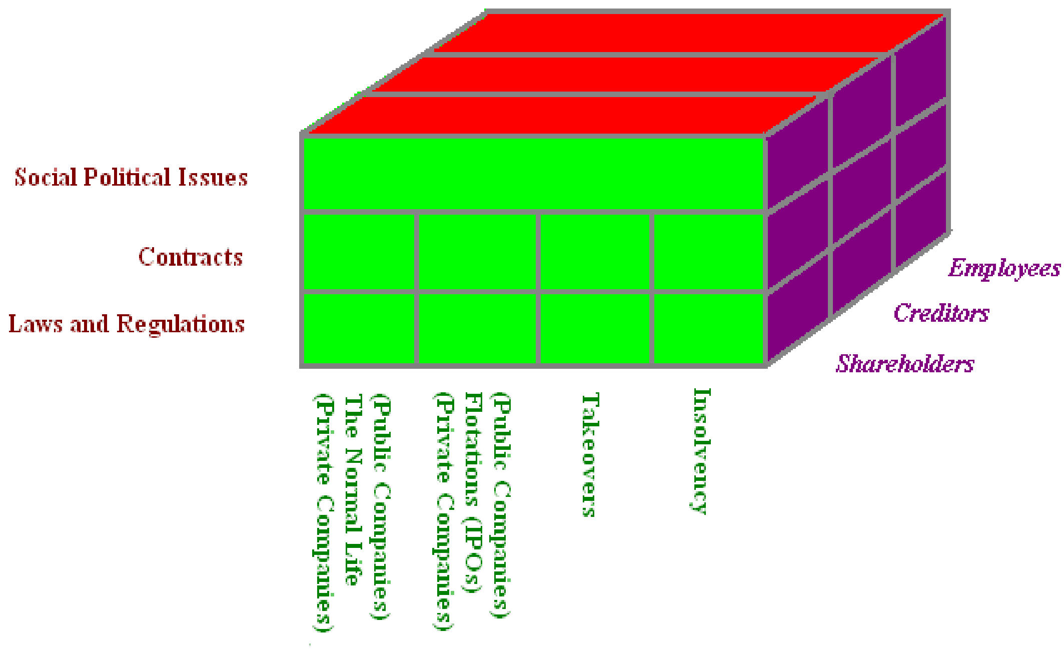


Diagram 1-3 The Structure of the Thesis

CHAPTER 2. CORPORATE RESTRUCTURING AND CORPORATE GOVERNANCE

INTRODUCTION

The foregoing chapter presents for this research a three-dimensional methodology, according to which I propose to discuss how interests of subjects are protected and constrained along the temporal dimension of the life cycle of corporate governance. The identification of the three junctures, *i.e.*, flotation, takeover, and insolvency, however, is only sufficient for the purpose of describing the research methodology. Indeed, compared with the importance of factors on the other two dimensions in the following chapters, the role of corporate restructuring activities, a collective concept which refers to the above three junctures, is downplayed. This chapter is to redress this deficiency.

For that purpose, I want to discuss two aspects of the corporate restructuring transactions in general. I will first discuss the economic aspects of such transactions in Part I. By presenting empirical evidence and management theories on the motives for, the governance role of, and the social implications of such transactions, I want to give a general idea of the role of corporate restructuring in the life cycle of corporate governance.

In Part II, I provide an outline of the legal institution of corporate governance and discuss the legal approach to corporate restructuring transactions. The objective of this Part is to narrow down the discussion to the specific situation of the UK. A conclusion follows at the end.

PART I. CORPORATE RESTRUCTURING IN THE LIFE CYCLE OF CORPORATE GOVERNANCE

A. FLOTATIONS

1. Motives for Flotations

Flotations can be initiated for several reasons. First, flotations provide entrepreneurs with alternative financial resources. Investors may prefer investments in a public capital market to those in a closed and limited market since they can freely transfer their investments. Furthermore, the low cost derived from the free transferability of shares traded on the public stock market also facilitates mergers and acquisitions through share-for-share transactions. Thus, the liquidity of the capital market may provide companies with financial resources at cheaper costs than those provided by private capital.[1]

Second, flotations can help insiders cash out their shareholdings in the entrepreneurship.[2] For example, it is a usual practice that venture capitalists stipulate in their contracts with the entrepreneur that the company will go public at a chosen time.[3] Such exits facilitate capital movement for more efficient uses and accelerate the investment cycle. Moreover, even though it is doubtful whether the management knows the true value of the firm,[4] the going public process and the potential takeover bidding process can help to achieve a favourable valuation for shareholders.[5] Alternatively, entrepreneurs may also take advantage of flotations to exit for a higher value than they can get from an outright sale.[6] Indeed, one recent study even points

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[1] Scott, J., *A Theory of Optimal Capital Structures,* (1976), *Bell Journal of Economics*, 7:33-54.
[2] Zingales, L., *Insider Ownership and the Decision to Go Public,* (1995), *Review of Economic Studies,* 62:425-448 and Mello, A., and Parsons, J., *Hedging and Liquidity,* (2000), *Review of Financial Studies,* 13:127-153.
[3] Gompers, P., and Lerner, J., *The Venture Capital Cycle,* (2000), MIT Press Cambridge MA, and Cumming, D., and MacIntosh, J., *A Cross-Country Comparison of Full and Partial Venture Capital Exit Strategies, Exits*, (2003), *Journal of Banking and Finance*, 27(3):511-548, also available at *http://ssrn.com/abstract=268557*.
[4] Rock, K., *Why New Issues are Underpriced.,* (1986), *Journal of Financial Economics,* 15:187-212.
[5] Chemmanur, T., *The Pricing of Initial Public Offerings: A Dynamic Model with Information Production,* (1993), *Journal of Finance*, 48:285-303.
[6] Zingales, (1995).

out that the primary motive for private companies to go public is to facilitate being taken over later at a better price.[7]

Third, instead of being used as a way to exit, flotations can be used as a way for entrepreneurs to regain control from external controllers by taking advantage of the liquidity of the public capital market.[8] By buying shares of external finance providers or external controllers, entrepreneurs can accumulate their own shareholding and enhance their decision rights. As a result, entrepreneurs can keep consistency in decision making by regaining the initially divided control.[9]

Other benefits of flotations include the enhanced reputation[10] and more favourable analyst coverage.[11] Nevertheless, high compliance costs and stringent disclosure on the public capital market result in losses of the privacy entrepreneurs used to enjoy in a private company. Additionally, as more information is disclosed to the public, potential offerors have more opportunities to understand the real, especially financial, situation of the offeree companies. Since it will be easier for offerors to purchase shares on a liquid market than through negotiations with obstinate and inbound insiders, a new public company is also under incremental threats of being taken over.[12] Besides, it is documented that public trading also exposes the company to more intensive competition on the product market.[13] The decision to go public can thus only be the end result of a series of cost-benefit

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[7] Brau, J., and Fawcett, S., *Initial Public Offerings: An Analysis of Theory and Practice,* (2006), *Journal of Finance*, 61(1):399-437.
[8] Black, B., and Gilson, R., *Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets,* (1998), *Journal of Financial Economics,* 47:243-277.
[9] Aldrich, H., *Organizations Evolving,* (1999), Thousands Oaks CA: Sage.
[10] See Gomes, A, *Going Public without Governance: Managerial Reputation Effects,* (2000), *Journal of Finance,* 55:615-646 and Pagano, M., and Röell, A., *The Choice of Stock Ownership Structure: Agency Costs, Monitoring, and the Decision to Go Public,* (1998), *Quarterly Journal of Economics,* 113:187-225.
[11] Bradely, D., *et al*., *The Quiet Period Goes out with a Bank,* (2003), *Journal of Finance,* 58:1-36.
[12] Anti-takeover procedures and terms with objectives to block such potential threats are widely inserted in the charter of the companies going IPO in the US. See Daines, R., and Klausner, M., *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs,* (2001), *Journal of Law, Economics and Organizations*, 17(1):83-120; Bebchuk, L., *Why Firms Adopt Antitakeover Arrangements,* (2003), *U. Pa. L. Rev.,* 1(52):713-753. However, such practices are not popular within the UK capital market because of the reluctance of institutional investors to accept such anti-takeover measures. Also, General Principle 3 and Rule 21 of the Takeover Code and Part 28 of the CA 2006 all prohibit antitakeover measures without the prior approval of offeree shareholders.
[13] Schultz, P., and Zaman, M., *Do the Individuals Closest to Internet Firms Believe They are Overvalued?,* (2001), *Journal of Financial Economics,* 59:347-381 and Maksimovic, V., and Pichler, P., *Technological Innovation and Initial Public Offerings,* (2001), *Review of Financial Studies,* 14:459-494.

analyses by decision makers with due consideration of specific situations of both the capital and product market.

2. The Influence of the Existing Governance Structure

(a) The Founders' Retention of Control

The founders' retention of control has been testified in several empirical studies, which show that founders have strong incentives to retain their control by designing corporate charters and the initial ownership structure.[14] In turn, original shareholders have to trade off between the retention of control and the benefits arising from a better portfolio diversification when they decide whether to go public.[15]

The retention of control by the founders may bring benefits to the company. For instance, it is widely known that a flotation implicates a change from an entrepreneurial management or an '*untested management*'[16] to a professional management. The experiences and external ties of entrepreneurs may accordingly facilitate both the psychological transition process of existent board members and the introduction into the board of outside directors who provide legitimacy and prerequisite social ties to the new public company.[17] Also, the retention of the founder CEO can help to maintain the trust shaped and accumulated among employees during the entrepreneurship, an important effect which can lead to positive outcomes.[18] Thus, founders' retention of control in some cases can be justified during the transition

[14] Field, L., and Karpoff, J., *Takeover Defences at IPO Firms,* (2002), *Journal of Finance,* 57:1857-1889 and the above discussion of the adoption of antitakeover arrangements when companies going public.
[15] Zingales, (1995); Bebchuk, L., *A Rent-Protection Theory of Corporate Ownership and Control,* (1999), NBER Paper No.7203, available at *http://www.nber.org/papers/*w7203 and Bolton, P., and von Thadden, E., *Liquidity and Control: A Dynamic Theory of Corporate Ownership Structure,* (1998b), *Journal of Institutional and Theoretical Economics,* 154:177-211.
[16] Certo, T., *et al.*, *Wealth and the Effects of Founder Management Among IPO-Stage New Ventures,* (2001), *Strategic Management Journal,* 22:641-658.
[17] D' Aveni, R., and Kesner, I., *Top Managerial Prestige, Power and Tender Offer Response: A Study of Elite Social Networks and Target Firm Cooperation During Takeovers,* (1993), *Organization Science,* 4:123-151; and Geletkanycz, M., *et al.*, *The Strategic Value of CEO External Directorate Networks: Implications for CEO Compensation,* (2001), *Strategic Management Journal*, 22:889-898.
[18] Bolino, M., *et al.*, *Citizenship Behavior and the Creation of Social Capital in Organizations,* (2002), *Academy of Management Review*, 27:505-522 and Brockner, J., *et al.*, *When Trust Matters: The Moderating Effect of Outcome Favorability,* (1997), *Administrative Science Quarterly,* 42:558-583

period.

(b) The Anomaly of Underperformance

Most companies going public are expected to have a sound historical record[19] or at least a good product or the potentiality to have a good performance after flotations. Loughran and Ritter notice that the median age of companies going public in the US is stable at around 7 years ever since 1980 but with exceptions of a fall to 5 years in the Internet bubble period and a rise to 12 years in 2001.[20] Correspondingly, the median age of 1007 companies going public in Europe from 1995 to 2001 is 13 years.[21] It is thus natural to expect good performance of companies going public for a reasonable period.

However, empirical evidence on company performance after flotations proves otherwise. Both Ritter *et al.*[22] and Loughran *et al.* [23] report a long-term (3-5 years) underperformance of IPO stocks compared with non-IPO stocks matched on equity size.[24] Also, in a study of IPOs in Australia from 1984 to 1993, Balatbat *et al* find that operating returns (accounting-based) of IPO companies are significantly lower than those of non-IPO peer companies from the third post-listing year but remain stable for up to five years after the IPO.[25] Indeed, Balatbat *et al.* also find that the insider ownership declines *monotonically* over the first 5 post listing years. Such evidence shows not only the successful efforts of the insider ownership to survive in the exposed public market in the first two or three years but also the failure of the insider controllers to improve their performance in the following years.

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[19] For a number of basic criteria, see LR 6.1 of the Listing Rules. In fact, the Three-Year Rule forms the cornerstone of the Listing Rules' quality control thresholds for companies to join the official list.
[20] Loughran, T., and Ritter, J., *Why has IPO Underpricing Changed over Time?*, (2004), *Financial Management*, autumn, 5-37, also available at *http://ssrn.com/abstract=331780*.
[21] Giudici, G., and Roosenboom, P., *Pricing Initial Public Offerings on "New" European Stock Markets*, (2002), EFMA 2002 London Meetings, available at *http://ssrn.com/abstract=314275*.
[22] Ritter, J., *The Long-Run Performance of Initial Public Offerings*, (1997), *Journal of Finance*, 47:3-27.
[23] Loughran, T., *et al.*, *Initial Public Offerings: International Insights*, (1994), *Pasic-Basin Finance Journal*, 2:165-199.
[24] But notice that the immature asset pricing methods may contest the reliability of such empirical evidence, see Ritter, J., and Welch, I., *A Review of IPO Activity, Pricing, and Allocations*, (2002), *Journal of Finance*, 57: 1795-1828, at 1820.
[25] Balatbat, M., *et al.*, *Corporate Governance, Insider Ownership and Operating Performance of Australian Initial Public Offerings*, (2004), *Accounting and Finance*, 44:299-328.

It has been argued that the dilution of the control by the original founders of the company and the resulting low managerial incentives can contribute to the underperformance of those companies going public.[26] In the UK, Brennan and Franks have observed that a dispersed shareholding structure only comes into being a few years after flotations because original founders effectively control the initial share allocation.[27] Such empirical evidence indicates a possible relationship between the founders' initiatives to retain the control and the long-term underperformance of companies going through flotations in the UK.

Nevertheless, it should be noted that the explanation of '*low incentive after IPOs*' does not exist in the study of Mikkelson *et al*.[28] Other empirical studies also document a lack of supportive evidence for the 'low-incentive' argument.[29] Thus, we are still not sure whether the founders' retention of control really contributes to the underperformance of companies going through flotations.

(c) Implications for Existing Stakeholders

A flotation process, as an important form of organizational transformation, may reset the *clock* of the operation of a company and subject the company to new risks.[30] Existing stakeholders may have to face the transformation accompanied with flotations. For instance, the dilution of the control rights and the increasing public scrutiny has been claimed as a *shock* to the new public company, forcing it to adapt to

[26] Jain and Kini find a positive relation between corporate performance and the shareholding retained by managers after the IPO. Jain, B., and Kini, O., *The Post-Issue Operating Performance of IPO Firms*, (1994), *Journal of Finance*, 49:1699-1726.

[27] Brennan, M., and Franks, J., *Underpricing, Ownership, and Control in Initial Public Offerings of Equity Securities in the UK*, (1997), *Journal of Financial Economics*, 45:391-413.

[28] Mikkelson, W., *et al*., *Ownership and Operating Performance of Companies that Go Public*, (1997), *Journal of Financial Economics*, 44:281-307.

[29] Agrawal, A. and Knoeber, C., *Firm Performance and Mechanisms to Control Agency Problems between Managers and Shareholders*, (1996), *Journal of Financial and Quantitative Analysis*, 31(3):377-397; Kole, S., *Managerial Ownership and Firm Performance: Incentives or Rewards?*, (1996), *Advance in Financial Economics*, 2:119-149; Loderer, C. and Martin, K., *Executive Stock Ownership and Performance: Tracking Faint Traces*, (1997), *Journal of Financial Economics*, 45:223-255, and Goergen, M., *Insider Retention and Long-Run Performance in German and UK IPOs*, (2005), in Filatotchev, I., and Wright, M., (eds), *The Life Cycle of Corporate Governance*, Cheltenham: Edward Elgar, 123-143, also available at *http://ssrn.com/abstract=149780*.

[30] Amburgey, T., *et al*., *Resetting the Clock: The Dynamics of Organizational Change and Failure*, (1993), *Administrative Science Quarterly*, 38:51-73.

the new regulatory scheme.[31] The enhanced shareholders' control, especially the control of minority shareholders, on the public capital market may, in turn, intensify conflicts between shareholders and other stakeholders. In addition, new explicit and implicit coalitions between and among stakeholders, shareholders and directors may also come into being once some of them have common interests either for their own benefits or against the interests of others.

Consequently, the transformation in flotations needs to be materialized with due consideration of the existing internal governance structure. Indeed, empirical evidence shows that positive feedback loops resulting from small differences from the initial situation can contribute to the success of firms undergoing transformation.[32] In other words, the impending and inevitable changes to the existing governance structure should not be a total repudiation of the existing governance structure. Rather, such changes should be deemed as an active but gradual acclimatization process of the internal governance structure to the new environment.

Nevertheless, as interests of stakeholders are covered more in the information disclosure, such as the consideration of interests of the employees and the material transactions relevant to creditors, the stringent regulatory scheme on the public capital market is generally favourable to stakeholders. For instance, companies with stakeholder oriented corporate governance structure in the US are found to experience less *shock* than shareholder oriented corporate governance when a firm goes public.[33] This function of inducing good corporate governance practices by the capital market, particularly that of the equity market, has been emphasized by Tadesse as "*a conduit of socially valuable governance services …distinct from capital provision*" and "*the value of this service is economically large.*"[34]

[31] Frye, M., and Smith, S., *IPO Shocks to Corporate Governance: Stockholder vs. Stakeholder Firms,* (2003), Financial Management Association 2003 Conference Paper, available at *http://207.36.165.114//Denver/Papers/fi_vs_nfi_ipogov.pdf*.
[32] Noda, T., and Collis, D., *The Evolution of Intra-industry Firm Heterogeneity: Insights from a Process Study,* (2001), *Academy of Management Journal,* 44:897-925.
[33] See Frye and Smith, (2003).
[34] Tadesse, S., *The Allocation and Monitoring Role of Capital Markets: Theory and International Evidence*, (2004), *Journal of Financial and Quantitative Analysis*, 39(4):701-730, also available *http://ssrn.com/abstract=236102*, at 6.

3. The Monitoring Role of the Public Capital Market

The liquidity of the public capital market provides investors with opportunities to freely move their investment from companies with poor performance records to those with good ones. As more investors will go for those with good performance, companies with better performance are able to raise capital on more favorable terms than those inefficient ones.[35] Alternatively, as mentioned earlier, the liquidity of the public capital market also performs its monitoring role through the potential takeover activities on the market.

However, the effectiveness of even an efficient capital market is limited to the extent that corporations must rely on this market to seek capital in the first place. Thus, the monitoring role of capital markets should not be exaggerated in a market where companies rely more on other sources to meet their financial needs. For example, the effectiveness of the public capital market may have to be discounted for companies in the US where undistributed profits, rather than capital raised from the public, are the main source of funds for most public corporations.[36]

Moreover, investors are not always rational. In a hot flotation market, everybody touts the shares going through flotations and the demands may simply be fads. Under such situations, the demand rather than the disclosed information will be the prevailing factor in deciding the price of new shares.[37] Besides, investors having missed the former opportunity to be the original owners of flotation shares may not want to be excluded from the next opportunity again. Such regret may distort the rational decision which should have been made according to the information disclosed.[38] In some cases, entrepreneurs may intentionally delay their flotations when their companies are undervalued, compared with their own expectation, until the bear market turns into a bull market.[39] Given such considerations, the monitoring role of the public capital market should be taken with reservation.

[35] Stout, L., *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, (1988), *Mich. L. Rev.*, 87: 613.
[36] Goshen, Z., *Shareholder Dividend Options*, (1995), *Yale L. J.*, 104:881, at 882.
[37] Choi, S., and Pritchard, A., *Behavioral Economics and the SEC*, (2003), *Stan. L. Rev.*, 56:1, at 14-15.
[38] Shefrin, H., *Beyond Greed and Fear: Understanding Behavioral Finance and the Psychology of Investing*, (1999), OUP, at 241-3.
[39] Lucas, D., and McDonald, R., *Equity Issues and Stock Price Dynamics*, (1990), *Journal of Finance*, 45:1019-1043.

4. The Social Implications

A flotation is an alignment process between the internal governance scheme and the social environment. This alignment process can be understood in the following mutually influenced ways. On the one hand, as private companies go public, they have to go through lots of social pressures. The reputation established within the legally prescribed period dictates that a company going through a flotation may have to undertake necessary reorganization to show its fitness and justify its legitimacy[40] as a public company to the outside society.[41]

Moreover, more stringent social rules may also come into play. If the company going public is in a traditional industry, widely accepted rules and customary business practices may well be established among public companies in the same industry. A new public company in such an industry may in turn be subject to the strong influence imposed by those social rules. Alternatively, if a company is in an emerging industry, a company may be left with more discretion at the beginning. Still, social rules in similar fields may well be borrowed to apply to the new public company.[42] Moreover, as more companies in the same line go to the public market, accepted rules and commercial practices may quickly come into being by "*converging around the template of a highly visible and apparently successful firm in the field.*"[43] Thus, companies going public are subject to more stringent monitoring not only on the capital market but also of the society. This implies that companies going through flotations must undergo a transformation to justify themselves in both the public capital market and the wider society. Viewed from this perspective, the existing governance structure may thus act as a social political transformation shield to the organizational change.[44]

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[40] Legitimacy is '*a generalized perception or assumption that the actions of an entity are desirable, or appropriate within some socially constructed system of norms, values, beliefs, and definitions.*' See Suchman, M., *Managing Legitimacy: Strategic and Institutional Approaches*, (1995), *Academy of Management Journal*, 20(3):571-610, at 574.
[41] Martens, M., *IPO Effects: Corporate Restructuring When a Firm Goes Public*, (2003), *Journal of Public Affairs*, 4(2):155-170.
[42] DiMaggio, P., and Powell, W., *Introduction*, in Powell, W., and DiMaggio, P., (eds), *The New Institutionalism in Organizational Analysis*, (1991), Chicago University of Chicago Press, 1-38.
[43] Martens, (2003), at 160.
[44] Fischer, H., and Pollock, T., *Effects of Social Capital and Power on Surviving Transformation*

On the other hand, flotations may also engender disruptive effects on the society. In addition to the long-term underperformance of companies going through flotations, empirical evidence also indicates that shares are usually underpriced in flotations in comparison with their first day market closing price.[45] While several reasons have been proffered to explain the anomaly of underpricing,[46] one reason entails special attention that underpricing is the compensation for underwriters who agree to sell the flotation shares and bear the risk if not all shares are sold.[47] Indeed, compensation for underwriters has been identified as a main reason for the significantly higher underpricing in flotations in the UK.[48]

The issue however is that public investors may not benefit from such high commissions for underwriters. Empirical evidence has shown that underwriters taking advantage of underpricing usually allocate underpriced shares to institutional investors for potential future cooperation (this is especially the result of the book building process) or to senior executives of unrelated companies so as to attract potential corporate finance businesses.[49] The implication of such allocation practices is that public individual investors on the flotation market may have few opportunities to buy from these shares. Professor Coffee observes that 75% of the market value of the flotation shares has been acquired by either underwriters or institutional investors.[50] What exacerbates the situation is that the industry practices and the legal scheme at the meantime attract those unlucky individual investors to buy later at a higher price, with the premium skimmed by those original buyers. As a result, the

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Change: The Case of Initial Public Offerings, (2004), *Academy of Management Journal,* 47(4):463-481.

[45] Ritter and Welch, (2002).

[46] *ibid*. Such reasons include information asymmetry between insiders and public investors; over-optimistic attitude of the public investors to new public companies; the avoidance of potential legal actions initiated by disappointed investors; and a tax-avoiding wealth transfer to employees or business partners.

[47] McDonald, J., and Fisher, A., *New Issue Stock Behavior,* (1972), *Journal of Finance*, 27:97-102; Ibbotson, R., *Price Performance of Common Stock New Issues,* (1975), *Journal of Financial Economics*, 2:235-272. Additionally, underwriters with good reputation find it easier than their peers to attract new clients. Carter, R., *et al., Underwriter Reputation, Initial Returns, and the Long-run Underperformance of IPO Stocks,* (1998), 53(1):285-311; Chen, C., and Mohan, N., *Underwriter Spread, Underwriter Reputation, and IPO Underpricing: A Simultaneous Equation Analysis,* (2002), *Journal of Business Finance and Accounting*, 29(3/4):521-540.

[48] Ljungqvist, A., *Conflicts of Interests and Efficient Contracting in IPOs,* (2003), New York University Centre for Law and Business Working Paper CLB 03-03, available at *http://ssrn.com/abstract=333820*.

[49] Benveniste, L., and Spindt, P., *How Investment Bankers Determine the Offer Price and Allocation of New Issues*, (1989), *Journal of Financial Economics*, 24:343-361.

[50] Coffee, J., *The IPO Allocation Probe: Who is the Victim,* (2001), *N. Y. L. J.*, 18 Jan 2001, at 5.

accumulating benefits for underwriters, institutional investors and favoured executives are in stark contrast to the loss suffered by the public individual investors. Considering the IPO market in the US, Hurt comments that "*What at first seems to be a very respectable process, managed by the most elite investment banks, analysts, and venture capitalists substantially conforming to existing securities laws, turns out to be a Wall Street-sponsored "pump-and-dump" scheme.*" [51] In this sense, IPOs or flotations can engender disruptive effects both on the existing governance structure of the companies going public and on the society as a whole.

B. TAKEOVERS

The active market for corporate control has long been shaping the industrial development in the UK.[52] Takeover transactions can largely be divided into two groups.[53] One group is that of the disciplinary takeovers, or more often what are termed 'hostile takeovers', and the other group is that of 'synergistic takeovers', or friendly takeovers as they are easily accepted by both sides, through which synergies between the offeree and the offeror company can be achieved. Franks *et al* reported that there were typically around 230 takeovers of publicly listed companies per annum and around 40 of these takeovers were hostile in nature.[54] Since friendly takeover bids can be amicably reached between the offeree shareholders and the offeror company, it is the hostile takeover that attracts our attention. Also, as hostile takeover transactions usually involve the inter-relationship between the offeree and the offeror company, governance structures of both companies are relevant. Moreover, due to the recent resurgence of going private transactions, they also deserve a separate discussion.

Another relevant concept is that of the transfer of undertaking, which can occur through statutory arrangements under s425 of the Companies Act 1985 or Parts 26 and 27 of the Companies Act 2006 or under s110 of the Insolvency Act 1986.

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[51] Hurt, C., *Moral Hazard and the Initial Public Offering*, (2005), *Cardozo Law Rev.*, 26:711-790, at 713.
[52] Hannah, L., *The Rise of the Corporate Economy*, (1976), Methuen & Co Ltd London.
[53] Shleifer, A, and Vishny, R., *Large Shareholders and Corporate Control*, (1988a), *Journal of Political Economy*, 94: 462-489. Still, it is worth noting that *takeover* here covers the Mergers and Divisions of public companies, as defined in Part 27 of the Companies Act 2006.
[54] Mayer, C., *Corporate Governance in the UK*, (2000), *Hume Papers on Public Policy*, 8(1):1-9.

However, these two statutory arrangements are more often employed as corporate rescue efforts. Accordingly, they are not discussed here though they will be included in the phase of insolvency in the following chapters.

1. Motives for Takeovers

For offeror companies, takeovers can be further divided into diversification and divestiture. The former is a method to pursue growth and the latter to downsize. We will discuss these two categories separately.

(a) Diversifications

The first motive for diversification is to acquire the control of more resources. Wernerfelt finds that return-generating specialized resources in one company but complementary to resources in another company may only be economically accessed *via* acquisition of the company if a full control of the resources is necessary.[55] In this regard, takeover transactions provide companies with a channel to quickly access technological assets of rival companies, to acquire knowledge stock from a researchers' team, to exploit their existing technological base (production knowledge and skills, technical know-how etc.) and to enhance the R&D efficiency of the offeror company.

The second motive for diversification is to achieve efficiency enhancement. If managerial capability is really some currency which can be transferred between different lines of business, diversifications can lead to efficiency enhancement. A well-controlled group can cut information costs and transaction costs within the group if the control centre of the group takes advantage of its resources and inside information. Subsidiaries may also benefit from intra group transactions. Matsusaka argues that diversification is a dynamic search process, through which companies try to match with their organizational capabilities.[56]

[55] Wernerfelt, B., *A Resource-Based View of the Firm*, (1984). *Strategic Management Journal*, 5(2):171-180.
[56] Matsusaka, J., *Corporate Diversification, Value Maximization, and Organizational Capabilities*,

The third motive for diversification is the provision of a bigger pool of inner capital. The availability of inner capital helps to overcome constraints of the external funding.[57] Headquarters with control of a bigger capital pool may take advantage of the internal administrative structure and make more efficient uses of capital.[58] Even though the increasing liquidity of the stock market and the variety of the products on the stock market has downplayed the importance of the internal capital market, the dual status of the internal capital providers may still engender incomparable monitoring initiatives.[59] On the one side of the coin, internal capital providers are insiders compared with external capital providers, since they are more knowledgeable of the situation of the firm and can better deploy firm resources. On the other side of the coin, they are outsiders to division business management. They control the capital, which the division management does not own. They will thus impose more intensive monitoring activities though at the cost of decreasing managers' entrepreneurship. Indeed, if the headquarter can allocate resources to divisions with the best investment opportunities, the cross-subsidization of investment among different divisions within the same diversified company may be more efficient than the outside capital market.[60] This attraction of the internal capital market thus provides a sound basis for diversification because the bigger the size of the group, the more capital the headquarter can control and the bigger the benefits can be engendered.[61]

However, the effect of diversification is not without its dark side. For example, diversification may be initiated to achieve management entrenchment[62] or for the purpose of empire building.[63] Accordingly, the offeror board may serve their own

(2001), *Journal of Business*, 74:3.

[57] Stulz, R., *Managerial Discretion and Optimal Financing Policies*, (1990), *Journal of Financial Economics*, 26:3-27.

[58] Stein, J., *Internal Capital Markets and the Competition for Corporate Resources*, (1997), *Journal of Finance*, 52:111-133.

[59] Gertner, R., *et al.*, *Internal versus External Capital Markets*, (1994), *Quarterly Journal of Economics*, 109(4):1211-30.

[60] Hubbard, R., and Palia, D., *A Re-examination of the Conglomerate Merger Wave in the 1960s: An Internal Capital Market View*, (1998), *Journal of Finance*, 54(3):1131-1152, also available at *http://ssrn.com/abstract=226274*.

[61] Hubbard and Palia, (1998). Nonetheless, reliance on incumbent management to make sound decision should be held in doubt.

[62] Shleifer, A., and Vishny, R., *Management Entrenchment: The Case of Manager-Specific Investments*, (1989b), *Journal of Financial Economics*, 25:123-39.

[63] For instance, overpaying acquisitions are consummated even though the price paid exceeds the

interests rather than the interests of their company. Moreover, when a company is diversified into unrelated lines of business, bureaucracy of headquarters will be fostered which in turn can offset any efficiency achieved in diversification transactions.[64]

(b) Divestitures

Related to diversification transactions are divestiture transactions, which, according to some theorists, are pursued to redress earlier business mistakes of the management.[65] For instance, even though Ravenscraft and Scherer find that the declining profitability of the divested is the reason for the decision of divestiture, they still argue that some divestitures are corrections of earlier acquisition decisions since internally developed units are sold less than those acquired units.[66] Also, Porter found 33 of the largest 100 corporations in the US divested the majority of the businesses they acquired in the 1970s.[67] In his study, such correcting divestitures happened in over 50% of related acquisitions but 74% of unrelated lines of business.

However, it is worth noting that managers may make initial decision mistakes in good faith. In that situation, takeovers are initiated not to redress earlier discretionary abuses of their control as claimed by the agency theory, because the real merit of strategic decisions cannot be judged *ex ante* but can only be assessed *ex post*.[68] Still, the *good intention* argument is set up on a precarious presumption that an effective internal governance scheme is in place so that these *bona fide* managerial inefficiency and mistakes can be identified and corrected in time. In other words, the good intention argument is merely a modification of the *discretionary misuse of*

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projected gains. For a summary of empirical evidence on this issue, see Mueller, D., *The Effects of Conglomerate Mergers: A Survey of the Empirical Evidence,* (1997), *Journal of Banking and Finance,* 1(4):315-47.

[64] Berger, P., and Ofek, E., *Causes and Effects of Corporate Refocusing Programs*, (1999), *The Review of Financial Studies*, 12(2):311-345.

[65] Markides, C., and Singh, H., *Corporate Restructuring: A Symptom of Poor Governance or a Solution to Past Managerial Mistakes?*, (1997), *European Management Journal*, 15(3):213-219.

[66] Ravenscraft, D., and Scherer, F., *Mergers, Selloffs and Economic Efficiency,* (1987), Washington, D. C.: Brookings Institution.

[67] Porter, M., *From Competitive Advantage to Corporate Strategy,* (1987), *Harvard Business Review,* 65(3):43-59.

[68] Markides and Singh, (1997).

control argument and it may still be true that divestiture is mainly used as a method to redress the former decision mistakes, though intentions of management may be various.

Alternatively, the efficiency effects of divestitures are still confusing. For instance, by studying 130 large-scale downsizings that occurred between 1985 and 1994, Denis *et al.* find positive evidence of performance enhancing at least within two years following such activities.[69] However, their study also shows that these restructured companies reverted back to underperformance (compared with the average performance of their industry and their control companies) by the third year following downsizing.

2. The Influence of the Existing Governance Structure

(a) Governance Structure of the Offeror

Due to the separation of ownership and control in big companies, board monitoring in offeror companies (which are often big companies) is important for offeror shareholders. Empirical evidence has shown that the percentage of independent outside directors on the offeror board is an important factor that offeror shareholders are concerned with in evaluating the bid proposal.[70] Indeed, offeror companies with independent outside directors holding over half of the seats on the board are found to have higher abnormal returns on the announcement date than comparable offerors.[71]

Still, shareholders' control cannot be de-emphasised. In a usual takeover transaction, the offeror board must either seek authorization from their own shareholders[72] or already have such authorization as stipulated in the articles of

[69] Denis, D., and Shome, D., *An Empirical Investigation of Corporate Asset of Downsizing*, (2005), *Journal of Corporate Finance*, 11(3):427-448.
[70] Constantinou, C., and Constantinou, C., *The Effect of Board Structure on Bidder-Shareholders' Wealth: Further Evidence from the UK Bidding Firms*, (2003), ESRC Working Paper 261, available at http://www.cbr/ca,/ac/uk/pdf/wp261.
[71] *ibid*.
[72] For a detailed discussion, see B2 in Part IV of Chapter 3. Here, the increase of share capital, class 1

association. In fact, the marginal premium or loss for shareholders of the offeror company may present obstacles for the offeror board to persuade their shareholders in the first place. Moreover, large shareholding by outsiders may play an important role in reviewing the justification for takeovers.[73] So, a concentrated shareholding by management may facilitate the passing of a takeover proposal at the general meeting.

(a) Governance Structure of the Oferee

i) Shareholding Structure

In takeover transactions, offeree shareholders enjoy a control right in deciding the fate of an offer. For offeree shareholders, an important issue is the voting structure of shareholders. In this regard, we may observe competing effects of substantial voting rights. On the one side of the coin, block shareholders may pursue their own interests at the cost of minority shareholders. On the other side of the coin, the frustration of blockholders to the intended takeovers may also improve shareholders' negotiation position thus increasing the premium to offeree shareholders in takeovers.[74]

The analysis of shareholding structure can also be extended to the shareholding by management and that by employees. Management shareholding is closely connected with the attitude of the offeree company to takeovers. On the one hand, management with shareholding can exercise their voting rights with a strong propensity to retain their existing control. But on the other hand, considering the gains to shares in takeovers, management with shareholdings may just agree to transfer the control for share premiums. Thus, management shareholding presents a dilemma to the incumbent management, a situation which corresponds to Stulz's observation that managerial equity holding and the wealth gains for shareholders of offeree companies are of a nonlinear U-shaped relationship.[75] Empirical evidence in the UK also shows

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transactions, and financial assistance for the purchase of a company's own shares all require shareholders' approval.

[73] Shinn, E., *Returns to Acquiring Firms: The Role of Managerial Ownership, Managerial Wealth, and Outside Owners,* (1999), *Journal of Economics and Finance,* 23(1):78-89.

[74] Burkart, M., *Initial Shareholdings and Overbidding in Takeover Contests,* (1995), *Journal of Finance,* 50:1491-1515.

[75] Stulz, R., *Managerial Control of Voting Rights,* (1998), *Journal of Financial Economics,* 20:25-54.

that a low level of share ownership by the management is associated with financial motives whereas a high level of ownership by the management is related to the control motives from the management.[76] Management shareholding thus is important in deciding the fate of the takeovers.[77]

Alternatively, if an employee shareholding scheme has already been introduced into the offeree company, the offeror company may have to give a second thought to its intended offer because of the dual status of employee shareholders in the offeree company. Worried about their job security, employee shareholders may well rebuff any takeover initiatives.

Another important factor is the shareholding by the offeror company in the offeree company. It is not difficult to think that the more shares the offeror company holds in the offeree company, the easier the intended takeover will succeed. Shareholding by the offeror company in the offeree company, however, may lessen the gains to shareholders of the offeree company. Stulz *et al* found that the higher the shareholding of the offeror company in the offeree company, the less the gains for shareholders of the offeree company.[78] In the UK, Franks and Harris found that the negative relationship is apparent only when the offeror company holds over 30% of shares of the offeree company.[79]

ii) Anti-takeover Stance of the Offeree Board

The fate of a hostile offer can also be decided by another important factor, *i.e.*, the discretion of the offeree board to adopt anti-takeover procedures in case of takeover threats. Since the management also has specific investment and private stake

[76] Holl, P., and Kyriazis, D., *Wealth Creation and Bid Resistance in UK Takeover Bids,* (1997b), *Strategic Management Journal,* 18(6):483-498.
[77] O' Sullivan, N., and Wong, P., *The Impact of Board Composition and Ownership on the Nature and Outcome of UK Takeovers*, (1998), *Corporate Governance: An International View*, 6(2):92-100.
[78] Stulz, R., *et al.*, *The Distribution of Target Ownership and the Division of Gains in Successful Takeovers,* (1990), *Journal of Finance*, 45(3):817-833.
[79] See Franks, J., and Harris. R., *Shareholder Wealth Effects of Corporate Takeovers: The UK Experience, 1955-1985,* (1989), *Journal of Financial Economics,* 23:225-249. The research covered 1800 takeovers from 1955 to 1985. Companies studied included both private and public companies. However, Rule 9 of the City Code on Takeovers 2002 requires of a mandatory bid once the threshold of 30% is exceeded.

in the company, incumbent management may try to avert restructuring activities.[80]

However, the regulatory regime in the UK has long been constraining the discretion of the offeree board to adopt antitakeover measures without the prior approval of the offeree shareholders.[81] Nevertheless, board's resistance to takeover bids is still possible and, in fact, has been observed in such various ways as through an announcement of a profit forecast or an increased dividend payouts with the aim to discourage shareholders from selling their shares to the offeror company, re-evaluation of company assets with the aim to increase the cost of the offer and thus frustrating offering efforts, or a referral to antitrust authorities in the hope that the transaction can be blocked by the government.[82] However, it is worth noting that such resistance from the offeree board can benefit offeree shareholders by forcing up the offer price.[83]

3. The Monitoring Role of Takeovers

Given that the liquidity of the stock market effectively decreases the exit cost, the monitoring role of corporate restructuring transactions should not be underestimated. Empirical evidence shows that a company faces a significantly higher risk of being taken over if its cost performance lags behind its industry benchmark.[84] This incomparable monitoring role is important in deterring directors from pursuing their own interests while leaving behind the interests of the other actors because the market for corporate control creates high-powered incentives for managers by the threat of job losses and the damage on their reputation.[85] Thus, the strong disciplinary

[80] Maug, E., *Boards of Directors and Capital Structure: Alternative Forms of Corporate Restructuring,* (1997), *Journal of Corporate Finance,* 3:113-139.
[81] See Takeover Code General Principle 3 and Rule 21 and CA 2006 Part 28 Chapter 2 Impediments to Takeovers.
[82] Holl, P., and Kyriazis, D., *Agency Bid Resistance and the Market for Corporate Control*, (1997a), *Journal of Business Finance and Accounting*, 24(7-8):1037-1066.
[83] Holl and Kyriazis, (1997b).
[84] In specific, cost is (the cost of goods sold plus selling, general and administrative expenses) per unit of revenue. Trimbath, S., *et al.*, *Corporate Inefficiency and The Risk of Takeover*, (2000), Economic Research Reports from C.V. Starr Center for Applied Economics Working Paper 00-14, available at *http://www.econ.nyu.edu/cvstarr/working/2000/RR-14.PDF*.
[85] Fama, E., *Agency Problems and the Theory of the Firm*, (1980a), *Journal of Political Economy*, V.88 No.21 288-307; Fama, E., *The Disciplining of Corporate Managers,* (1980b), Chicago Graduate School of Business University of Chicago Selected Paper No. 56, available at *www.chicagogsb.edu/research/selectedpapers/sp56.pdf*.

role of the market for corporate control is a good supplement to the often failed internal governance scheme and the incomplete competition on the product market.[86]

This said, empirical evidence on the effectiveness of the monitoring role of takeovers is mixed. On the one hand, positive evidence abounds. For instance, Weir found that takeovers play a positive monitoring role on the poor internal governance practices of offeree companies.[87] Sustained performance improvement over a period at least up to two years after takeover transactions was also documented in later researches.[88]

On the other hand, negative evidence also exists. Franks and Mayer notice that hostile takeovers do not perform their disciplinary role as expected, as directors from both the badly and normally performing offeree companies are ousted from their positions.[89] They also found that offeree companies in hostile takeovers are not so bad performers as their peer companies.[90] In another study, Herman and Lowerstein observe that offeror companies are not necessarily better performers than offeree companies before takeovers and it may be hard to tell they are better afterwards, indirectly vitiating the disciplinary role of takeover transactions.[91]

In parallel, by examining the long-run pre- and post-takeover performance of hostile takeovers in the UK from 1985 to 1996, Cosh and Guest find that offeree companies may not be less poorly managed than non-merging companies and offeror companies are not necessarily better performers compared with their peer companies in terms of profit levels.[92] They conclude that "*There is little evidence that they [hostile takeovers] play an important role in reversing the non-value maximizing*

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[86] Marris, R., *The Economic Theory of Managerial Capitalism*, (1964), Macmillan London.
[87] Weir, C., *Corporate Governance, Performance and Takeovers: an Empirical Analysis of UK Mergers*, (1997), *Applied Economics*, 29:1465-1475.
[88] Weir, C., *et al.*, *Internal and External Governance Mechanisms: Their Impact on the Performance of Large UK Public Companies*, (2002), *Journal of Business Finance & Accounting*, 29(5&6):579-611 and Cosh, A., and Guest, P., *The Long-run Performance of Hostile Takeovers: UK Evidence*, (2001), ESRC Research Paper No.215, available at *http://www.cbr.cam.ac.uk/pdf/wp215.pdf*..
[89] Franks, J. and Mayer, C., *Hostile takeovers and the Correction of Managerial Failure*, (1996), *Journal of Financial Economics*, 40:163-81.
[90] But note that Weir, (1997), discriminate the relative performance from the absolute performance. Weir found that it is the relative performance that counts in the initiation of takeover offers.
[91] Herman, E. and Lowerstein, L., *The Efficiency Effects of Hostile Takeovers*, (1988), in Coffee, J., *et al.*, *Knights, Raiders and Targets: The Impact of the Hostile Takeover*, (1988), OUP, 211-240.
[92] Cosh and Guest (2001).

behaviour of target companies."

In addition, the ineffectiveness of the market for corporate control can also be probed from other perspectives. First, potential offerors must exist in the market to locate those inefficient corporations. This may not be easy if those companies occupy a niche or monopoly on the market. Second, efficient capital markets are needed to provide financial support and accurate information. However, the efficiency of capital markets is at best a debate without unanimous agreement.[93] Last but not least, since management also has specific investment and private stake in the company, underinvestment in human capital will arise if the incumbent management anticipates that implicit contracts between them and the company would be breached.[94] In such situations, takeover activities may backlash on the effectiveness of the internal control system.

4. Special Cases of Takeover Transactions

(a) MBOs and MBIs

Takeovers can be initiated not only by an offeror company but also by individuals such as the management team of the company in concern (MBOs) or that from an outside company (MBIs).

The benefits of MBO transactions are multi-faceted. First, company managers may be more knowledgeable about the specific situation of the division and thus may be more competent than outsiders to manage the division. Second, since such transactions necessitate a high debt ratio, increasing monitoring from such outsiders as bankers or venture capitalists may help to constrain the discretion of the management. Third, the enhanced control enjoyed by the incumbent management after MBOs may align their own interests with those of the company. Empirical

[93] Fama, E., *Efficient Capital Market: A Review of Theory and Empirical Work*, (1970), *Journal of Finance*, 25(2):383-417 and *Efficient Capital Markets: Reply*, (1976), *Journal of Finance*, 31(1):143-5; and Houthakker, H., and Williamson, P., *The Economics of Financial Markets*, (1996), OUP, at 130-40.
[94] Maug, (1997).

studies also show a usual premium of 40% to shareholders in MBO transactions.[95]

The monitoring role of MBOs, however, is confusing. Information asymmetry between managers and outside investors on the intrinsic value of the company may lead to a misevaluation of the company concerned. Indeed, the ability of the management to be cashed out in the ensuing going public process after the company goes private has already led some observers to suspect the initiatives of such transactions.[96] Moreover, the high debt ratio in MBOs and MBIs may invalidate any ambitious plan to engender cash flows in the following years. In addition, proceeds from these downsizing plans may well be reinvested into other projects with low efficiency. Thus, some MBOs and MBIs can also be deemed as indicators, rather than rectifiers, of the often-observed agency concern.

Nevertheless, the negative argument should not be overrated. In fact, if there is under-evaluation of the value of the company by the incumbent management, it is hard to imagine why outside potential bidders may overlook such opportunities on the open market. Rather, it is highly possible that the same management team will have to face a potential threat from other outside raiders, who, if they acquire the information of under-evaluation, may initiate their own takeover efforts, destroying the originally planned MBOs or MBIs. Empirical evidence also supports the above argument. For example, Kaplan found that managers who hold substantial amounts of equity but are not part of the post-buyout management team are systematically selling their shares into the buyout.[97] If managers are insiders taking advantage of their inside information for their own benefits, such activities observed by Kaplan may seem odd.

[95] Kaplan, S., *The Effects of Management Buyouts on Operating Performance and Value*, (1989b), *Journal of Financial Economics*, 24: 217-254, and Kaplan, S., *The Staying Power of Leveraged Buyouts*, (1991), *Journal of Financial Economics*, 29: 287-313.
[96] Hoskisson, R. and Turk, T., *Corporate Restructuring: Governance and Control Limits of the Internal Capital Market*, (1990), *Academy of Management Review*, 15(3):459-477 and Bowman, E., and Singh, H., *Corporate Restructuring: Reconfiguring the Firm*, (1993), *Strategic Management Journal*, 14:5-14.
[97] Kaplan, S., *Sources of Value in Managed Buyouts*, (1990), *Journal of Financial Economics*, 27(1):215. Also Lee, S., *Management Buyout Proposals and Inside Information*, (1992), *Journal of Finance*, 47 (3):1061-1079.

(b) The Wave of Private Equity and Hedge Funds

Recent Management Buy-Out and Buy-In transactions are more often supported by private equity and hedge funds.[98] Private equity used to suffer the trouble of illiquidity. However, the development of the secondary market has largely mitigated this concern.[99] Alternatively, hedge funds implement long-term lock up agreements in their fund structure to show their confidence in the project they invest in, mitigating the traditional short-term concern of their investment.[100] In addition, both private equity and hedge funds can effectively align the interests of the fund managers with the performance of the funds through a creative design of the partnership structure. The resurgence of buyout transactions supported by private equity and hedge funds is thus not a surprise.

The ripple effects of these funds on the governance practices of public companies can be located at two levels. One level is that of the target companies. In practice, funds usually take up a material share of the equity of the investee company and sit on the board through detailed contractual arrangements so that their transformation efforts can be carried out without too much resistance.[101] Moreover, by engaging in club-deals and high gearing debt ratios, private equity firms and hedge funds are usually proactive or in some cases even aggressive in improving the governance practices of targeted public companies. In addition, with their expertise in certain industries and their efforts of due diligence, fund managers usually '*professionalize*' the new company, bring new staff and input new finance into the company to improve the governance practices.[102] Indeed, the relatively long-term objective has positioned private equity firms and hedge funds as meaningful co-

[98] FSA, *Hedge Funds: A Discussion of Risk and Regulatory Engagement,* (2005), FSA Discussion Paper 05/4. (FSA, *Hedge Funds*); FSA, *Private Equity: A Discussion of Risk and Regulatory Engagement,* (2006), FSA Discussion Paper 06/6 (FSA: *Private Equity*), in Para. 2.8. The FSA observed that "*In the first half of 2006 the total value of UK mergers and acquisitions was £69.5bn, an increase of 40% on the same period in 2005. Buyout activity almost trebled in value in the first half of 2006 compared to the same period in 2005, reaching £34.4bn, or 50% of total M&A activity*", see para. 1.2. Such development also gives birth to the development of the secondary market for private equity assets, which "*in the first half of 2006 represented 32.4% of the total value of UK MBO and MBI.*" See para.3.36.
[99] FSA, *Private Equity*, paras. 3.22-3.25.
[100] *ibid.*, para. 3.26.
[101] *ibid.*, para. 3.95.
[102] *ibid.*, paras. 3.95-3.102.

operators with the management team.[103]

Alternatively, the governance effect of these funds is also apparent among the other public companies in general. The painful due diligence and the deep-digging of the potential of the governance practice of public companies do keep warning those insolent boards. In fact, even those companies that are not targets are employing similar governance practices used by such funds.[104]

Admittedly, the resurgence of the private equity wave "*appears to facilitate more accurate valuation of companies, factoring in their growth and restructuring potential as well as current balance sheet, profit and loss account and cash flow fundamentals.*"[105] However, such transactions are usually structured through complex transactions with excessive leverage and ambiguous ownership of economic risks.[106] Moreover, the adoption of complex transaction structure and financial innovation and derivatives may bring in systematic risk to the capital market.[107] Nevertheless, after a series of consultation on issues arising from the wave of hedge funds and private equity, both the Takeover Panel and the FSA stop short of imposing more stringent regulations.[108]

While financial market regulations and corporate rules are slow in imposing further constraints, regulations may still be imposed for other reasons. The staggering income for some fund managers has already courted criticism from employees for fair

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[103] Though there are indicators that private equity funds become more short-term oriented recently, the FSA is with the understanding that such a trend is merely a cyclical issue. See FSA, *Private Equity*, para. 3.106. Moreover, the traditional tag of short-termist attached to hedge funds may also be changed as hedge funds are open-ended with no finite lifespan and carry illiquid side pockets. See FSA, *Private Equity*, paras. 3.27 and 3.108.
[104] *ibid.*, para. 4.36.
[105] *ibid.*, para. 4.32. In regard of this issue, a similar argument is also applicable to hedge funds.
[106] *ibid.*, at 7. Unclear economic risk bearer is due to "*extensive use of opaque, complex and time consuming risk transfer practices such as assignment and sub-participation, together with the increased use of credit derivatives*."
[107] *ibid.*, paras. 2.29, 3.115 and 4.19-4.26. For example, given the increasing number of participants, price sensitive information is incrementally at the risk of being misused.
[108] FSA, *Hedge Funds* and FSA, *Private Equity*; The Code Committee of the Takeover Panel, *Shareholder Activism and Acting in Concert*, (2002), PCP 10; *Dealings in Derivatives and Options Outline Proposals Relating to Amendments Proposed to Be Made to the Takeover Code and the SARS*, (2005), PCP 2005/1; *Dealings in Derivatives and Options Part 1: Disclosure Issues*, (2005), PCP 2005/2. Indeed, a self-regulatory approach is preferred in the regulatory debate over private equity, see Sir David Walker's report to the BVCA, *Disclosure and Transparency in Private Equity*, (2007), available at *http://walkerworkinggroup.com/sites/10051/files/walker_consultation_document.pdf*.

distribution.[109] The government has also responded with potential tax reforms.[110] Viewed from this perspective, the current resurgence of buyout transactions backed by private equities or hedge funds provides another piece of evidence that corporate governance can only be studied from the institutional approach.

5. Social Implications of Takeovers

It is widely known that takeover transactions can engender disruptive effects on the implicit contracts between the company and its stakeholders, especially employees.[111] Stakeholders usually invest in the company achieving something that is not useful outside the company. The new management after takeovers usually disrupts the original implicit contracts between the stakeholders and the original company. In turn, stakeholders will under-invest their firm-specific investment and/or require higher compensation for the potential loss. The resulting jeopardy on such non-economic values as loyalty, community and cultural continuity is also noteworthy.

The essence of what is objectionable of takeovers is the '*unusual scope and rapidity of the change*' they engender.[112] In fact, persistent takeover activities may produce an impression of a turbulent business world among top executives and management consultants. Top executives may then be pressed to act according to a cognitive order which deems takeovers as unequivocal possibilities in the real business world. Such a psychological state will engender a negative loop which can further reinforce the turbulence of the real business world. In contrast, subordinate employees may have a cognitive disorder.[113] For one thing, subordinates may not place a similar value on the board's strategic decisions to align a company with its

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[109] Responses from employees are serious. For one thing, the rise of private equity and hedge funds indicates the unfair income distribution; for another, it has resulted in insolvency of some pension funds. For a more detailed discussion see Chapter 5.
[110] Houlder, V., *Tax Loopholes Leave Private Equity Investors to Clean Up*, Financial Times, June 11 2007. See also, Treasury Committee Press Notice No.61, session 2006-07 26 June 2007 on private equity and the Treasury Committee announces the inquiry into private equity on 20 March 2007, see Treasury Committee Press Notice No.36, Session 2006-07 20 March 2007.
[111] Implicit contracts are informal agreements based on trust and mutual understanding which are not enforceable in law. See Spencer, P., *The Structure and Regulation of Financial Markets*, (2000), OUP, at 150; also more discussion in Chapter 5 of this thesis.
[112] Gordon, J., *Corporations, Markets, and Courts*, (1991), *Column. L. Rev.*, 91:1931-1988, at 1972.
[113] Mckinley, W., and Scherer, A., *Some Unanticipated Consequences of Organizational Restructuring*, (2000), *Academy of Management Review*, 25(4):735-752.

outside turbulent business world. For another, once takeover decisions have been made, subordinates may have to face new information and new options in implementing the decisions. Established operation norms within the company may thus be challenged. Such a bifurcating effect may escalate takeover activities in the real world, enhancing the disruptive effects of takeover activities on subordinate employees.

This, in combination with the high turnover of the management of the offeree company, and subsequent large assets sales and breakup of companies, has led Mayer to claim that "*the market for control appears to be more closely associated with changes in strategies of firms than with corporate governance and the disciplining of bad management*."[114]

However, the disruptive effects of takeover transactions may easily be exaggerated. In fact, positive empirical evidence also exists.[115] Still, the positive evidence of takeover transactions on employment should not overshadow the disruptive effects on displaced employees and the wider society. In consequence, a balanced view of both the potential efficiency and the disruptive effects of takeover transactions should be preferred. In this regard, the succinct comment by Parkinson is pertinent:

> "*In short the market for control may promote dynamic efficiency, but as a society we may prefer less efficiency of that kind in order to obtain the benefits of greater social stability and the maintenance of community values*."[116]

C. INSOLVENCY

1. Insolvency as a Governance Device

As companies face insolvency, significant changes to the existing governance structure occur. Since the worsening performance becomes widely known among

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[114] Mayer, (1999).
[115] See discussion in Chapter 5.
[116] Parkinson, J., *The Role of 'Exit' and 'Voice' in Corporate Governance*, in Sheikh, S. and Rees, W., (eds), *Corporate Governance and Corporate Control*, (1995), Cavendish Publishing Limited, 75-110.

stakeholders, they will modify their behaviour accordingly. In the vicinity of insolvency or if insolvency is imperative, shareholders may prefer risky projects in consideration of their own short-term interests at the expense of the interests of creditors, as they know what is at stake is the money of creditors and the utmost loss for them is the fixed amount of share capital, which may be worth nothing in the case of insolvency. Or, shareholders may simply prefer a quick exit from a long troubled distress.

In comparison, creditors, especially secured creditors, may want to realize their collateral as quickly as possible so that they can invest in other businesses. The result of such exits, however, is a decrease of the value of the pool of assets of the company. Employees may also make underinvestment if they realize their jobs have already become unsafe. Morale among employees will thus decline. Alternatively, employees may be inclined to get a decent compensation and start their new life elsewhere rather than remain enmeshed in a distressed company. Directors attracted by the generous severance compensation package will at most not interfere to save the troubled business. Or they may simply continue the business recklessly for the benefits of shareholders or for their own reputation without due consideration of the interests of creditors. Or they may set up coalitions with employees for the reason of job security but at the cost of both shareholders and creditors by failing to achieve a better result through quick liquidation.

Such diverse initiatives, if left unregulated, will be disastrous. For the purpose of regulation, two concerns are of special importance. We may have to decide first who should participate in the insolvency process and second how to regulate individual efforts of each participant to pursue his own objectives.[117] Viewed from the perspective of corporate governance, insolvency regulations can be deemed as a governance device for companies in distress.

[117] Korobkin, D., *Contractarianism and the Normative Foundations of Bankruptcy Law*, (1992), *Tex. L. Rev.*, 71:541-632, at 545.

2. Insolvency in the Continuum of Corporate Governance

(a) Implications of the Existing Governance for Insolvency

In general, insolvency does not come into being at a stroke. While empirical evidence does not show a clear causal relationship between good governance practices and good corporate performance, it is usually the case that corporate insolvency will be a destined result of bad corporate governance when the company is still a going concern.[118]

Moreover, governance arrangement instituted when companies are going concerns can still persist when companies turn into distress. For instance, even though creditors are protected collectively in insolvency, the interests of secured creditors over their collateral or security are expressly excluded from the collective distribution scheme. Alternatively, creditors can stipulate in their contracts with the company much stricter initiating terms than the general requirement in insolvency law. In consequence, creditors may intervene in corporate governance when such terms are satisfied rather than when rescue efforts will be tried in vain. Therefore, pre-insolvency contractual arrangements may well penetrate into the control structure around the invocation of insolvency.

(b) Implications of Insolvency for Governance in the Normal Life

Conversely, the role of insolvency as a monitoring mechanism can be extended to governance practices of healthy companies.[119] For instance, insolvency is tested according to two tests, one of which is the 'cash flow' insolvency, according to which a company is insolvent if it is "unable to pay its debts" when they are due, while the other is the 'balance sheet' insolvency, according to which liabilities of a company exceed its assets.[120] The common point is thus that the solvency status of a

[118] Patterson, J., *The Link Between Corporate Governance and Performance,* (2000), Canada Conference Board No.1276-00-RR, available at *http://www.conferenceboard.ca/documents.asp?rnext=890*.
[119] Pochet, C., *Institutional Complementarities within Corporate Governance Systems: A Comparative Study of Bankruptcy Rules,* (2002), *Journal of Management and Governance*, 6:343-381, at 343.
[120] IA1986 s123(1) and s123(2) respectively.

company is legally evaluated in financial terms only. In turn, even if we are not sure what best governance practices are, we are definitely certain that bad financial performance meeting these criteria will lead to insolvency. The strong financial orientated criteria at the end of the life of a company thus keep ringing a bell to directors when it is operated as a going concern.

Such understandings can, then, help us explain the current disadvantaged position of employees in corporate governance in general. It is curious to find no proposal has ever been made to include non-financial interests of stakeholders into the insolvency criteria prescribed in law. In other words, if such inclusive criteria are still infeasible in practice, the current claim for stakeholder oriented governance may only lead to efforts in vain.

Moreover, an efficient corporate insolvency system is also relevant to the initiatives of entrepreneurs to set up businesses in the first place.[121] Entrepreneurship is highly risky. Though limited liability of their investment in the company helps to encourage entrepreneurship, an efficient insolvency system will encourage entrepreneurs to start from scratch again by helping entrepreneurs escape from the trap of bad investment efforts and use either their entrepreneurship or financial resources in other areas. It must be realized that this is not only an issue to give a distressed company a second chance to revive through corporate rescue efforts but also a concern to encourage entrepreneurs to bear risk to begin a new business. The latter is more of a concern of efficiency in the wider society. Viewed from this perspective, insolvency law is relevant not only to the demise of a company but also to the birth of a new company.

Discussion in this section thus reveals that governance in the normal life and governance around insolvency are mutually influenced. An appropriate inference drawn from the above discussion is that governance in insolvency is just a phase in

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[121] Armour, J., and Cumming, D., *Bankruptcy Law and Entrepreneurship*, (2005), ESRC Center for Business Research, University of Cambridge Working Paper No. 300, available at *http://ssrn.com/abstract=762144*; Ayotte, K., *Bankruptcy and Entrepreneurship: The Value of a Fresh Start*, (2007), *Journal of Law, Economics, and Organization*, 23(1):161-185, also available at *http://ssrn.com/abstract=463000*.

the continuum of the life cycle of corporate governance.[122]

3. The Monitoring Role of Insolvency

Insolvency itself may be deemed as a violent penalty for incumbent managers, who usually find it hard to find similar jobs when their companies go insolvent.[123] This deterrent effect of insolvency is a real menace to incumbent directors as it is hard to imagine that directors do not consider the potential threat of insolvency, the institution of which has long been in existence.[124] Still, as for the deterrent effect of insolvency, Hart warns that

> "*A bankruptcy mechanism that is 'soft' on management … may have the undesirable property that it reduces management's incentive to avoid default, thus undermining the bonding or disciplinary role of debt.*"[125]

However, since "*the invocation of corporate insolvency law has typically been treated as the end of the road for a company*" in the UK,[126] the deterrent effect of insolvency on directors cannot be deemphasized.

In addition, directors' control is strictly controlled in insolvency law. For instance, if a director of a company in distress still allows the company to continue to operate though he should have known there is no reasonable prospect of survival, the director may be under the coverage of the wrongful trading action under the Insolvency Act 1986 unless he takes every reasonable step to avoid the insolvent liquidation.[127] In fact, directors' duty of care and skill has largely been lifted to a higher level by adopting both objective and subjective criteria according to the

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[122] Nestor, S., *Insolvency systems and corporate governance: some general remarks*, presented at the Third Meeting of the Latin American Corporate Governance Roundtable, OECD on 8-10 April 2002, available at *http://www.oecd.org/dataoecd/1/1/2085780.pdf*.
[123] Grossman, S., and Hart, O., *Corporate Financial Structure and Managerial Incentives*, (1982), in McCall, J., *The Economics of Information and Uncertainty*, (1982), Chicago University of Chicago Press, 107-140.
[124] Bernstein, E., *All's Fair in Love, War & Bankruptcy? Corporate Governance Implications of CEO Turnover in Financial Distress*, (2006), *Stan. J. L. Bus. & Fin.*, 11(2):299, at 321.
[125] Hart, O., *Corporate Governance: Some Theories and Implications*, (1995), *The Economic Journal*, 105(May):678-689.
[126] Armour, J., *et al.*, *Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom*, (2002), *Vand. L. Rev.*, 55:1699, at 1755.
[127] IA 1986 s214.

wrongful trading section of the Insolvency Act 1986.[128] Moreover, shareholders and creditors may also initiate misfeasance actions against past or present directors who breach their fiduciary duty and other duties to the company.[129] Besides, the disciplinary role of insolvency on directors is further substantiated by the Company Directors Disqualification Act 1986, according to which unfit directors may be disqualified from serving on a board for a period up to 15 years.[130]

In addition to the above disciplinary role of insolvency, the pro-creditor insolvency scheme may also help to increase creditors' incentives to make investments. In turn, the potential increase of the ratio of debt to equity may indicate an enhanced governance role of creditors in governance in the normal life. However, it is worth noticing that given the priority for secured creditors in case of insolvency, they may just have fewer incentives to care about the corporate governance in general than to be concerned about the disposition of their collateral once their contractual rights are breached.[131] Viewed from this perspective, the pro-creditor insolvency governance scheme in the UK may indirectly discount the governance role of secured creditors in healthy companies.

4. Corporate Rescue

If liquidation or winding-up does happen, the dissolution of the company will almost be certain.[132] In that case there is little need to discuss the governance of the company. Thus, the importance is attached to the period in the vicinity of insolvency, and more specifically, the performance of those companies going through turn around

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[128] IA 1986 s214. *Norman v. Theodore Goddard* [1991] BCLC 1028; *Re D'Jan of London Ltd* [1994] 1 BCLC 561; case law also shows that directors can be required to contribute personally to corporate assets, see *Re Produce Marketing Consortium Ltd* [1989] 5 BCC 569.

[129] Oditah, F., *Misfeasance Proceedings against Company Directors,* (1992), LMCLQ, 207.

[130] CDDA 1986 s10. Unfitness can be found either for dishonesty or for laxity. See CDDA 1986 ss. 6-9 and *Re Barings PLC* [2000] 1 BCLC 523 (Ch. D. 2001); *Re Continental Assurance Co. of London PLC* [1997] 1 BCLC 48 (Ch. D. 1997); *Re Hitco 2000 Ltd* [1995] 1 BCLC 63 (Ch. D., 1995).

[131] Stein, J., *Rescue Operations in Business Crisis*, in Hopt, K., and Teubner, G., (eds), *Corporate Governance and Directors' Liabilities: Legal, Economic, and Sociological Analyses on Corporate Social Responsibility,* (1985), Walter De Gruyter, 380-400, at 394.

[132] R3's 12th Survey, *Corporate Insolvency in the UK,* (2004), "*Liquidation (Creditors' Voluntary and Compulsory) is the usual fate of those businesses where rescue is not an option – and 90% of liquidations end in a break-up sale. Most insolvency practitioners agree that businesses that enter liquidation are incapable of rescue at the time of insolvency,*" available at http://www.r3.org.uk/publications, at 30.

or corporate rescue.

(a) The Necessity of Corporate Rescue

Generally, corporate rescue is a worthy pursuance mainly for two reasons. For one thing, corporate rescue is necessary for the purpose of saving the value of the company in distress. This is because once the insolvency procedure is initiated, the value of the company may precipitate, and, in turn, the speed of the collapse will be accelerated due to the precipitation of the value of the company.[133] Also, the going concern value of a company as a whole is greater than the accumulation of the value of assets in separate sales.[134]

For another, the disruptive effect of the failure of a company provides another rationale for corporate rescue. It was emphasized in the Cork Report that "*[t]he chain reaction consequent upon any given failure can potentially be so disastrous to creditors, employees and the community, that it must not be overlooked.*"[135] This is because stakeholders' long-term investment in the company brings them private benefits, which will be lost in liquidation.[136] Besides, the confidence and morale of investors can also be maintained in a pro-rescue culture. Successful corporate rescue is thus beneficial to all stakeholders and the society as a whole. Viewed from this perspective, corporate rescue involves a holistic consideration of all the parties, rather than creditors alone, who have vested interests in the company.[137]

The traditional lack of a corporate rescue culture in the UK has been widely criticized.[138] However, efforts to build a corporate rescue culture have been ongoing since 1982, when the Cork Committee introduced the administration procedure, the

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[133] Mocroft, T., (FCCA), *The Review of Insolvency Framework in the Light of the Experience of the MG Rover Collapse*, (2005), Commissioned by MG Task Force.

[134] Rogers, J., *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship between the Fifth Amendment and the Bankruptcy Clause*, (1983), *Harv. L. Rev.*, 96:973 at 975 and Westbrook, J., *The Control of Wealth in Bankruptcy*, (2004), *Tex. L. Rev.* 82:795, at 811.

[135] Cork Report, para. 204.

[136] Franks, J. and Nyborg, K., *Control Rights Debt Structure and the Loss of Private Benefits the Case of the UK Insolvency Code*, (1996), *The Review of Financial Studies*, 9(4):1165-1210, at 1168-1170.

[137] Korobkin, (1992).

[138] For a brief summary of the history, see Armour, J. and Mokal, R., *Reforming the Governance of Corporate Rescue: The Enterprise Act 2002*, (2005), *Lloyd's Maritime and Commercial Law Quarterly*, 28-64, also available at http://ssrn.com/abstract=567306.

effect of which was to freeze the enforcement of rights against the company so that the administrator appointed by the court can manage the company to facilitate the regime of voluntary arrangements.[139] Besides, company voluntary arrangements (CVAs) for small companies[140] and statutory arrangements under s425 of the Companies Act 1985 and s110 of the Insolvency Act 1986 for big companies are all good examples of corporate rescue efforts in law.[141]

The recently introduced Enterprise Act (2002) for most purposes limits the availability of administrative receivership, through which creditors holding floating charges enjoy a disproportionate power and lack sufficient incentives to rescue a failing company as a whole.[142] Instead, this Act obliges the administrative receivers appointed by courts to consider interests of all creditors rather than only those of secured creditors. It is also hoped that the limitation of secured creditors to appoint administrative receivers will help to increase the reliance on administration and CVAs in the current law.[143]

Besides, administrators are required to prioritise the survival of the company as a going concern among the other stated objectives.[144] However, the law further states that once the administrator, according to his own subjective judgment, thinks it is not reasonably practicable to achieve that objective, the interests of creditors as a whole will be the substitute primary objective.[145] Such arrangements may in practice change little the dominant pro-creditor insolvency scheme and do little to promote proactive participation from the other stakeholders.

Despite the benefits of corporate rescue, for those companies which do not

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[139] DTI, the Cork Committee, *Insolvency Law and Practice: Report of the Review Committee,* (1982), cmnd 8558, London: HSMO. (Cork Report). And for a brief summary of the efforts, see Milman, D., *Reforming Corporate Rescue Mechanisms*, in de Lacy, J., (ed), *The Reform of United Kingdom Company Law,* (2002), Cavendish Publishing Limited, Ch17.
[140] IA 1986 s1A and Sch 1.
[141] A CVA is more appropriate for small companies because the agreement reached will be binding only on those creditors who "*in accordance with the rules had notice of*" the meeting. See IA 1986 s5(2)(b). For a large company, the majority rule and the binding effect on all creditors provided by s425 of the CA1985 (to be replaced by Parts 26 and 27 of the CA 2006) may be more preferable.
[142] Armour and Mokal, (2005).
[143] DTI/IS, *Productivity and Enterprise: Insolvency—A second Chance*, (2001), cm 5234, London TSO, available at *http://www.insolvency.gov.uk/cwp/cm5234.pdf*.
[144] See IA1986 Sch B1 paras. 3(1)-(4).
[145] See IA1986 Sch B1 para. 3(3).

have such a realistic future as going concerns, corporate rescue efforts may insensibly dissipate assets that would otherwise be available for distribution.[146] In such cases, immediate liquidation may be a better choice to maximize the pool of assets for distribution or to help enmeshed capital find new opportunities.[147] Unviable companies will then not absorb and waste new credits, which may be provided to other promising projects.

(b) Governance in Corporate Rescue

To project the end result of corporate rescue efforts, however, is not easy. The uncertainty of the end result of corporate rescue efforts in effect engenders conflicts between creditors and other stakeholders. In law, the ambiguity has led to two different cultures of corporate insolvency systems: liquidation oriented or pro-creditor corporate insolvency and rescue oriented or pro-management corporate insolvency arrangement.[148]

The role of incumbent management in corporate rescue still needs empirical evidence to clarify. On the one hand, a corporate rescue culture requires an active involvement of the incumbent management, who is familiar with the company. But on the other hand, it is possible that these people will take advantage of the debt enforcement moratorium period to pursue risky projects to gamble the fate of the company. Empirical evidence in the US indicates that insider information and expertise of the incumbent management may be indispensable in corporate rescue of a small company while this may not be the case in big public companies.[149] Thus, the benefits of the retention of the management control may well be a case sensitive judgment.

[146] Such an argument of the efficient functioning of the market however cannot be overemphasized. If, as some scholar argues, companies in distress are worth the rescue efforts only when the company is inherently viable, corporate rescue may in practice be negated as such a judgment is hard to make *ex ante*. For this Darwinian argument, see Argenti, J., *Corporate Collapse: The Causes and Symptoms*, (1976), London: McGraw-Hill, at 170.
[147] Amour and Cumming, (2005) and Ayotte, (2007).
[148] Frost, C., *The Theory, Reality and Pragmatism of Corporate Governance in Bankruptcy Reorganizations*, (1998), *Am. Bankr. L. J.*, 72:103, at 105.
[149] LoPucki, L., and Whitford, W., *Bargaining over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, (1990), *U. Pa. L. Rev.*, 139:125 at 149-150 and Baird, D., and Rasmussen, R., *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, (2001), *Va. L. Rev.*, 87:921-959.

In the UK, we can observe that the traditional pro-creditor liquidation oriented insolvency arrangements co-exist with pro-management rescue oriented insolvency arrangements. For example, the incumbent management will still be in office and remain in full control of the company during the moratorium under a CVA albeit an insolvency practitioner will exercise a monitoring role in the process. In contrast, in an administration, insolvency practitioners will run the company but with an objective to serve first the interests of the company and, if that objective cannot be achieved, the interests of creditors as a whole.[150]

Moreover, even though corporate rescue has not been found as a main character of the traditional insolvency law in the UK, business practice in reality presents us with a different picture. Franks and Susamman find that about 75% of the small to medium sized companies in their study avoid formal insolvency procedures.[151] They attribute this to the existence of one main creditor who dominates the corporate borrowing, a situation which provides the creditor with special advantages so that "*it can control the resolution of financial distress, both within formal insolvency, and in rescue.*" In comparison, no such dominant creditor exists for big public companies. However, it is widely claimed that "the London Approach" is a practice with the import of corporate rescue.[152] This approach is applicable where banks are lenders to the same major borrower in financial distress. The leading bank, *i.e.* the bank with the largest exposure, initiates this voluntary procedure that provides short-term collective support and stability while a longer-term solution is sought for. In this procedure, the Bank of England usually acts as a "facilitator". Banks agree to stand still and not to gain advantages over the other banks. The input of "*super-secured*" fresh capital also helps the salvage process.

Another aspect of the corporate governance in corporate rescue is the widely

[150] See IA 1986 Sch B1 para. 3.
[151] Franks, J. and Sussman, O., *The Cycle of Corporate Distress, Rescue and Dissolution: A Study of Small and Medium Size UK Companies*, (2000a), LBS Research Paper 306, available at *http://facultyresearch.london.edu/docs/306.pdf*.
[152] Armour, J., and Deakin, S., *Norms in Private Insolvency Procedures: The 'London Approach' to the Resolution of Financial Distress*, (2001b), *Journal of Corporate Law Studies*, 1:21-51, also available at *http://www.cbr.cam.ac.uk/pdf/wp173.pdf*.

observed coalitions among stakeholders in the UK.[153] Since insolvency almost inevitably indicates a reshuffle of the board and the management teams, especially in the case of big public companies, it is highly possible that unions, the board and the management may set up some kind of coalition to resist any potential turnover. This is because employees and directors are often displaced in divestiture, which is often used in corporate rescue to achieve a lean structure. The concern of job security may thus induce the two parties to set up a coalition. Moreover, unsecured creditors and shareholders may prefer risky efforts since they are more often than not left with nothing in liquidation. In turn, a coalition between unsecured creditors and shareholders may also be set up against the interests of secured creditors, who may prefer a quick exit by realizing their collateral. Therefore, coalitions among stakeholders in corporate rescue may distort the corporate rescue process as set up under the insolvency law.

(c) The Effect of Corporate Rescue

The study of the effect of corporate rescue in the UK is comparatively sparse. In its survey,[154] R3 Association of Business Recovery Professionals found that from January 2002 to June 2003 creditors of insolvent companies got back about 18.5 pence for every pound though ordinary trade creditors are in the worst position with only 5 pence for every pound. Among the current available insolvency procedures, secured creditors recover most (53%) from administration and least from company voluntary liquidation (8.8%) whereas unsecured creditors get back most (17%) in CVAs and least in company voluntary liquidation (4.8%).

As for the influence of insolvency on employees, R3 found a job preservation rate of 41% in their sample. While administration has played an important role in keeping 66% job preservation, CVAs are the second worst in preserving nearly 26% jobs, only better than the 20% preservation rate in company voluntary liquidation. This has been attributed to the fact that CVAs have been adopted by small and service sector business, "*both of which are inclined to use staff reduction as a key cost-saving*

[153] Lai, J. and Sudarsanam, S., *Corporate Restructuring in Response to Performance Decline: Impact of Ownership, Governance and Lenders*, (1997), *European Finance Review*, 1:197-233.
[154] R3, (2004).

technique."

Discussion in Part I reveals that corporate restructuring transactions engender disruptive effects on both the existing governance structure of participating companies and the society as a whole. Both motives for and economic effects of such transactions are multifarious. Still, what are common to all such transactions are the disruptive effects on the existing governance structure, indicating that the recurrent conflicts of interests in the normal life of corporate governance become intensified in corporate restructuring activities. Moreover, our discussion also reveals that corporate governance in corporate restructuring transactions can produce important implications on governance practices when companies are going concerns. In specific, we accentuate the governance role of insolvency in the life cycle of corporate governance. In a word, discussion in this Part substantiates our argument that corporate governance develops in a life cycle pattern.

An alternative implication of the above discussion is that government interventions in corporate restructuring transactions are necessary. We will then discuss in the next Part the legal institution of corporate governance in general and that of corporate restructuring transactions in specific.

PART II. CORPORATE GOVERNANCE AND CORPORATE RESTRUCTURING: THE LEGAL INSTITUTION

A. THE GENERAL FRAMEWORK

From the perspective of the regulatory approach to corporate governance, corporate governance systems can be categorized into the self-regulated system, as the traditional case of the UK, and the statutory-regulated system, as in most countries with a civil law system.[155] However, it may be safe to say that regulations of corporate

[155] But note that Germany, France and Italy *etc.*, all have self-regulatory codes. See Hopt, K., and

governance in different jurisdictions are more often at some point between these two extremes.[156]

Considering the economic regulation in the UK, Professor Wilkes commented:

> *"British economic regulation involves a striking combination of continuity in ideas (or traditions) and innovation in organisations. British traditions of public administration have consistently attached importance to the autonomy of the firm. This has rested on a deep-seated respect for property and the freedom to contract, combined with the legacy of a non-interventionist, minimalist state. In practice this has translated into 'arm's length' regulation and has produced a regulatory style, which is based on accommodation, mutual respect and negotiation."*[157]

Correspondingly, the corporate governance system in the UK had long been predominantly relying on regulations by the private sector.[158] For instance, the Hampel Committee Report on Corporate Governance stated:

> *"Business prosperity cannot be commanded. People, teamwork, leadership, enterprise, experience and skills are what really produce prosperity. There is no single formula to weld these together, and it is dangerous to encourage the belief that rules and regulations about structure will deliver success."*[159]

In such a system, members of the regulated sector bear the task of creating the rules, supervising activity and operating enforcement mechanisms. Regulation in such a system may also be delegated through the use of 'self-regulation' in addition to the public intervention.[160] An example is the regulation of takeover transactions by the City Code on Takeovers and Mergers before Part 28 of the Companies Act 2006 comes into effect. The Takeover Panel did not in the past have any legal authority,[161] though it performed a public authority role through stipulations of other statutory regulations, such as the Financial Services and Market Act 2000.

Leyens, P., *Board Models in Europe Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France and Italy*, (2004), ECGI law Working Paper No.18/2004, available at http:///ssrn.com/abastract=487944.

[156] Burke, K., *Regulating Corporate Governance through the Market: Comparing the Approaches of the United States, Canada and the United Kingdom,* (2000), *J. Corp. L.*, 27:341.

[157] Wilkes, S., *The Amoral Corporation and British Utility Regulation,* (1997), *New Political Economy,* 2:280.

[158] Villiers, C., and Boyle, G., *Corporate Governance and the Approach to Regulation*, in Macgregor, L., *et al.*, (eds), *Regulation and Markets Beyond 2000*, (2000), Dartmouth Publishing Company Limited, Ch.11, at 221.

[159] *The Hampel Committee on Corporate Governance*, (1998), Final Report, London, para. 1.1

[160] Prosser, T., *Law and the Regulators*, (1997), Oxford: Clarendon, at 4.

[161] The Takeover Panel is now a statutory body under Part 28 of the Companies Act 2006.

Notable among the merits attributable to self-regulation is its flexibility. For example, the City Code was conducted in pursuance of its spirit rather than its letter by prescribing some general principles without defining the precise extent of such principles.[162] However, it is worth noting that "*the argument for our preference for flexibility arising from self-regulation shall not be attributable to our strong commitment to autonomy, or our ignorance of the merits of different systems, but to our recognizance that there is no universal rule applicable to every situation.*"[163] In other words, it is the limitation of our ability to deal with the versatile reality that justifies the argument of flexibility for self-regulation.

Self-regulation, meanwhile, enjoys the benefits of expertise, dynamism and great sensitivity to specific circumstances. Accordingly, flexibility also comes together with speed, *i.e.*, the speed to create, to cover gaps in regulations and to apply them. Accompanying costs may also be saved in monitoring and enforcements due to the internalization of administrative costs and the reliance of the self-regulatory regime on mutual trust between the regulator and the regulated.[164]

But on the other hand, the flexibility of a self-regulation scheme may lead to a lack of precision and transparency.[165] Moreover, even though active participants with expertise are the characteristic of the self-regulatory authority, rent seeking may still be a big concern due to the relative absence of both accountability and external constraints.[166] Besides, the reliance upon outside control and the lack of authority to investigate in its enforcement are two main demerits of a self-regulatory scheme.[167]

Compared with self-regulatory schemes, statutory-regulated schemes rely more on public authorities, which prescribe hard and fast legal rules for companies to observe. For example, corporate internal matters like the structure of board are

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[162] See the Introduction to the *City Code on Takeover and Mergers* 2002. This is also maintained in the *Takeover Code*.
[163] Riley, C., *The Juridification of Corporate Governance*, in de Lacy, J., (ed*), The Reform of United Kingdom Company Law*, (2002), Cavendish Publishing Limited, 179-202, at 196-7.
[164] Ogus, A., *Rethinking Self-Regulation,* (1995), *Oxford Journal of Legal Studies*, 15(1):97-108.
[165] Villiers and Boyle, (2000), at 231.
[166] Ogus, (1995), at 98. The rent here is supra-competitive profit conferred on the regulated firms. But also see the same article for the critique of these traditional criticisms.
[167] Cane, P., *Self Regulation and Judicial Review*, (1987), *C. J. Q.*, 324-347.

prescribed in German law.[168] While statutory regulation has the merit of "*democratic legitimacy, accountability of ministers and open and independent enforcement through the courts*,"[169] the inflexibility inherent in this kind of system fails to meet the flexible and complex nature of commercial practice. Additional compliance cost is another drawback compared with the self-regulation system. Moreover, statutory regulation may lead to bureaucracy and legalistic observance of the letters rather than the spirit of the regulation.

Even though the continuing codification of corporate governance has been vital in recent corporate governance development,[170] the importance of self-regulation cannot be overlooked. For instance, the Combined Code on Corporate Governance[171] of listed companies itself does not have a similar legal status to the Listing Rules, which are made and can be enforced by the statutory authority.[172] In fact, the Code itself is not a part of the Listing Rules though the latter does require that a listed company incorporated in the UK make 'appliance' and 'compliance' statements in its annual reports and any non-compliance of the Code be given a reasoned explanation.[173] The underlying theme of such a regulatory scheme is that while good governance practices are promoted through the Code, flexibility is still maintained by providing companies with discretion to justify any non-compliance according to the specific situation of any given company.

The '*comply or explain*' philosophy established in the Combined Code can be understood as "*the latest gloss on UK company law's long-standing preference for private ordering*."[174] Indeed, before the introduction of the Financial Services and Markets Act 2000 (FSMA 2000), even the rule making process of the Listing Rules was under the control of the London Stock Exchange (LSE), which is a private company but with a strong regulatory role. Such a quasi-regulator "*can adopt*

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[168] Hopt, K., *The German Two-Tier Board: Experiences, Theories, Reforms*, in Hopt, J., *et al.*, (eds), *Comparative Corporate Governance – The State of the Art and Emerging Research*, (1998), OUP, 225-258, at 228.

[169] Villiers and Boyle, (2000).

[170] Copp, S., *Corporate Governance: Change, Consistency and Evolution: Part 1*, (2002), *I.C.C.L.R.*, 14(2):65-74, and Riley, (2002), at 179.

[171] The current version of the Combined Code 2006 is available at *http://www.frc.org.uk/documents/pagemanager/frc/Combined%20Code%20June%202006.pdf*.

[172] FSMA 2000 Pt VI.

[173] LR 9.8.6R.

[174] Riley, (2002), Ch 8.3.

innovative approaches to problems and modify ineffective solutions quickly by its own rule-making process" and "*can craft rules for listed companies in areas where law makers lack the proper jurisdiction.*"[175] However, since the FSMA 2000 removed the listing authority from the LSE to the Financial Services Authority (FSA), which is a governmental regulator, a loss of flexibility and expertise accompanied with the self-regulatory or the semi-regulatory governance scheme can be expected. While it may go too far to claim that the introduction of the FSA signifies the demise of the self-regulation within the City,[176] the regulatory scheme of the Combined Code can fairly be described as a '*hybrid form of self-regulation*' for the closeness of the Code with the Listing Rules and the potential for the FSA to enforce the disclosure obligation.[177] The implication of such efforts to integrate the market discipline into the regulatory structure is still hard to tell for the time being.

While the initiative to strengthen the power of the single regulator on the financial market comes from inside the UK, the pressure to codify takeover regulations and establish a public authority to regulate takeover transactions comes from the EU. In order to implement the Thirteenth Directive on Takeovers and Mergers[178] while at the same time preserving the characteristics of the former takeover regulation, the UK Government introduced "*statutory underpinning to the regulatory activities of the Panel*" and left "*the Panel considerable scope to decide its internal structures and operational framework.*"[179] Thus, the UK complies with the legal requirements from the EU in form but maintains the benefits of self-regulation in essence.

Besides, the regulatory scheme of corporate governance should also cover those laws and regulations outside the scope of company law. At least, as will be discussed, employment law should also be included. Even though the interests of

[175] Burke, (2000), at 347-8.
[176] Blair, M., *et al*., (eds), *Blackstone's Guide to the Financial Services and Markets Act 2000*, (2001), OUP, at 13-15.
[177] Even though the c*omply or explain* approach largely attaches a default nature to the Combined Code, the mandatory nature of LR9.8.6R, which refers to the application of the Combined Code, has indirectly imported a mandatory effect to the default nature of the Combined Code itself. For a more detailed discussion, see MacNeil, I., *The Evolution of Regulatory Enforcement Action in the UK Capital Markets: a Case of "Less is More"?*, (2007), *Capital Markets Law Journal*, forthcoming.
[178] The Takeovers Directive 2004/25/EC.
[179] DTI, *Implementation of the EU Directive on Takeover Bids Guidance on the Changes to the Rules on Company Takeovers*, (2007), available at http://www.dti.gov.uk/files/file37429.pdf.

employees are considered perfunctorily without substantive legal supports within the scope of company law, the legal development in the EU and the corresponding changes to the employment law in the UK have already changed the picture.[180] In other words, employment law is also an indispensable component of the legal institution on corporate governance.

B. LEGAL APPROACHES TO CORPORATE RESTRUCTURING

In general, grounds for regulation can largely be categorized into seven groups, *i.e.*, 1) information asymmetry; 2) market stability; 3) rent control; 4) spillover correction; 5) moral hazard; 6) rationalization and 7) other considerations.[181] A brief review of the above discussion provides sound grounds for regulating corporate restructuring transactions. For instance, information asymmetry among governance participants informs the whole life of corporate governance. Also, the disruptive effects of corporate restructuring on both the product and the capital market are evident. Besides, we have seen the importance of distribution within the rationale for insolvency regulations. In other words, legal regulation of corporate restructuring is necessary.

Still, we need to move a little step forward. In this section, this author is going to discuss as a general picture how the legal approach changes in different phases of the life of company. More detailed analyses regarding shareholders, creditors and employees are carried out in the following chapters.

1. Rules Setting

Rules, in contrast to standards, prescribe behavior *ex ante*.[182] They are widely used in the corporate context and financial market regulations. Corporate governance

[180] See discussion in Chapter 5.
[181] Breyer, S., *Analyzing Regulatory Failure: Mismatches, Less Restrictive Alternatives, and Reform*, (1979), *Harvard Law Review*, 92(3):547-609.
[182] Hansmann, H., and Kraakman, R., *Agency Problems and Legal Strategies*, in Kraakman, R., *et al.*, *The Anatomy of Corporate Law A Comparative and Functional Approach*, (2004), OUP, 21-32, especially at 23-26.

rules can be divided into default rules and mandatory rules. The former is largely in the sense that rules will apply unless stated otherwise by the regulated. Accordingly, the regulated have a choice to adopt the rules or to contract around them. Viewed from transaction cost theories, one benefit of default rules is that they can cut the transaction costs, which have already been identified as hurdles in efficiency pursuance. Moreover, default rules can also stipulate terms which are not likely to be adopted by agents. With these ‘penalty default rules’ in place, agents will have to negotiate otherwise *ex ante* by revealing their private information to the other party or the third party in order to avoid the more expensive *ex post* court determination.[183] Default rules thus both provide the flexibility to suit the varieties in the real world and play the gap filling role in cases of possible hiatuses.

In contrast, mandatory rules are rules which must be observed without modification and therefore cannot be contracted around by economic agents. Thus rigidity is the main character of mandatory rules. The rigidity preferred by the regulator may arise from concerns of public interests, the distributive justice, or social fairness. In other words, such immutability is justified to protect parties within the contract (paternalism) or parties outside the contract (externalities).

In light of such a differentiation, we may observe a changing combination of mandatory rules and default rules in the life cycle of corporate governance. Corporate governance rules for companies in their normal life can mainly be located in company law and the Combined Code on Corporate Governance for listed companies.[184] These rules are largely default in nature. For instance, by default rules, company law grants a company great discretion to deal with a wide range of issues, including the board structure and the distribution of rights and duties among stakeholders in the companies regulated.[185] Indeed, the Companies Act 1985 had been claimed by some scholars as an Act with “*minimum standards*”.[186]

[183] Ayres, I., and Gertner, R., *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, (1989), *Yale Law Journal*, 99: 87-130, at 91.
[184] For the nature of the Combined Code, see above n177 and relevant discussion.
[185] But notice that statutory instruments set out an important set of *default* rules, see Companies (Table A-F) Regulations 1985 (SI 1985/805).
[186] Leader, S., and Dine, J., *8 United Kingdom*, in Pinto, A., and Visentini, G., (eds), *The Legal Basis of Corporate Governance in Publicly Held Corporations, A Comparative Approach*, (1998), Kluwer Law International, 219-252, at 222.

In contrast, a strong role of mandatory rules is evidenced in the regulations on corporate restructuring transactions since corporate restructuring activities, as discussed, involve intense conflicts of interests and potentially violent disruptive effects on the capital market, the product market and the wider society. Indeed, as will be discussed, mandatory information disclosure is the main approach to regulate flotations and takeovers.[187]

More apparently, mandatory rules are also the main feature of the insolvency law. When companies are regarded as going concerns, free negotiations are the norm among corporate actors. Default rules can accordingly be justified as the main character of company law. In contrast, collective autonomy fails to settle those intensive conflicts among stakeholders in companies in financial distress. Whether to turn around the business in distress or to discontinue the business of the company and redistribute the assets among stakeholders, a reshuffle of the rights and duties of participants is unavoidable. Mandatory rules are thus entailed to impose a new governance scheme to address the above concerns. In addition, the establishment of the corporate rescue culture in law and the introduction of more efficient rescue legal arrangements, such as the introduction of the moratorium period in company voluntary arrangements and the out-of-court appointment of administrators, are all achieved through mandatory rules.

Nevertheless, the distinction between mandatory rules and default rules should not be exaggerated.[188] Some rules may be default *prima facie* but mandatory indeed. The discussed Combined Code is a relevant example. Alternatively, mandatory rules may in fact be of a default nature. Ever since the adoption of the Second Company Law Directive[189] in 1976, pre-emption has been a statutory principle in the UK. However, the default nature of this rule has changed little, as it can be disapplied by stipulations in the articles of association or by a special resolution at the meeting.[190]

[187] See the following discussion of information disclosure.
[188] MacNeil, I., *Company Law Rules: An Assessment from the Perspective of Incomplete Contract Theory*, (2001), *Journal of Corporate Law Studies*, 1(1):107-140.
[189] Second Company Law Directive 77/91/EEC OJ 1977 L26/1.
[190] See CA 1985 s95 and CA 2006 s569-s573. For a detailed analysis of this rule, see MacNeil, (2001), at 128-130.

2. Standard Setting

By setting standards, a regulator controls the regulated *ex post*.[191] Standard setting has been divided into three forks.[192] One is the target standard, according to which penalty is imposed for certain harmful consequences. A relevant example is that issuers and directors are responsible for their negligent misrepresentation in a prospectus or registration statement. The second is the performance standard, which stipulates the criteria of the quality at the point of supply of the product. Suppliers are, however, free to choose the way they meet the criteria. For instance, directors' fiduciary duty and common law duty of care and skill can be said to be performance standards. Another example is that a company applying for an IPO on the Stock Exchange has to produce a sound record of a certain period. The third is the specification standard, which may proscribe or prescribe certain production methods or materials. Detailed prescription of the contents of the prospectus and listing particulars for companies going public is the example of the specification standard. Moreover, the International Accounting Standards or the International Financial Reporting Standards can also be put in this group.

One concern in corporate governance rules may be too many inconsistent standards. A review of accounting standards will tell how complex the current situation is. Different accounting standards will produce different reports regarding the same fact, a concern which may be relieved to some extent by adopting the International Financial Reporting Standards in the consolidated accounts for those companies listed in the EU.

3. Information Disclosure

Information disclosure is a main technique used in financial market regulations and corporate governance rules. Information disclosure covers both the mandatory information disclosure and the control of misrepresenting information.[193] The basic aims of information disclosure include: 1) making sufficient information

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[191] Ogus, A., *Regulation Legal Form and Economic Theory,* (1994), Clarendon Press Oxford, at 150-1.
[192] *ibid*.
[193] *ibid*.

available to the market so that no party may take an undue advantage of the information and 2) allowing an information receiver to access and assess the information and make informed decisions. As the Cadbury Report states:

> *"The lifeblood of markets is information and barriers to the flow of relevant information represent imperfections in the market. The need to sift and correct the information put out by companies adds cost and uncertainty to the market's pricing function. The more the activities of companies are transparent, the more accurately will their securities be valued."*[194]

The exploitation of the technique of information disclosure can be found in both Companies Act 1985 and Companies Act 2006. The principal relevant aspects of the statutory regime are the annual accounts, the directors' report and the business review.[195] Public disclosed reports cover not only financial aspects but also directors' duties and the consideration of the stakeholders. Information disclosure so required is to meet the spirit rather than only the letter of relevant rules. The cardinal principle is to present a true and fair view of the company performance.[196]

In addition, the management of a public company is under more stringent monitoring through their continuing obligations required by the Stock Exchange and through self-regulation like the Combined Code. Main Principle C.1 of the Combined Code states that: "*the board should present a balanced and understandable assessment of the company's position and prospects.*" To be balanced indicates that "*setbacks should be dealt with as well as success*" and to be understandable means that both words and figures should be emphasized.[197] The detailed and extensive disclosure requirement thus aims to streamline the corporate governance structure and enhance the corporate performance.

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[194] Cadbury Report, para. 4.48.

[195] CA 1985 s227, s234 and s235 respectively, and CA 2006 Part 15. Even though the well-intended Operating and Financial Review is short lived, (see the Companies Act 1985 (Operating and Financial Review) (Repeal) Regulations 2005, SI 2005/3442), a Business Review is introduced by s417 of the CA 2006. The replacement however cannot be downplayed. While the statutory link through s417 of the CA 2006 between narrative reporting and directors' duties is an admitted strength, the loss of a higher level of audit may indicate a downgrade of the role of the narrative reporting in the UK. For a more detailed discussion, see Burns, T., and Paterson, J., *Gold Plating, Gold Standard or Base Metal? Making Sense of Narrative Reporting after the Repeal of the Operating and Financial Review Regulations*, (2007), *I.C.C.L.R.*, 18(8), 247-260.

[196] See CA 2006 s393 (Accounts to give true and fair view).

[197] Cadbury Report, para.4.50.

The above information disclosure is a continuing obligation of companies in their normal lives. When companies go through the three thresholds in the life cycle of corporate governance, information asymmetry appears more important than when companies are going concerns.[198] In specific, to regulate information asymmetry signifies to regulate the content, the timing, the quality and the accessibility of the information. All these issues are of special importance in cases of special junctures in the life cycle of corporate governance.

(a) Information Disclosure in Flotations

The dominating principle underlying the law in this area '*is easy enough to define*':

> "*It is that members of the public who are offered company securities are entitled to full disclosure to them of the nature of what is on offer before they make a financial commitment, and to effective remedies to redress any loss incurred as a result of failure on the part of the company to make complete or accurate disclosure.*"[199]

The above quotation reveals that information asymmetry is the main concern in regulating flotations. Companies going public have normally developed from private companies about which outside investors know nothing. Without sufficient information, investors will have to average the quality of the products on the market and thus pay less for good products and more for bad. The upshot is the '*market for lemons*',[200] where products with low quality will drive out those with good quality. On the other hand, investors are also inclined to free ride on the others' efforts to investigate the offeree companies. Mandatory information disclosure is thus necessary to ensure that investors will be given sufficient quality information to make their informed decisions, achieving efficiency in allocating financial resources.

In specific, control of misrepresenting information is especially evident in the regulation of the prospectus required for public offers of both listed and unlisted

[198] Bebchuk, L., *Asymmetric Information and the Choice of Corporate governance Arrangements,* (2002), Harvard Law School Discussion Paper No.398, available at *http://ssrn.com/abstract=327842*.
[199] Davies, P., *Gower and Davies' Principles of Modern Company Law*, (7th edn), (2003a), London Sweet & Maxwell, at 642.
[200] Akerlof, G., *The Market for "Lemons": Quality, Uncertainty and the Market Mechanism*, (1970), *Quarterly Journal of Economics*, 84:488.

securities.[201] An offeror, who makes a public offer, is responsible for any compensation to investors if they suffer a loss due to the inaccuracy in the information contained in the prospectus.[202]

(b) Information Disclosure in Takeovers

In takeover transactions, information asymmetry exists between directors and shareholders, between different groups of shareholders of both the offeree and the offeror company, and between different competing offeror companies as well. The objective of the regulation of information asymmetry is to ensure information receivers make informed decisions on the basis of the information received on an equal basis.

Investors in security markets are inherently vulnerable in changes of corporate control. For instance, offeree shareholders are often in such a disadvantaged situation. In an unregulated market for corporate control, the open period of the offer may be limited, leaving scarce time for shareholders to make an informed decision. In addition, an offeror may not be bound to take up the tendered acceptances, placing later-tendering shareholders at the mercy of the offeror if there is an oversubscription. Furthermore, the incumbent management with a hope to keep their position may stall the offer. Or considering the generous severance payment to the incumbent management, they may transfer the control without due consideration of the interests of shareholders. In consequence, an unregulated takeover offer will invariably be made "*under a cloak of secrecy*".[203] Additionally, the above-mentioned actions also transmit wrong signals to the market and may intensify the fluctuation of the market. In turn, integrity of the market will be compromised. In a word, information asymmetry can badly compromise the interests of investors but unfairly benefit those inside information holders.

Besides, competing offerors should receive equal treatment from the

[201] FSMA2000 Part VI.
[202] See FSMA 2000 s85, but see s86 for relevant exemptions for 'financial promotions'.
[203] Ogowewo, T., *The Underlying Themes of Tender Offer Regulation in the United Kingdom and the United States of America*, (1996), *Journal of Business Law,* 463-481, at 463.

management of the offeree company in acquiring relevant information.[204] In *Heron International v Lord Grade*[205], the Court of Appeal indicated that even if the board had already given irrevocable undertakings to accept what turned out to be the lower bid, the higher of the two competing bids should still be preferred. Additionally, the offeree management must seek competent independent advice on the offer. Their opinions are also required to be circulated to shareholders. Thus, board neutrality is required so that offeree shareholders can be provided with timely, accurate and comprehensive information to make their informed decision.

Information disclosure is required not only for the purpose of financial market regulations but also for the consideration of the interests of other stakeholders. Takeovers without due consideration of interests of employees are doomed to destroy employees' loyalty and waste resources invested by both the employer and employees. While information disclosure in the public capital market is one channel for employees to acquire information, such disclosure may be too late for employees to transform their destiny. Thus, employees should have the right to know the impending changes of corporate control and the implication of such changes on their job security, issues which have already been covered in the Information and Consultation Directive, the Works Council directive, the Transfer of Undertakings (Protection of Employment) Regulations (TUPE) and other relevant European Directives and domestic laws.[206]

(c) Information Disclosure in Insolvency

Information disclosure is also vital in insolvency as creditors can only know the financial status of the company through information disclosed by the company. Such a concern involves the standards of the information disclosure to achieve a fair and true revelation of the value of the company in concern. While financial reports and the directors' report have been the ongoing obligation of companies, such reports may be especially important in insolvency. Directors of a company facing insolvency

[204] Takeover Code r. 20.2.
[205] [1983] B.C.L.C. 244. However, for the confusion regarding whether directors can fetter their discretion in escaping the initial bid, see Davies, P., *Gower and Davies Principles of Modern Company Law*, (7th edn), (2003a), London Sweet & Maxwell, at 719-721.
[206] For more detailed discussion, see Part IV of Chapter 5 Employees.

commit offences if they falsify the company's books [207] or make any material omissions in any statement relating to the company's affairs.[208]

Information disclosure is also important for the reason that insiders may acquire their own benefits at the cost of other stakeholders in corporate rescue activities. The law accordingly prescribes the disclosure of transactions during a certain period prior to the file of insolvency.[209] Also, negotiated rescue plans must be approved by courts or court-assigned insolvency practitioners, who are further required to keep records of their acts and dealings in discharging their duties.[210] The basic objective of these arrangements is to let all relevant parties know the facts and compromises reached. In other words, almost every deal in insolvency is under the supervision of either the court or the insolvency practitioner.

Protection to creditors is further enhanced as disclosure rules are enforced on all companies and directors may be sanctioned for the breach of their duties to creditors.[211] For employees, if transfers of undertaking are involved in corporate rescue efforts, information disclosure to employees or representatives is also required under the TUPE and the Employment Rights Act 1996. This is additional to the information and consultation rights of employees under the Information and Consultation Directive.[212]

The above discussion thus reveals that mandatory information disclosure is a main characteristic of the legal approach to corporate restructuring transactions. Since such information disclosure requirements are initiated by the occurrence of specific events, they are event-driven and thus more specific than the general information disclosure as required when companies are going concerns.

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[207] See IA 1986 s209.
[208] See IA 1986 s210.
[209] For example, s240(1) (a) of the IA1986 extends the period to 2 years before the onset of insolvency "*in the case of a transaction at an undervalue or of a preference which is given to a person who is connected with the company (otherwise than by reason only of being its employee)*". Section 207 of the IA 1986 extends the period to 5 years before the commencement of winding up for fraudulent disposition of company's property by directors.
[210] For relevant requirements for supervisors in CVA, see Insolvency Rules (IR) 1986 r.1.26(1); for receivers, IR 1986 r.3.32; for liquidators, Insolvency Regulations 1994 (S.I. 1994, No.2507) reg. 11 and IA1986 s143(2) and s170.
[211] See IA 1986 s211.
[212] For more discussion, see Part V of Chapter 5 Employees.

4. Prior Approval of Intermediaries

Prior approval is the strongest intervention by the authority among the regulatory techniques.[213] This form of regulatory technique is especially important in the area of financial market regulations. For example, both Recognized Investment Exchange and Recognized Clearing House in the FSMA 2000 are examples of this technique.[214] As for corporate restructuring transactions, licensed accountants, auditors and lawyers are all indispensable actors.

Apart from that, we may observe specific intermediaries need additional prior approval of the court or other regulatory authorities. For instance, a flotation on a Stock Exchange must involve licensed intermediaries. A sponsor approved by the FSA acts as the intermediary between the issuer and the FSA. Such a sponsor is a person recognized by the Stock Exchange to carry out stipulated activities, including to make '*due and careful enquiry*' of the issuer, and to ensure that the directors acknowledge their duties and the compliance by the company with the Listing Rules.[215] The importance of the regulation of intermediaries can also be evidenced on the Alternative Investment Market, where even though three-year records are no longer strictly required, the role of advisors who must play an active role in monitoring and screening the flotation is reinforced.[216]

As for insolvency, insolvency practitioners, like liquidators and administrators are more often licensed accountants or lawyers and court appointed. As for takeover transactions, there is no corresponding mandatory approval of intermediaries apart from approval required for professionals from their associations they belong to. However, financial advisors, strategic investors and banks are experienced takeover specialists who are familiar with the law and commercial practice in the takeover market. Considering the intensive competition in the market for corporate control, intermediaries on the takeover market may in fact be subject to high requirements of

[213] Ogus, (1994), at 150.
[214] FSMA 2000 Part XVIII.
[215] FSMA 2000 s88(3).
[216] LSE, *AIM Rules for Companies*, (2007), Part One Section 1. And advisers must comply with the requirements in *AIM Rules for Nominated Advisers* by London Stock Exchange.

their clients.

C. COSTS OF REGULATION

According to Posner and Stigler, regulations may bring more costs than benefits.[217] The first cost is the moral hazard, which means actors may adapt their behaviour as a result of a particular arrangement, including regulation. The classical example is the response from the private sector to the provision of fire insurance. Individuals who purchase insurance will be more inclined to be careless to potential risks. As applied to regulation, moral hazard may result in a relaxation of normal standards of prudence. A similar situation also occurs when company insolvency law provides strong protection for secured creditors, who may thus be lax in playing their monitoring roles when companies are going concerns. Such effects are thus counterproductive and undesirable.

The second is the compliance cost. Document requirements in flotations and the ongoing information disclosure obligation of the listed companies are only two of the apparent examples. Compliance costs can be so high that they may function as deterrents to some participants. For example, high compliance costs involved in a flotation may either stop some companies from entering the market or encourage them to delist from the market, vitiating the role of the public capital market to raise capital for companies.

Moreover, there are some indirect costs arising from the compliance cost. For example, the regulated may try to coin obfuscated words to meet the requirement. The upshot is the provision of low quality and less understandable information, which is not the originally intended objective of the regulation. One example will make it vivid. In an explanation for the discrepancy from the Combined Code, a listed company stated: "*Save where detailed below, Yell complied with the 1998 Code…*".[218] In this

[217] Posner, R., *Theories of Economic Regulation,* (1974), *Bell Journal of Economics,* 5(2):335-358 and Stigler, G., *The Theory of Economic Regulation*, (1971), *Bell Journal of Economics*, 2(1):3-21.
[218] Yell Group Plc Annual Report 2003/2004, available at *http://www.yellgroup.com/files/6RLD36/2004+yell+group+plc+annual+report+with+graphics.pdf*, at 25.

case, instead of giving a clear statement of any discrepancy, the company leaves the reader to identify any areas of non-compliance within the report.[219]

Other categories of costs include the decreased economic efficiency, which can be attributed to the few activities of agents after the introduction of regulations, and the increased dynamic cost of regulations, which is attributable to the inertia of regulators who may resist potential beneficial changes for their own interests. Thus, given the potential high costs of mandatory rules, some scholar argues that "*mandatory rules (in corporate rules) should apply only to elements of the corporate contract which would not voluntarily be adopted.*"[220]

However, all these costs may also bring benefits as well. Even though compliance costs are a heavy burden for small companies, small companies can in fact save fees on research and development and adopt sophisticated management or production standards by complying with statutory requirements. In other words, the dynamic cost can also engender benefits by inciting more innovations.

Last but not least, authorities may intentionally prefer regulation costs for public interests. In the financial market in the UK, authorities have been creating both entering and exiting costs, which effectively prevent those 'hit and run' raiders from destroying the stability of the financial market and thus help to preserve the integrity of the market.[221]

CONCLUSION

In this chapter, I discuss corporate restructuring transactions from both an economic and a legal perspective. I first present diverse motives for flotation, which range from to acquire an alternative financial resource at a lower cost to exit from original investments. While benefits of the public capital market are attractive, management, who usually hold large shareholding and thus can decide the fate of

[219] Pensions Investment Research Consultants Limited, *Corporate Governance Annual Review 2004*, at 9.
[220] MacNeil, (2001), at 133.
[221] LR 5.24R-5.2.11R

flotation, may have to strike a balance between these benefits and the increasingly stringent public disclosure. Management's retention of control, however, has in many empirical studies been linked with the anomaly of underperformance of floated companies after they go public. In combination with that anomaly, shares are usually underpriced in flotations. Empirical evidence shows that the anomaly of underpricing is connected with the collaboration between institutional shareholders and underwriters in floatations. Accumulatively, these two anomalies engender the observed social disruption of the current flotations.

But the flip side of the management's retention of control is that it can also contribute to a successful transformation from a private company to a public company. In fact, a small difference from the existing governance structure is helpful in achieving a successful transformation. But, it must be noticed that since interests of shareholders, especially interests of minority shareholders, are enhanced on the public capital market, a flotation may intensify the conflicts of interests among different groups of stakeholders. Nevertheless, the regulatory environment of the public capital market can produce an overall net positive effect on stakeholders.

In parallel, we also observe the intensified interest conflicts among and between shareholders, stakeholders and the management in takeover transactions. We discuss takeovers from the perspectives of both the offeree company and the offeror company. From the perspective of the offeree company, we see that different shareholding structures may have different effects on the takeover offer. We also see that the pro-shareholder stance of the Takeover Panel largely restricts the discretion of directors to rebuff takeover offers even though antitakeover measures by the board may still be observed in the UK. From the perspective of the offeror company, we further divide takeovers into diversification and divestitures. Motives for these activities can be either *mala fide* or *bona fide*. But in contrast to diversification, which may produce both positive and negative performance, divestitures are often carried out to redress the former mistakes in diversification. On the whole, even though takeover transactions can bring financial benefits to offeree shareholders, the monitoring role of takeover transactions is confusing.

As special cases in takeover transactions, MBO and MBI transactions are discussed as a separate topic. Empirical evidence on the performance of MBO and MBI and the recent private equity wave is still incomplete and confusing. However, the co-existence of both positive and negative evidence regarding takeover transactions may indeed lead us to deem the market for corporate control as an environmental factor which should not be bluntly cleared away. Still, the violent social implications of takeover transactions need us strike a delicate balance between economic efficiency and the social stability.

As for the case of Insolvency, we first see that insolvency is a continuum of the existing governance structure. We then analyse corporate governance around corporate rescue. Here, we emphasize both the legal rescue efforts and the private rescue efforts. The strong intrusion of law produces important effects on governance practice when companies are still going concerns. The discussion also warns us that even though corporate rescue is recommendable, the long-term performance after rescue may not be strong.

With these discussions, we strengthen our argument that flotations, takeovers and insolvency are thresholds in the life cycle of corporate governance. We then move on to the legal institution on corporate restructuring transactions. We first explain the dominant self-regulatory regime of corporate governance in general, though juridification is incrementally perceptible. While default rules are the feature of governance rules for companies as going concerns, mandatory rules inform regulations on corporate restructuring transactions. In specific, we discuss such legal approaches as rule setting, standard setting, information disclosure and prior approval of intermediaries. We specially discuss mandatory information disclosure which is widely used to solve governance issues throughout the life cycle of corporate governance. Still, except for a growing preference to corporate rescue, neither preference nor opposition to restructuring transactions *per se* is observed in relevant regulations. While regulations can be necessary and may produce positive effects, the accompanying costs of regulations are also undeniable.

In sum, this chapter further develops the life cycle of corporate governance by a detailed analysis of the mutual influence between the existing governance structure and the three restructuring activities. The confusing empirical evidence on the effect of these restructuring transactions provides a huge challenge to the government and regulatory authorities. However, strong disruptive effects of restructuring transactions do provide a strong rationale for government intervention for the purpose of public interests and social stability. Nevertheless, the legal institutions discussed in the latter part of this chapter show that the legal approach to corporate restructuring transactions adopts a neutral policy to, *i.e.*, neither favouring nor opposing restructuring transactions. As a result, the law in this area is more to provide a level playing field than to prescribe concrete steps to be adopted by participants.

CHAPTER 3. SHAREHOLDERS

INTRODUCTION

In this chapter, I will apply the research structure set up in the first chapter to shareholders. With a brief introduction of social political issues relevant to shareholders, I will examine how interests of shareholders are constrained in the life cycle of corporate governance through the perspectives of contracts, and laws and regulations.

The basic aim of such a discussion is to provide the governance institution specifically relevant to shareholders. In the social political discussion I will mainly discuss the one-share-one-vote norm and the dispersed shareholding structure of public companies in the UK. I will also talk about the influence of the concentration of shareholding for institutional shareholders and discuss the role of institutional shareholders in corporate governance. In the remaining parts, I will discuss shareholders in the normal life, flotations, takeovers, and insolvency consecutively. By analyzing contractual arrangements and relevant laws and regulations in the four capsules, we will examine how the interests of shareholders are promoted and constrained. One point to make at the outset is that corporate rules and contracts may largely overlap as it is widely recognized that company law provides a standard contract through a set of default rules.

In Part I, I will look at social political issues; from Part II to Part V, I will discuss shareholders in the normal life, flotations, takeovers, and insolvency in sequence. A conclusion follows at the end.

PART I. SOCIAL POLITICAL ISSUES

A. A BRIEF HISTORICAL REVIEW

1. The Development of Shareholders

Modern company law developed from the earlier partnership law, where shares were mainly used as a vehicle to calculate the rights and liabilities of partners. [1] In a partnership, partners are owners of the firm collectively. They enjoy the rights and assume the responsibilities according to a prefixed ratio of their respective share holdings. Conversely, shares in a partnership are not transferable, or can only be transferred with prior approvals of the other partners. The non-transferability is balanced by the fact that most partners are closely involved in the management of the partnership. The inheritance of this conception by the early joint stock companies helps to explain the origin of the modern idea that shareholders are the owners of the companies in which they hold shares.

However, the financial requirement arising from the industrial revolution, especially with the advent of the railways, necessitated the availability of capital of a bigger size but with a greater transferability. This market driven process spurred the development of a company as a separate legal personality, leading shareholders a step away from their original image as partners.[2] In fact, once companies are recognized as separate persons in law, shareholders can no longer be deemed as owners of companies. Companies, in law, are not things and cannot be owned by shareholders. They enjoy the legal status as persons just as shareholders do. Indeed, they themselves are often shareholders, who invest in other companies. Viewed from this perspective, shareholders can only be deemed as financial resource providers for companies.

Still, some legal rights attached to partners are successfully retained by shareholders. One example is their decision right. Even though shareholders are no longer partners or owners of a company, they still enjoy the right to vote on important

[1] For a relevant historical review, see Ireland, P., *Company Law and the Myth of Shareholder Ownership*, (1999), *M. L. R.*, 62: 32.
[2] Blair, M., *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, (2003), *U.C.L.A. L. Rev.*, 51(2):387-455.

strategic issues and the right to appoint and dismiss members of the board, who largely control the daily management of a company. In other words, the deprivation from shareholders of the ownership rights originally conferred on partners is legally counterbalanced by the retention of decision rights for shareholders. Thus, shareholders' legal rights can only be appropriately understood as an outgrowth of legal development.

2. The Superiority of Capital to Labour in the UK

In a similar vein, the current '*enlightened shareholder*' value model of internal governance in the UK must also be studied through a historical perspective. Labour in the UK has not been as strong as its counterpart in Germany ever since World War II. One consequence of this historically established superiority of capital to labour in the UK is that labour has been historically dislocated out of the management in the UK, a situation which contributed to the establishment of the single-tier board in the UK rather than the two-tier board in Germany.[3]

However, as the integration of the European Market moves on, the increasing political influence of labour can also be seen in the UK as more pro-employee regulations and directives of the EU are implemented in the UK.[4] Indeed, when the Steering Group issued its final report on the company law review, it said:

> "*it sets as the basic goal for directors the success of the company in the collective best interests of shareholders. But it also requires them to recognize, as the circumstances require, the company's need to foster relationships with its employees, customers and suppliers, its need to maintain its business reputation, and its need to consider the company's impact on the community and the working environment.*"[5]

This view is further written in the Companies Act 2006 where directors are expressly required to take into consideration the interest of employees and other

[3] Hopt, K., *The German Two-Tier Board: Experiences, Theories, Reforms*, in Hopt, J., *et al.*, (eds), *Comparative Corporate Governance – The State of the Art and Emerging Research*, (1998), OUP, 225-258, at 228.
[4] The obligation to take the interests of employees into account was introduced by the CA 1980.
[5] DTI, *Modern Company Law for A Competitive Economy, Final Report*, (2001), at para. 3.8. (DTI, *Final Report*).

stakeholders in performing their duties to achieve the success of their company.[6] Consequently, the strong influence from the EU may have already changed the so-called shareholders' primacy in a significant manner.

The above brief historical review of the legal status of shareholders and the development of the relationship between capital and labour tells us that the governance debate must be understood as a dynamic issue because different social political environments may dictate different internal governance arrangements.

B. SHAREHOLDING STRUCTURE IN THE UK

1. The Norm of Dispersed Shareholding and One-Share-One-Vote

Dispersed shareholding is the norm in the UK. According to the European Corporate Governance Network, the median size of the largest block in the UK is just 10%, in stark contrast to the 34% in Spain and 52% in Austria.[7] Crespi-Cladera and Renneboog also document that over 85% of listed companies lack a shareholder with 25% or more of voting rights.[8] Combined with this dispersed shareholding theme is the business norm of One-Share-One-Vote in the UK,[9] a norm which is important in maintaining the integrity and the liquidity of a free stock market and the market for corporate control.[10]

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[6] CA 2006 s172.

[7] Becht, M., *Strong Blockholders, Weak Owners and the Need for European Mandatory disclosure,* (1997), ECGI research paper, available at *http://www.ecgi.org/research/control_europe/documents/eu.pdf*.

[8] Crespi-Cladera, R. and Renneboog, L., *United We Stand: Corporate Monitoring by Shareholder Coalitions in the UK*, (2000), Center for Economic Research Working Paper 2000-18 Tilburg University, available at available at *http://ssrn.com/abstract=276656*.

[9] Table A Art. 54 provides that every member shall have one vote on a show of hands and one vote for each share on a poll. Also, Listing Rules 6B5(a) requires the disclosure of the nature of the voting rights. In a recent study, among the 80 British companies in the FTSE Europfirst 300 as of 1 July 2004, 12% do not comply with the one share/one vote principle. However, considering the low frequency and the relatively small portion (less than 20%) of non-voting shares (the most often employed deviating voting policy of the capital), the survey concludes that "*resulting voting right distortion remains limited.*" See a commissioned survey for Association of British Insurers by Deminor Rating, *Application of the One share-One Vote Principle in Europe,* (2005), available at *http://www.deminor.com/download.do?doc=deminorratingDocs/ABI**OneShareOneVote**FullReport.pdf*, at 17.

[10] Warren, M., *One Share, One Vote: A Perception of Legitimacy*, (1988), *Journal of Corporation Law*,

The combined effect of the dispersed shareholding structure and the one-share-one-vote scheme is that individual shareholders have little or no incentive to monitor the management. The atomized shareholding structure leads individual shareholders to exercise their statutory rights only when the company undertakes very controversial decisions. Moreover, since a shareholder does not owe fiduciary duties to the company or the other shareholders, he can vote in his own interests. This is the case even when directors holding shares in the company exercise their voting power as shareholders.[11] Alternatively, shareholders in large public companies have long been claimed to pay more attention to their short-term return on their investment than the long-term development of the company.[12] Such observations partially explain why shareholders' proactive performance of their monitoring role is of importance in the current corporate governance reform.

But on the other hand, the norm of dispersed shareholding should also be understood bearing in mind that in the UK coalitions of the five largest shareholders in a company can in fact control 30% of a company's outstanding equity.[13] Similarly, Leech has also argued that a bloc of a few large shareholders working in concert can control many big companies in the UK and in almost all such companies, the top six shareholdings can accumulate a working control without holding a majority of the shares.[14] In fact, shareholders' control through a constellation of interests has already been a strong characteristic of the majority of enterprises in the USA and Britain.[15] In other words, the norm of dispersed shareholding may eclipse the underlying concentrated voting structure, a real concern of the internal governance scheme.

14: 89-110. In stark contrast to the one-share-one-vote is the cumulative voting scheme, which complicates the voting structure as shareholding structure can no longer be simply used as a starting point to calculate the voting structure of a company in concern. But also see Grossman, S., and Hart, O., *One Share-One Vote and the Market for Corporate Control*, (1988), *Journal of Financial Economics* 20:175-202, for certain conditions under which a deviation from one share/one vote may be optimal. And Burkart, M., *et al.*, *Why Higher Takeover Premia Protect Minority Shareholders?* (1998), *Journal of Political Economy*, 106:172-204 for the potential benefits resulted from the intensified bidding competition.

[11] *Northwest Transportation Co. v. Beaty* (1887) 12 A.C. 589; *Burland v. Earle* [1902] A.C. 83.

[12] Miles, L., and Proctor, G., *Unresponsive Shareholders in Public Companies: Dial "M" for Motivate,* (2000), *Company Lawyer,* 21(5):142-144.

[13] Franks, J., and Mayer, C., *Governance as a Source of Managerial Discipline*, (2000), available at http://www.dti.gov.uk/cld/franksreport.pdf.

[14] Leech, D., *Shareholder Voting Power and Corporate Governance: A Study of Large British Companies*, (2001), *Nordic Journal of Political Economy*, 27(1):33-54.

[15] Scott, J., *Corporations, Classes and Capitalism*, (2nd edn), (1985), Hutchinson Educational London

2. The Concentration of Shareholding in the Hands of Institutional Shareholders

Although the dispersed shareholding structure is the norm in individual companies, the shareholding structure in the whole corporate sector does not have a similar picture. In fact, partly due to the fact that pension funds and other funds have been attracted by the higher returns from shares by comparison with fixed interest securities and partly due to the current government policy which encourages fund managers to invest proactively, the UK equity market has become more 'institutionalized' ever since the 1960s.[16] Empirical evidence reveals that individual share ownership dramatically fell from over 50% of the equity market to under 20%[17] while at the same time institutional investors in the UK own assets worth more than half the quoted equity markets.[18] The concentration of shareholding in the hands of institutional investors thus indicates a gravity of voting rights to institutional shareholders in the corporate sector. The importance of institutional investors in corporate governance practice is thus apparent.

However, in stark contrast with the important role implied in the concentration of voting rights to institutional investors is the negative empirical evidence which reveals that most institutional shareholders are rather dormant than proactive in governance practice.[19] But why institutional shareholders with their concentration of

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[16] Davies, P., *Shareholder Value, Company Law, and Securities Markets Law, A British View*, (2003b), in Hopt, K., and Wymmersch, E., (eds), *Capital Markets and Company Law*, (2003), OUP, 261-289, at 271, also available at *http://ssrn.com/abstract=250324*.

[17] Myners, P., *Institutional Investment in the UK A Review,* (2003), available at *http://www.hm-treasury.gov.uk/media/2F9/02/31.pdf*, (Myners Report) at 27. Source ONS, '*Share Ownership, A Report on the Ownership of Shares at 31/12/99*', at 4 and 8.

[18] Myners Report, at 4.

[19] Franks, *et al.* find that the performance of those listed UK companies with high institutional holdings on average is neither better nor worse than that of companies in the control panel. Moreover, they locate too little evidence to establish a significant relationship between institutional shareholding and management turnover. See Franks, J., *et al.*, *Who Disciplines Management in Poorly Performing Companies?*, (2001), *Journal of Financial Intermediation*, 10(3):209-248, also available at *http://ssrn.com/abstract=283259*. In a similar vein, by investigating the board structure of non-financial firms prior to and post the implementation of the recommendation of the Cadbury Committee, Dedman found no evidence of pressure from institutional shareholders in encouraging recommended board structure. See Dedman, E., *An Investigation into the Determinants of UK Board Structure Before and After Cadbury*, (2000), *Corporate Governance: An International Review* 8(2):27-67. But Stapledon pointed out that institutional shareholders' activism may be "*masked by the methodology employed*" in

voting rights do not exercise their rights proactively? In this section, I will explore the reasons for the observed weak voice of institutional shareholders in individual companies. As the analysis goes on, it can be seen that the active role of institutional shareholders is, however, expressed in the wider corporate sector.

(a) Factors Contributing to the Weak Monitoring Role of Institutional Shareholders in Individual Companies

Institutional investment is managed by fund managers, who get their payment according to the performance of the fund. Given that the remuneration for fund managers is evaluated by the performance of the shares they are in charge of, the indexed investment policy[20] is accordingly preferred as it more or less ensures a fund manager a general performance assessment equivalent to that of the market, if not better. Moreover, the peer bench-marking among fund managers further stereotypes the indexed investment policy. Because the risk of terminating the mandate in case of underperformance is disproportionately large compared with the beneficial effect of winning a new customer through better performance, fund managers may thus follow the widely adopted indexed investment policy among their peers for a safe choice.[21]

Since institutional investors pursuing the diversified investment policy usually '*[hold] literally a thousand or more stocks*'[22] in which no single stock is likely to make up a small percentage of the whole portfolio, active monitoring of the management in any particular company will be forestalled by a low expected payoff and the information overload problem.[23] Moreover, the indexed investment policy may produce a *lock-in* effect because a transfer from one share to some other cannot outperform the market but rather only increase the costs to fund managers.[24] Thus,

such studies, see Stapledon, G., *Institutional Investors: What are their Responsibilities?*, in Parkinson, J., *et al.*, (eds), *The Political Economy of the Company*, (2000), Hart Publishing, 195-232, at 201.

[20] Indexed investors hold a portfolio of securities the composition of which is the same as that of an index on the market. This kind of investment policy is a vivid application of the Efficient Capital Market Theory, which proposes that market cannot be beaten but only be followed.

[21] Myners Report, para 5.10.

[22] Coffee, J., *Institutional Investors as Corporate Monitors: Are Takeovers Obsolete*?, in Farrar, J., (ed), *Takeovers Institutional Investors and the Modernization of Corporate Laws*, (1993), OUP, 12-105, at 82.

[23] Coffee, (1993), at 87.

[24] Empirical evidence in the UK shows that occupational pension funds do not opt for exit despite the

institutional shareholders' monitoring of corporate governance practices of the companies in the portfolio may not be cost-benefit efficient.

In addition, the weak voice of institutional investors can also be explained by the intricate business relationships between the firm the fund manager works for and the company the firm invests in. In practice, an active governance promoter may find the business of its firm's corporate finance arm has been prejudiced.[25] Thus, considering the fierce competition for mandates among fund managers, they may just prefer free riding or dormancy to active confrontation with the corporate management.[26]

In sum, both the diversified investment policy and the agency cost concern contribute to the weak monitoring role of institutional shareholders in individual companies. Still, it must be emphasized that fund managers with the guidance of this kind of investment policy care more about the whole economic performance than the short-term price fluctuations in any given company or companies in their portfolio.[27] In other words, corporate governance concerns are of importance to institutional shareholders in the sense of the whole corporate sector rather than specific practices in individual companies.

(b) Collective Action

Nor should the weak voice of institutional shareholders in corporate governance in individual companies eclipse their strong collective voice in instituting governance rules in general. Indeed, "*UK institutional investors have been active in*

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relative poor performance of the companies concerned, a situation which has been attributed to the high costs in both the possible monitoring and potential exit. See Faccio, M., and Lasfer, A., *Do Occupational Pension Funds Monitor Companies in which They Hold Large Stakes?*, (2000), *Journal of Corporate Finance*, 6:71-110.

[25] Davies observes that: "*It is perhaps not surprising that the most publicly activist institutions are those which do not suffer from such conflicts of interests because they are single function bodies.*" Davies, (2003b), at 276.

[26] Short, H. and Keasey, K., *Managerial Ownership and the Performance of Firms: Evidence from the UK*, (1999), *Journal of Corporate Finance*, 5:79-101. The study has shown that UK institutional investors prefer to exert their influence informally through consultation outside the general meeting.

[27] Gilson, R., and Kraakman, R., *Reinventing the Outside Director: An Agenda for Institutional Investors*, (1991), *Stanford Law Review*, 43:863.

lobbying regulators or in seeding market norms."[28]

It has already been noted that "*British institutional investors tend to act collectively through umbrella institutions when dealing with the corporate management*."[29] Associations of institutional investors often cooperate in sharing experience and expenses of their confrontation with and challenges to the incumbent management. They usually issue guidelines which not only regulate the action of their own members but also provide meaningful predictions to the management of the attitude of institutional investors on issues covered by relevant guidelines. For instance, even though the pre-emptive rights of existing shareholders may well be defaulted in practice, the Stock Exchange Pre-Emption Group Guidelines[30] with the aim to avoid either the control dilution or the financial dilution among existing shareholders, must be considered seriously by corporate management.

Another example is the disadvantaged position of management in takeover transactions. It is usually believed that the dispersed shareholding structure in the UK should predict a greater discretion for directors and thus, like what happens in the US, the possibility of anti-takeover measures being put in place. However, at the time when the City Code was introduced, institutional shareholders had taken under control about 20% of the equity shares of companies listed on the London Stock Exchange. Moreover, the takeover rule making process was then delegated by the Government to the City institutions, which include institutional investors.[31] Interests of management were thus less considered than those of City institutions. Accordingly, the concentration of shareholding by institutional shareholders effectively facilitates their collective negotiation position in establishing rules against anti-takeover measures.[32]

In addition, the collective voice of institutional investors is also of importance

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[28] Armour, J., and Skeel, D., *Who Writes the Rules for Hostile Takeovers, and Why?—The Peculiar Divergence of US and UK Takeover Regulation,* (2007), *Georgetown Law Journal*, also available at *http://ssrn.com/abstract=928928*, at 54.
[29] Coffee, (1993), at 51.
[30] The ABI/NAPF Pre-emption and Underwriting Joint Position Paper (1996), available at *http://www.abi.org.uk*. In addition, the Association of British Insurers has issued guidelines on vendor placings.
[31] That is prior to the statutory framework in the EC Directive and the CA 2006.
[32] Bebchuk, L., and Ferrell, A., *Federalism and Corporate Law: The Role to Protect Managers from Take-overs,* (1999), *Columbia Law Review,* 99:1168 at 1192-3; also Armour and Skeel, (2007).

in setting up the self-regulatory governance institution in the UK. Indeed, the geographical concentration of institutional investors with in the Square Mile of the City of London has produced two implications.[33] For one thing, such closeness, in combination with the close communication and experience sharing among institutional investors, reinforces the political solidarity among institutional investors. For another, the closeness reinforces the monitoring role of reputation among such repeated game players as institutional investors, indicating that self-regulation without government intervention can be a real possibility. The mutually enhanced implications thus institute a historical preference for a self-regulatory regime on corporate governance in the UK.

(c) Implications for Corporate Governance Reform

The above discussion tells us that the role of institutional shareholders in corporate governance must be viewed from two perspectives. On the one hand, their dispersed shareholding in any given individual company implies a weak voice in the company concerned. On the other hand, institutional shareholders play an important role in the corporate sector through their collective actions. Thus, a fair view of the role of institutional shareholders in corporate governance entails due considerations from both perspectives.

Nevertheless, institutional shareholders' proactive voting in individual companies can still make sense simply for the reason that "*no voter can correctly argue ex ante that his or her vote will not count, whatever may be observed ex post. No trustees have the right to assume, just because the holding is small, that they are therefore without influence or power.*"[34] Thus, the positive collective role of institutional shareholders in the corporate sector should not overshadow the concern of their weak voice in governance practices of individual companies.

Moreover, if the traditional nonchalant attitude of institutional shareholders continues, the intensive political pressure will be expected to impose on them a

[33] Armour and Skeel, (2007), at 54-55.
[34] Charkham, J., and Simpson, A., *Fair Shares, The Future of Shareholder Power and Responsibility*, (1999), OUP, at 145.

specific legal duty of mandatory voting.[35] In order to stave off such heavy government interventions, institutional investors have reacted by promoting wide responsible intervention and developing best practice principles for voting.[36] In addition, the revised Combined Code has also reiterated that institutional investors should avoid "box-ticking" but enhance their proactive role in the corporate governance by encouraging "*a dialogue with companies based on the mutual understanding of objectives*" and "*[making] considered use of their votes.*"[37]

C. Social Democracy and Minority Shareholder Protection

Within the group of shareholders, the tenet of social democracy dictates that majority shareholders should not be privileged and minority shareholders should not be disadvantaged.[38] Correspondingly, we observe direct legal protections of minority shareholders and stringent stipulations constraining the discretion of such corporate plutocrats as large shareholders or voting trusts.[39]

Still, the promotion of the interests of minority shareholders must be differentiated from the inference that each individual shareholder should hold one vote. This inference confuses the inhuman nature of shareholders, who are merely the personification of shares, with the personal rights of shareholders as individual citizens and thus distorts the image of shareholders in corporate governance.

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[35] Newbold Committee, the Committee of Inquiry into UK Vote Execution (Yve Newbold, Chair), *Report*, (1999), London National Association of Pension Funds, at 3, where the Committee suggested that a failure to increase the voting level "*would …justify further investigation by the Government*". Also see Short, H., and Keasey, K., *Institutional Voting in the UK: Is Mandatory Voting the Answer?*, (1997), *Corporate Governance: An International Review*, 5(1):37-77; and Ferran, E., *The Role of the Shareholder in Internal Corporate Governance*, in Ferrarini, G., *et al.*, (eds), *Reforming Company and Takeover Law in Europe*, (2004), OUP, 417-454, at 446. More, as for the current stance of the government, see CA 2006 ss1277-1280 on information as to exercise of voting rights by institutional investors.

[36] See Institutional Shareholders' Committee, *The Responsibilities of Institutional Shareholders and Agents—Statement of Principles* (2002).

[37] See the *Combined Code on Corporate Governance 2003*, E.1 and E.3, and the Myner's Report.

[38] Dunlavy, C., *Corporate Governance in Late 19th Century Europe and the US: The Case of Shareholder Voting Rights*,(1998), in Hopt, K., *et al.*, (eds), *Comparative Corporate Governance The State of the Art and Emerging Research*, (1998), OUP, 5-40.

[39] See discussion in the following section.

PART II. SHAREHOLDERS IN THE NORMAL LIFE

A. THE ROLE OF CONTRACTS

1. Shares and Shareholders

The legal nature of shares and shareholders in modern companies has long been perplexing to scholars.[40] Indeed, legal definitions of share or shareholders cannot be found in statutes. A share, however, has been defined in a case as "*an interest measured by a sum of money and made up of various rights contained in the contract, including the right to a sum of money of a more or less amount.*"[41] In other words, shares are contracts to label an investor as a shareholder of a given company.

To be a shareholder of a company indicates that a holder of shares will assume liabilities and enjoy benefits attached to the shares he subscribes.[42] Viewed from this perspective, legal regulations on shareholders are in essence those on shares and a shareholder in law is merely a personification of shares attached with different rights and duties.[43] However, shares are not the only contracts shareholders are bound to. Shareholders are also bound by the mutual covenants between and among shareholders, among which the contract implied in the Articles of association is just one example.[44] A shareholder can accordingly be referred to as a contractual party to a series of contracts either among and between shareholders or with a company.

Here, it is worth noting that the flexibility of contracts does not lead to the multitude variety of shares. It is true that shares can be classified. But, rights and duties attached to shares in each one class are undeniably uniform. Moreover, a

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[40] Pennington, R., *Can Shares in Companies Be Defined,* (1989), *Comp. Law.*, 10 (7):140-144.
[41] Farwell J in *Borland's Trustee v Steel Bros & Co Ltd* [1901] 1 Ch 279, 288.
[42] Interests of shareholders may strictly be limited to the terms attached to shares. For example, the common law tells us that preferential rights attached to preferential shares, shares "*which in respect of dividends and/or capital, [enjoy] priority, for a limited amount, over the company's ordinary shares,*" (Ferran, E., *Company Law and Corporate Finance,* (1999), OUP, at 323), must be expressed and cannot be implied. See *Re London India Rubber Co* (1869) LR 5 Eq 519.
[43] Admittedly, rights and duties is normally uniform to shares in the same class.
[44] As it is well known that Table A to the CA 1985 provides a set of standard articles of association to companies in the UK, the discussion of contracts regarding shareholders will thus overlap with discussion of laws and regulations.

common interest in profit maximization can easily be identified among different classes of shareholders.[45] The uniformity of the interests of shareholders is especially apparent when compared with the variety of the individual expectations of both creditors and employees, or with the strong human nature of employees. Viewed from this perspective, shareholders "*are in significant senses immortal, uncommitted and universal*."[46]

2. Articles of Association

Section 14 of the Companies Act 1985[47] is a legal recognition of the contractual nature of the Articles of Association. Within the Articles of Association, we can observe stipulations on the inter-relationship between shareholders and on that between shareholders and directors. Such relationships are mainly constrained by the voting rights of shareholders, through which shareholders may in law have the decision rights on most important issues of corporate matters and the right to decide the membership on the board.

A change to the Articles of Association may not be easy as usually a special resolution with three quarters of approval from shareholders is required.[48] Moreover, the law explicitly permits entrenched provisions of the Articles.[49] Thus, contractual relationship established through Articles of Association may not be a meaningful reliance for unsatisfied shareholders in public companies where articles of association may have been fixed a long time ago without expectation of the specific changes later on. In consequence, individual shareholders in public companies, who do not have a strong negotiating power, may bear an inborn preference to exit rather than to voice in corporate governance practices.

[45] It is worth noting that shareholders may pursue either a long-term or a short-term financial interests or even a pure moral one as in the ethical investment or socially responsible investment. However, such a variety is not important when our focus is on telling the difference among and between the three subjects we are studying in this thesis.
[46] Greenwood, D., *Fictional Shareholders: For Whom are Corporate Managers Trustees, Revisited,* (1996), *S. Cal. L. Rev.*, 69:1021, at 1025.
[47] To be replaced by s33 of the CA 2006.
[48] CA 1985 s9, to be replaced by CA 2006 s22.
[49] CA 2006 s22(1).

3. Shareholders' Agreement

Shareholders' agreements are different documents from the Articles of Association. In these agreements, shareholders are bound by an agreement only when they are contractual parties to the agreement concerned. Thus, shareholders' agreements suffer from the strict rule of mutual consent and thus may be inefficient when we imagine that a new contract has to be signed each time a new member joins a company or an old member exits from the company. In practice, shareholders' agreements may only be of a constitutional sense among all the shareholders in private companies with limited number of shareholders.[50]

But on the other hand, shareholders' agreements may provide a good supplement to the Articles of Association. In comparison with the rigidity of the Articles of Association, shareholders' agreements are rather flexible because shareholders can negotiate and reach agreements on any issue at any time. For instance, minority shareholders can establish a voting coalition protecting their common interests.[51] Shareholders' agreements can thus supplement deficiencies in the constitutional documents according to the specific development of the company and specific interests of shareholders involved. However, in the case that shareholders' agreements are in conflict with mandatory rules of company law, the law up till now supports the shareholders agreement only to the extent that it is an agreement on voting activities by contractual shareholders.[52]

It has been claimed that shareholders' agreements are not common in the UK though they are mainly used in management-buy-out transactions and joint venture projects.[53] Given the limited usages in the UK and the legal effects on contractual parties, shareholders' agreements are discussed to the extent that such agreements may make a difference to the voting activities of shareholders.

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[50] *Russell v Northern Bank*, [1992] 3 All ER 161. However, such ag4reements may subject to public disclosure, see CA 1985 ss380 (1) and (4)(c) (to be replaced by CA2006 s30(1) and s29(1) respectively).
[51] Roe, M., *Strong Managers, Weak Owners, The Political Roots of American Corporate Finance,* (1994), Princeton University Press.
[52] *Russell v Northern Bank*, [1992] 3 All ER 161.
[53] Sealy, L., *Cases and Materials in Company Law,* (2001), (7th edn), Butterworths, at 107.

4. Shareholders' Contractual Rights

(a) Voting Rights and the Right to Voice

The right to vote and that to sell are two important rights attached to shares. However, since voting rights attached to shares to a large extent overlap with the relevant stipulations in company law, we will further discuss this issue in the next section. The importance of this issue here is that voting rights are rights to voice, or to participate in corporate governance autonomously. In contrast, the right to sell is a right to exit. While exit plays an important disciplinary role as too many exits can precipitate the share price of a company, such exits may make the company a vulnerable target for potential offeror companies or may even go insolvent. Also, exit implies a passive rather than an active role of shareholders in corporate governance. Thus, it is the proactive voice, rather than the passive exits, of shareholders in the corporate governance when companies are going concerns that is emphasized in the current governance reform.

(b) Dividend Rights

Another important right attached to shares is shareholders' right to dividend. In the UK, an ongoing and regular dividend payment is the norm.[54] An ongoing regular dividend payment sends to shareholders positive signals of the performance of the company.[55] An abrupt deviation from the norm may signify poor performance of the company, and thus precipitate the value of the company.[56] Moreover, a regular payout of dividends constrains the discretion of directors and blockholders to misuse

[54] Cheffins, B., *Dividends as a Substitute for Corporate Law: The Separation of Ownership and Control in the United Kingdom,* (2006), *Washington and Lee Law Review*, 63:1273-1338, also available at *http://ssrn.com/abstract=906068* and Renneboog, L., and Trojanowski, G., *Patterns in Payout Policy and Payout Channel Choice of UK Firms in the 1990s,* (2005), ECGI Finance Working Paper No.70/2005, available at *http://ssrn.com/abstract=664982*, the authors observe that despite the increased uses of share repurchases as a method of payout to shareholders, dividends still constitute a vast proportion of the total payout.

[55] Lease, R., *et al.*, *Dividend Policy: Its Impact on Firm Value,* (2000), Boston: Harvard Business School Press, at 102-6.

[56] This however may engender a process of "dividend 'smoothing'", *i.e.*, companies will generally be prudent and adopt a conservative dividend policy in which dividend incremental, if any, will be gradual so that it can be sustainable for a long term. See Ross, S., *et al.*, *Corporate Finance*, (7th edn), (2005), McGraw-Hill, at 526-527.

the free cash flow in the company.[57]

Additionally, shareholders' rights to dividends are protected by default rules in company law, according to which though shareholders do not have a right to modify the size of the dividend, they usually have a veto right to the dividend policy proposed by the board.[58] Thus, even though shareholders' veto rights to the dividend policy may never be adopted in practice,[59] the business norm of the regular, ongoing payment of dividends still implies that shareholders' rights to dividends can implicitly play an active monitoring role in the UK.[60]

(c) Actions against the Company

Shareholders also enjoy litigation rights based on their contracts with the company. Shareholders can initiate either a derivative action on behalf of the company or a personal action against the company on their own. However, shareholders' derivative actions are not promoted in the UK. For one thing, this can be attributed to shareholders' free-rider concern, *i.e.*, a shareholder who initiates the derivative action may bear the cost and the risk of losing the case by himself while the benefits, if the case succeeds, will be enjoyed by the company first and indirectly by him. For another, courts in the UK have long been following the established rules set up in *Foss v Harbottle*,[61] which strictly constrain the *locus standi* of individual shareholders to sue on behalf of the company. As Lord Davey summarized in *Burland v Earle*,[62] there are two principles set up in *Foss v Harbottle*: one is that courts do not interfere in the internal management and the other is that the company should be the proper claimant. Such a widely accepted tradition among courts has "*made it very difficult, and in many cases impossible, for shareholders with grievances—sometimes shareholders*

[57] Faccio, M., *et al.*, *Dividends and Expropriation,* (2001), *American Economic Review,* 91:54, at 55.
[58] Companies Act 1985 Table A Articles 102-3.
[59] Edwards, J., and Mayer, C., *An Investigation into the Dividend and New Equity Issue Practices of Firms: Evidence from Survey Information,* (1985), Institute for Fiscal Studies, Table 2.
[60] Dividends play a more important role in corporate governance in the UK than in the US, as dividends paid out in the UK make up on average 40% of profits, almost double the corresponding figure for their counterparts in the US. See Oughton, C., *Competitiveness Policy in the 1990s*, (1997), *Economic Journal*, 107(444):1486-1503.
[61] *Foss v Harbottle* (1843) 2 Hare 461, 67 ER 189.
[62] *Burland v Earle* [1902] AC 83, at 93.

who are the victims of very real injustices—to obtain a legal remedy."[63]

Alternatively, a shareholder may also sue the company based on his personal contracts with the company.[64] Shareholders, however, must establish that he has '*some cause of action vested in him personally*.'[65] Nevertheless, even though case law demonstrates examples of such personal rights, there is no conclusive definition of such rights in common law or statute. So, the role of shareholders' personal action in protecting shareholders' interests may have to be discounted.

In sum, it is contracts that label an investor as a shareholder. By subscribing to shares, a shareholder enters into a series of contracts with the company and with other shareholders. The above discussion also shows that shareholders' interests are constrained by contracts attached to shares, articles of association, and shareholders' agreements. Among the contractual rights, voting rights and rights to dividends are emphasized as important governance tools in the UK. However, actions by shareholders against the company on the basis of their contracts with the company are not promoted in the UK.

B. THE ROLE OF LAWS AND REGULATIONS

1. Company Law Related

(a) Voting Rights as a Counterbalance to the Discretion of Directors

In the UK, only registered shareholders are entitled to vote.[66] Registered shareholders can exercise voting rights on any issue stipulated in the Articles of Association and in law. Viewed from this perspective, shareholders enjoy direct decision rights which other stakeholders do not. However, shareholders' voting rights

[63] Sealy, L., *Company Law and Commercial Reality*, (1984), Sweet & Maxwell London, at 53.
[64] *Re A Company* [1987] BCLC 82.
[65] Pettet, B., *Company Law*, (2001), Pearson Longman, at 234.
[66] See CA1985 s370 (6) (to be replaced by CA 2006 s284(1)(3)). Relevant to the voting rights, registered shareholders also enjoy the rights to receive notice, to appoint a proxy, and to convene a meeting, *etc*. See CA 1985 s368(1)(2) (to be replaced by CA 2006 s303(1)(2)(3)) on extraordinary general meeting; s370(1)(2); s372(1)-(7) and Table A Article 54-63 of the CA 1985, to be replaced by relevant provisions in Part 13 of the CA 2006.

must be considered with the separation of ownership from the control and the legal practice that subject to the provisions of the Companies Acts, the memorandum, the articles of association and directions given by shareholders in a special resolution, directors enjoy almost all the powers of management.[67] Indeed, shareholders can mandate directors' future powers only by way of a special resolution.[68]

Nevertheless, the great discretion and power vested in directors are subject to an important removal right, which cannot be overridden by other terms, in the hands of shareholders through an ordinary resolution at any time.[69] "*It means that the notion of a term of office for a director in Great Britain has little meaning.*"[70] It is true that shareholders could be largely written out of the appointment process, without violating the law, by inserting an appropriate provision in the articles. However, this rarely happens in reality due to the pressure to attract investors, especially institutional shareholders, to subscribe issued shares.

The strong menace of shareholders' removal rights, however, is largely disarmed by shareholders' voting activities in practice. Since few shareholders attend the meeting in person and they usually appoint directors as their proxies, shareholders' voting at the meeting is indeed a voting at the board by directors with proxies. In fact, shareholders' removal rights may only be exercised when the performance of the company or directors is especially poor. Viewed from this perspective, shareholders' rights to remove directors may only be a menace in letters in most of the normal life of the company.

Consequently, shareholders' voting rights are in essence both negative and incomplete.[71] They are negative because they are exercised by shareholders through vetoes. They are incomplete because they only cover certain specific areas of the whole spectrum of the management and also because they are not the norm of real business practices. But they are important in that they set boundaries to the discretion of the management. So, shareholders' voting rights and the right to displace

[67] CA 1985 Table A Article 70.
[68] *ibid*, also for a detailed analysis, see Davies, P., *Gower and Davies' Principles of Modern Company Law*, (7th edn) (2003a), London Sweet & Maxwell, at 303
[69] See CA 1985 s303, to be replaced by CA 2006 s168.
[70] Davies, (2003a), at 310.
[71] Herman, E., *Corporate Control, Corporate Power*, (1981), CUP.

incumbent management should more appropriately be deemed as tools in the corporate accountability mechanism to counterbalance the discretion of directors, rather than tools for shareholders to claim their supremacy among stakeholders.[72]

(b) Information Rights

Shareholders also have information rights relating to the performance of the company they invest in. Law plays an important role in prescribing the contents and accessibility of the information provided by the company so that shareholders are assured to receive quality and accurate information in due time for them to make informed decisions.[73] Within company law, the information disclosure is mainly focused on the disclosure of financial performance of the company and disclosure of directors' interests in the company. In addition, listed companies are subject to the continuing obligation as stipulated in the Listing Rules and the Combined Code. With these legal tools, shareholders are expected to monitor the performance of both the company and the directors.

(c) Shareholders' Pre-emptive Rights

Pre-emptive rights of existing shareholders in law may be initiated if the company decides to make a rights issue.[74] The two overriding objectives of the pre-emptive right are to protect the voting power of the existing shareholders from being diluted and to limit any fall in the share price if a discount is given to the issuance of new shares.[75] The first objective can be further understood in two situations, one of which is the issuance of shares to outside investors and the other is the issuance of shares to part of the existing shareholders or the issuance is made at odds with the original shareholding structure. Both will lead to the dilution of the voting powers of existing shareholders. The second objective targets another situation where a discount

[72] Bainbridge, S., *Corporate Law and Economics*, (2002), Foundation Press New York, at 441 and Parkinson, J., *Corporate Power and Responsibility Issues in the Theory of Company Law*, (1995), OUP, at 60.
[73] See Part VII Accounts and Audit of the CA 1985, to be replaced by Part 15 Accounts and Reports and Part 16 Audit of the CA 2006.
[74] See CA1985 s89, to be replaced by CA 2006 s561.
[75] Davies, (2003a), at 632.

is given to outside investors when a company issues new shares. The discount so given will lead to a '*financial dilution*' of the share price of the existing shareholders since the increase of the total number of shares will be beyond the capital and dividend paying capability of the company.

But, existing shareholders' pre-emptive rights will not be applied if the new issuance is made otherwise than in cash.[76] Also, new shares can be issued on a pre-emptive basis to shareholders of a certain class, limiting the general application of the pre-emption right.[77] Moreover, whereas private companies can exclude pre-emptive rights entirely or in part in the statutory constitution,[78] public companies can disapply the pre-emption rights of existing shareholders by a modification to the articles of association or by passing of a special resolution, which requires the consent of a 75% majority of shareholders voting on the resolution.[79] Thus, the pre-emptive right can be defaulted in due cases even though it is a statutory right for existing shareholders.[80]

(d) Statutory Litigation for Minority Shareholders

The provision of s459 of the CA 1985[81], and s122 of the IA 1986 are intended to protect disadvantaged minority shareholders. The current theme of the unfair prejudice remedy contained in s459, as supported by the Final Report by the Company Law Review,[82] culminates in the case of *O'Neil v Phillips*.[83] For S459 to be applicable, the treatment must be both unfair and prejudicial. However, the application of s459 should be under a '*useful cross-check*' *i.e.*, to '*ask whether [it] … would be contrary to what the parties, by words or conduct, have actually agreed.*'[84] What this signifies is almost equal to a resort to an actual promise, or a contract, which is enforceable as a matter of law, except for the concept of "*legitimate expectation*" which is subject to the traditional equitable principles.

[76] CA 1985 s89(4), to be replaced by CA 2006 s565.
[77] CA 1985 s89(2), to be replaced by CA 2006 s568(1).
[78] See CA1985 s91, to be replaced by CA 2006 s567.
[79] *ibid*.
[80] *ibid.*, and also see MacNeil, I., *Company Law Rules: An Assessment From the Perspective of Incomplete Contract Theory*, (2001), *Journal of Corporate Law Studies*, 1(1):107-140.
[81] To be replaced by CA 2006 s994.
[82] DTI, Company Law Review, *Final Report*, at para.741.
[83] [1999] 1 WLR 1092.
[84] *ibid.*, at 1101.

The concept of legitimate expectation covers two situations, *i.e.*, where the existence of a personal relationship prevents a member from exercising a constitutional power bestowed by the articles of association and where the power in the constitution is applied for an improper purpose. It can be seen that such exceptions only modify the original contractual relationship already in existence between the company and shareholders or between shareholders. Thus, it is not surprising to read a comment that s459 is a reflection in the law that "*contract is the cohesive force underlying corporate relationships.*"[85]

In comparison, s122 of the IA 1986, which cannot be granted if other alternatives are available, entitles minority shareholders to apply for a winding up of the company on a just and equitable basis. However, case law shows that the consideration of "just and equitable" will be superimposed only on exceptional conditions, for example, where there is a mutual confidence between shareholders due to their personal relationship, or an agreement that stipulates participation by all or some of the shareholders in the management, or where restrictions of share transfer may prevent a member from realizing his or her investment.[86] Additionally, such considerations must, as Lord Hoffman stated in *O'Neil*, "*be applied judicially and the content which is given by the courts must be based upon rational principles.*'[87]

The relatively wide coverage of s459 of the CA 1985 has largely eclipsed the application of s122 of the IA 1986 because a petition for the latter will be struck out if there is another appropriate remedy available, among which we can name s459 of the CA 1985.[88] However, with the enactment of CA 2006, shareholders' derivative actions will only be possible under Part 11 of the CA 2006 or as a result of an order of the court in proceedings under Part 30 of the CA 2006, according to which a court may possibly order a compulsory buy-out of those disaffected minority shareholders'

[85] Lowry, J., *Mapping the Boundaries of Unfair Prejudice*, in de Lacy, J. (ed), *The Reform of United Kingdom Company Law*, (2002), Cavendish Publishing Limited, at 245.
[86] Listed by Lord Wilberforce in *Re Westbourne Galleries Ltd*, [1973] AC360, at 379.
[87] [1999] 1 WLR 1092, per Lord Hoffman at 1098.
[88] Warner J pointed out in *Re A Company (No. 001363 of 1988)* [1989] 5 BCC 18, *ex parte S-P* [1989] BCLC 579 at 586, '*at the hearing of the [winding-up] petition the judge may, on the full facts when they are found, hold that it would be unreasonable to grant him the remedy of a winding up and that he should pursue his remedy under s459, but it is a very strong thing to say on the application to strike out, that it is plain and obvious that a petitioner is behaving unreasonably in seeking a winding-up order*.'

shares. The newly introduced scheme facilitates shareholders' derivative actions both by broadening qualified claimants to include both a member and a prospective-member who will hold shares in the company as a result of the operation of law, and by removing barriers to initiating derivative claims, for example, there is no need to show that wrongdoers are persons controlling the company and that the wrongdoers benefit from such actions. Also, a member of the company can continue a derivative action initiated by a company or some other members so that minority shareholders may not be deprived of opportunities to redress their suffering once the company or some other member initiates but later stalls the action.[89] Nevertheless, it is still too early to predict the end result of such statutory stipulations as it is hard to believe that the culture established in *Foss v Harbottle* long before the new act will perish that quickly.

2. Others

For the purpose of this thesis, laws relating to shareholders also include regulations on securities markets such as regulations of public offering of shares and share trading, regulations of insider dealings. In addition, the Combined Code of corporate governance also provides a regulatory regime for shareholders in public listed companies. Since they can rightly be covered in the following sections, they will not be further discussed here.

PART III. SHAREHOLDERS IN FLOTATIONS

A. THE ROLE OF CONTRACTS

For companies going through flotations, shareholders can be discriminated into existing shareholders of the (old) private company and shareholders of the new public company. On the one hand, existing shareholders play an important role in initiating flotations and in designing rights attached to new shares. But on the other hand, the shares issued must be attractive enough to new investors. This, in turn,

[89] See CA 2006 s262 and s264.

entails a special discussion of the share allotment process, in which institutional shareholders and financial intermediaries play important roles.

1. Contracts with Existing Shareholders

A decision to go public signifies the giving up of contractual control rights by existing shareholders in private companies. Once companies go through a flotation process, shareholders in the original private company will either choose to be shareholders of the new public company, thus accepting new rights and duties attached to their shares, or to exit through sales of their shares to other investors. Thus, a decision to go public is a result of the balance-striking process between the attraction of the bigger public capital market and the dilution of the control rights enjoyed by existing shareholders in private companies.[90]

As controlling shareholding by management is the norm of shareholding structure among companies going public, the unity of owners and managers limits the application of the separation of ownership from the management. In turn, the decision to go public reflects the interests of the majority shareholders or the management. In other words, contractual rights implied in shares safeguard the interests of block shareholders. But on the other side of the coin, contracts may not be a perfect solution to protect the interests of minority shareholders in private companies. If the one-share-one-vote scheme is adopted in private companies, minority shareholders can hardly rebuff the decision made by controlling shareholders. If a cumulative voting structure is adopted, it is hardly the case that non-management members will have the cumulative voting power. Thus, while the concentrated shareholding structure may facilitate the passing of the proposal to go public at the general meeting, it intensifies the conflicts between controlling shareholders and minority shareholders. Pagano and Röell warn that "*in this situation, the main conflict of interest is that between the controlling shareholder and the minority shareholders, rather than between hired*

[90] For example, family controlled companies are reluctant to transfer control to the widely dispersed outsiders for fear of losing control. See Goergen, M., and Renneboog, L., *Why Are the Levels of Control (So) Different in Germany and UK Companies? Evidence from Initial Public Offering*. (2003), *Journal of Law, Economics, and Organization*, 19(1):141-175, also available at http://ssrn.com/abstract=372420.

managers and the generality of shareholders."[91]

Moreover, what further complicates the governance structure of the company going public is the rather strong control role of venture capitalists, who often have the right to appoint members onto the board and that to decide the timing of going public. Venture capitalists can achieve such rights either through being shareholders of the company going public or through direct contractual arrangements with private companies. However, since venture capitalists are more prone to exit and invest elsewhere to achieve the highest value of their principal, their interests are different from those of founding shareholders. Within this context, the interests of the company going public can only be the end result of series of negotiations among different participants. Hence, it is hard to conclude that in a company going public, shareholders are the only constituency directors are acting for. One scholar points out, "*[for companies seeking to go public], the agent analogy is inaccurate, the focus is outward not inward, and the director's identification with other social groups may be quite as strong as that with the investors.*"[92]

2. The Allotment of New Shares

(a) The Role of Underwriters in Share Allotment

Flotations can be structured mainly in two ways in the UK.[93] One is through an offer for sale, in which financial intermediaries act as principals who sell those shares they buy from the issuer company. The difference between the price at which they acquire shares from the issuing company and that at which they offer to the public is the compensation for the intermediaries who bear the risk that the public do not take up the offer. The other is through an offer for subscription, in which the issuer

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[91] Pagano, M., and Röell, A., *The Choice of Stock Ownership Structure: Agency Costs, Monitoring, and the Decision to Go Public*, (1998), *Quarterly Journal of Economics*, 113:187-225, at 188.
[92] Whincop, M., *Entrepreneurial Governance*, (2000), available at *http://ssrn.com/abstract=254169*, at 11. Whincop argues that "*The public corporation inhabits a world quite unlike the milieu of the entrepreneurial firm. Relation between the entrepreneur and the investor is far more social than that between manager and shareholders, as the latter constituencies regularly change,*" at 7. In detail, such social groups may include investment banks, service providers, trade bodies, fund investors, industry contracts, underwriters, and the networks the entrepreneurship is active in, etc., see 10-11.
[93] The other methods include an open offer, placing, vendor consideration placing. See LR3.3.3R (2) and 9.5.10R (1).

company is the principal while financial intermediaries are agents who do not bear the risk of unsold shares.

Since most companies going public are one-time players, the reliance on underwriters is apparent. Thus, offer for sale is more often adopted than offer for subscription in practice. The issue here is that underpricing is used as a compensation for those intermediaries.[94] However, for existing shareholders of private companies, underpricing in flotations represents a wealth transfer from existing shareholders to the underwriter and those new public shareholders.[95] Thus, the role of underwriters in share allotment in flotations entails a special discussion.

(b) The Implicit Coalition between Institutional Investors and Underwriters

It must be realized that underwriters in flotations are not trustees of the issuer company and have their own interests to serve. Considering the strong financial power of institutional investors, it is not a surprise to find that underwriters usually keep a close relationship with institutional investors. On the one hand, underwriters need stable relationships with big subscribers so as to reduce the risk of undersubscription. A bad sales record will exacerbate the reputation of an underwriter and thus harm its future businesses.[96] On the other hand, fund managers of institutional investors require good investments in their portfolio. A stable coalition between institutional investors and underwriters thus brings mutual benefits.

Empirical evidence also supports the projected coalition. For example, Boehmer *et al.* demonstrate that underwriters "*systematically provide institutions with shares in firms that turn out to perform better.*"[97] This is partly due to the

[94] For a discussion of the combined implication of underperformance and underpricing in flotations, see discussion in the previous chapter.
[95] Griffith, S., *Spinning and Underpricing A Legal and Economic Analysis of the Preferential Allocation of Shares in Initial Public Offerings,* (2004), *Brook. L. Rev.*, 69:583-662.
[96] Booth, J., and Smith, R., *Capital Raising, Underwriting, and the Certification Hypothesis,* (1986), *Journal of Financial Economics*, 15(1-2):261, and Tinic, S., *Anatomy of Initial Public Offerings of Common Stock*, (1988), *Journal of Finance,* 43(4):789.
[97] Boehmer, B., *et al.*, *Do Institutions Receive Favourable Allocations in IPOs with Better Long Run Returns*, (2004), University of Miami Working Paper, available at *http://ssrn.com/abstract=350720*.

underwriters' other business opportunities with institutional investors and partly due to the institutional investors' potential status as informed investors in companies going public. In fact, studies have also shown that the more information institutional investors disclose to underwriters, the more allocation they receive in favourable offerings.[98] In sum, a stable coalition between institutional shareholders and underwriters can be developed over a long term for mutual benefits.

The coalition between underwriters and institutional investors is also evidenced in institutional shareholders' past experience of collecting underwriting commissions on rights issues. The bulk of the standard level of the commissions goes to sub-underwriters, the main participants of whom are institutional shareholders. Although the law does allow collections of such fees on certain conditions,[99] it is still possible that institutional shareholders' large stake in the commission can be prejudicial to the interests of other shareholders because institutional shareholders as members in the companies going public may take advantage of inside information and facilitate the passing of relevant proposals on the commission. Similar concerns were also expressed by the Office of Fair Trading, which found that large institutional investors earn substantial fees from the company they invested in while the possible losers will only be individual investors and other small institutional investors who are unable to take part in the sub-underwriting process.[100]

In sum, the strong role of underwriters in flotations and the stable implicit coalition between underwriters and institutional shareholders distorts the contracting activities as implied in the dispersed shareholding and one-share-one-vote scheme. For one thing, individual investors on the public capital market are accordingly double disadvantaged by the information asymmetry concern arising both from

[98] Jenkinson, T., and Jones, H., *Bids and Allocations in European IPO Bookbuilding*, (2004), *Journal of Finance*, 59(5):2309-2369 and Ljungqvist, A., and Wilhelm, W., *IPO Pricing in the Dot-com Bubble*, (2002), *Journal of Finance*, 58(2):723-752.
[99] CA1985 s97 (to be replaced by CA 2006 s553) allows a commission to be collected if the payment is authorized by the company's articles of association and the amount does not exceed the amount or rate authorized by the articles or 10% of the issue price, whichever is the less.
[100] This is reflected in several research projects of the OFT ever since 1994. See Marsh, P., *Underwriting of Rights Issues: A Study of the Returns Earned by Sub-Underwriters from UK Rights Issues*, (1994), OFT Research Paper No.6 November 1994; Breedon, F., and Twinn, I., *The Valuation of Sub-Underwriting Agreements for UK Rights Issues*, (1996), *Bank of England Quarterly Bulletin*, 36:193; *Underwriting of Equity Issues*, Report by the Director General of Fair Trading (March 1995); *Underwriting of Equity Issues*, OFT Report (December 1996).

institutional investors and from the private companies. For another, the superiority of institutional shareholders to other shareholders may have already come into being before the birth of the public company.

(c) Share Allotment to Other Stakeholders

In flotations, existing contracts with directors and key employees must be taken into consideration because compensation contracts with those people usually include a term that parts of their compensation package are made up of newly allotted shares. Also, as mentioned, venture capitalists may stipulate in their loan contracts with the company that part of the new shares should be allotted to them once the company goes public.

Allotment of new shares to public investors can only be made after these pre-flotation contracts between the company and existing stakeholders are satisfied. This observation thus provides another perspective to review underpricing of shares in flotations. Indeed, underpricing is also to the benefit of these existing contractual right holders because these parties may well skim the profits from the discrepancy of share prices.[101] Thus, if the negotiating power of these stakeholders permits, they may well achieve similar protections to those for shareholders by transforming their status into shareholders through their pre-flotation contractual arrangements with the company. In other words, conflicts between shareholders and stakeholders can be partially settled through private contractual arrangements.

B. THE ROLE OF LAWS AND REGULATIONS

If flotations were only controlled by contracts, we might expect more violent underpricing activities and outside investors, frustrated by the information asymmetry, will lose confidence in the entire securities market. Moreover, as said in the last section, minority shareholders may have to subject their fate to the decision of controlling shareholders. These concerns thus entail legal interventions.

[101] Griffith, (2004).

1. Information Disclosure

(a) Prospectus

Given the information asymmetry between insiders and outsiders in flotations, the law requires detailed information disclosure. Specifically, a prospectus is required of companies engaging in a flotation so as to provide public investors, or potential shareholders, with a standard statutory contract, a contract which can save transaction costs of public investors.[102] A contravention of relevant stipulations of prospectus may constitute a criminal offence.[103] Also, any significant change of the situation must be filed to the FSA for approval.[104] The offeror will be responsible for any loss of public investors caused by the inaccuracy in the listing particulars.[105] Alternatively, a subscriber may also rescind the share allotment contract if he can prove that his subscription is made on the faith of the contents of the prospectus.[106]

(b) Disclosure of Shareholding

While shareholders in private companies are not required to disclose their shareholding, a flotation may initiate stringent disclosure obligation on relevant parties under the company law.[107] Indeed, a public company can require any person to disclose information about his interests in its shares.[108] Moreover, vote holdings by concerted parties will be calculated cumulatively as shareholdings by one party.[109]

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[102] See the Prospectus Regulation (EC) No1606/2002, FSMA 2000 s90 and Sch.10. The requirement of a prospectus will be initiated when the transferable securities are to be offered to the public or traded on a regulated market. See FSMA 2000 s85. As for the contents of the Prospectus, see the FSA *Prospectus Rules.* Information required to disclose include the issuers' share capita, financial information, its recent development and prospects, the group structure, and management.
[103] *ibid*.
[104] See FSMA 2000, s80(1) for supplementary listing particulars and s87A(2) for supplementary prospectus.
[105] FSMA 2000 s79 and s80. Note that defence exists, see s90(2) and Sch.10.
[106] Some other conditions are also required to meet. For example, he must seek the relief within reasonable time after learning the truth or before the company goes into liquidation, *etc.* See Birds, J., et al., *Boyle and Birds' Company Law*, (6th edn), (2007), Jordans, para.18.31.
[107] Part 22 of the CA 2006 only applies to public companies, CA 2006 s791.
[108] CA 2006 s793 and ss820-825.
[109] CA 2006 s824 and s825.

In fact, the shareholding structure of a company going through flotations will have to be changed to make their shares attractive to the public investors and to meet the liquidity requirements of the exchange where the stocks are listed.[110] In addition, for listed companies, transparency rules dictates shareholders, and those with rights to acquire shares, must simultaneously disclose to both the issuer and the FSA of changes of their major shareholding. In contrast to the disclosure of interest in shares in company law,[111] transparency rules of the FSA pay attention to the “notifiable interest” in holdings of 3% or more of the issuer’s total voting rights.[112] Accordingly, any change from below 3% to 3% or a change of a whole percentage over 3%, is required to be disclosed. Such disclosure may effectively help the company to identify the major shareholders (or potential shareholders) who can exercise their meaningful voting rights to make a difference to the decision making process.

Once companies go through the flotation process, block stake building is not easy either. Indeed, due to the stringent shareholding disclosure requirements, especially the function of mandatory bid rule, blockholding in listed companies abruptly tapers off at 30%.[113] Moreover, controlling shareholders are also required to keep an arm’s length relationship with the company by the London Stock Exchange both through the Listing Rules and the Relationship Agreement signed with the listed companies.[114] Nevertheless, it must be realized that coalitions among shareholders, especially institutional shareholders, can substantially change the voting structure of most listed companies.[115]

[110] LR 18.2.8R, which states that: “*a sufficient number of certificates will be taken to have been distributed to the public when 25% of the certificates for which application for admission has been made are in public hands.*” But the FSA may accept some relaxations, see LR 18.2.9G.
[111] CA 2006 s793 and ss.820-825.
[112] DTR 5.1.2 R.
[113] Goergen, M., and Renneboog, L., *Strong Managers and Passive Institutional Investors in the UK*, in Barca, F., and Becht, M., (eds), *The Control of Corporate Europe*, (2001), OUP, 259-284.
[114] LR 9.8.4R (10) and (11) and for the contents of the Relationship Agreements, see Wymeersch, E., *Do We Need a Law on Groups of Companies*, (2000), paper presented at the conference on Company Law and Capital Markets, (Siena), available at *http://www.econ-pol.unisi.it/scdbanc/CONFERENZA/FILE_WORD6/9-Wymeersch.doc.*
[115] Goergen and Renneboog, (2001).

(c) Insider Dealing

Regulations of information disclosure also include relevant stipulations on insider dealing activities. Given the potential coalition between institutional shareholders and the underwriter, institutional investors may well be considered as insiders who receive price sensitive information not available to the general public before the transaction. The potential liabilities under insider dealing laws and regulations may thus frustrate institutional shareholders from proactive participation in the corporate governance during this period.

(d) Disclosure of Lock-Up Agreements[116]

Disposition of shares by directors and substantial shareholders may make a difference to the share price of the new public company. Thus, lock-up agreements signed between directors, substantial shareholders and the company are required to be disclosed in the prospectus.[117]

A mandatory disclosure of lock-up agreements has two benefits. On the one hand, such a requirement largely plays a role of signaling, through which public investors can overcome the information asymmetry concern. On the other hand, a disclosure requirement, in contrast to a mandatory expiry date, can effectively retain the flexibility provided by contractual arrangements, through which contracting parties may design contractual terms according to their own conditions. For instance, for owner directors in high tech companies, a longer lock-up period with a distant fixed expiry date may be a price paid for the information asymmetry. Since investors in such companies are more concerned with the future cash flow rather than historic figures in the accounts, a fixed but distant expiry date on lock-up agreements may thus be preferred by investors to an expiry date which, as usually prescribed in lock-up agreements of other companies, is tied with such events as the announcements of financial results and the publication of annual or interim reports.[118]

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[116] Even though 'lock-in agreement' is widely used in practice and academic circle, we employ the term 'lock-up agreement' as used in the FSA handbook.

[117] LR 9.6.16R and PR Appendix 3.1.

[118] A lock-up period tied with the publication of annual or interim reports provides some discretion to

2. Minority Shareholder Protection

It is true that an efficient capital market may well induce good governance practices by its pricing process because

> "*Prospective minority shareholders will realize that the owner-manager's interests will diverge somewhat from theirs; hence the price which they will pay for shares will reflect the monitoring costs and the effect of the divergence between the manager's interest and theirs.*"[119]

Thus, if minority shareholders are necessary participants in an efficient capital market, we may observe that corporations with sound minority shareholder protection can raise capital easily and cheaply. However, public capital markets in reality are never as efficient as scholars presume. In fact, an issuer company may well consider interests of institutional shareholders more important than those of minority shareholders. A total reliance on the efficiency of the capital market to protect minority shareholders may be too risky. Indeed, as discussed in the previous section, the intensive conflict between minority shareholders and controlling shareholders is one of the main governance concerns in companies going public. Legal intervention is thus necessary for the interests of minority shareholders.

While controlling shareholders do not owe statutory fiduciary duties to minority shareholders, the Prospectus Rules require that major shareholders and the nature of the potential control of major shareholders on the issuer be disclosed and that measures be in place to avoid the misuse of such control.[120] Moreover, minority shareholders in private companies going public may resort to the statutory litigation rights. However, minority shareholders' derivative actions for the company may not be a reliable remedy as the company's decision to go public can hardly be argued as against the interests of the company. In such cases, minority shareholders may rely on

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the company over the precise timing of the lock-up expiry date as directors can in practice decide the specific date of such information disclosure. See Espenlaub, S., *et al*., *IPO Lock-in Agreements in the UK*, (2001), *Journal of Business Finance and Accounting*, 28 (9/10):1235-1278.

[119] Jensen, M., and Meckling, W., *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, (1976), *J. Fin. Econ*., 3:305.

[120] PR Appendix 3.1, Annex 1 18.3.

s459 of the Companies Act 1985[121] or s212 of the Insolvency Act 1986. While s459 will apply if unfair prejudice is proved, the valuation of the shares in the private company may still be a big concern. In comparison, s212 of the Insolvency Act 1986 may not be applicable as it is hard to argue why a company going public should face a threat of dissolution on a just and equitable basis. Thus, even though legal intervention on minority shareholder protection provides a meaningful supplement to the disadvantaged position of minority shareholders in their contractual arrangement with the company, the net effect may be limited.

In addition to these corporate rules on information disclosure and minority shareholder protections, shareholders also enjoy other statutory rights applicable to the threshold of flotation. For instance, shareholders' approval is usually required for both an increase in the share capital[122] and a change of the nature of the company.[123] Discussion in this Part thus shows that benefits from this alternative capital source are achieved at the expenses of wide and stringent disclosure of any skeletons in the cupboard and the potential strict discipline on the public capital market.

PART IV. SHAREHOLDERS IN TAKEOVERS

A. THE ROLE OF CONTRACTS

The importance here is the role of contracts for shareholders of the offeree company. For offeror shareholders, the role of contracts is mainly expressed through the shareholding, or vote holding structure of the company, an issue which is similar to that discussed in Part II.

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[121] To be replaced by CA 2006 s961.
[122] CA1985 Table A Article 32 (an ordinary resolution is needed for alteration of share capital).
[123] CA2006 s90 (a special resolution is required), replacing CA 1985 s43.

1. Share Transfer

(a) The Block Vote Holding Structure

Due to the contractual nature of shares, a takeover transaction is actually undertaken by the offeror company with each individual shareholder in the offeree company. The dispersed shareholding structure norm among public companies in the UK accordingly indicates that the offeror may have to negotiate with a large group of individual shareholders to transfer the control of the offeree company.

However, as said, what matters is the voting structure rather than the shareholding structure of the offeree company. Since a fund manager is usually in charge of funds from several institutional shareholders, he can exercise aggregate voting rights in one company even though each institutional shareholder only holds a minor shareholding. In other words, a block voting rights holding structure is still a real possibility in public companies with dispersed shareholding structures. Alternatively, if the potential target is a private company, a block shareholding structure, or the block voting right holding structure, is the norm. Thus, block shareholders in private companies and block vote rights holders in public companies play important roles in takeover transactions.

This on the one hand may potentially reduce the number of share transfer contracts and the efforts involved in negotiating relevant contracts but on the other hand indicate that block voting rights holders can decide the fate of the takeover offer. Whereas block voting right holders can function as continuing internal monitors of discretionary management and accentuates the voice oriented insider control,[124] they can also constrain the outside monitoring of the market for corporate control through frustration by exercising their voting rights.

In both cases, given the marginal negotiating power and influence of minority shareholders in the corporate decision making process, it is justifiable for minority

[124] Bolton, P., and von Thadden, E., *Blocks, Liquidity, and Corporate Control*, (1998a), *Journal of Finance*, 53:1-25 and same authors, *Liquidity and Control: A Dynamic Theory of Corporate Ownership Structure*, (1998b), *Journal of Institutional and Theoretical Economics*, 154:177-211.

shareholders to free ride on the monitoring of block voting rights holders. Alternatively, frustration of block shareholders or block voting rights holders may also bring benefits to minority shareholders since frustration by the blockholders can enhance the negotiating power of shareholders as a whole. In turn, free-riding minority shareholders in a takeover may retain their shares waiting for more premiums arising from the increasing offer price by the offeror or from competing offers from other potential offerors.[125] Therefore, while the disciplinary role of takeover transactions may be discounted by frustrations of block voting right holders, the net effect on shareholders, especially on minority shareholders, is not clear.

(b) The Implication of Directors' Shareholdings

Another noticed character of the shareholding structure in the UK is that directors, with the inclusion of Non-Executive-Directors, hold an average 10% of all the shareholdings, recorded as the largest single blockholder in the UK.[126] Such a blockholding may be attributed to the pre-flotation arranged share allotment in compensation packages for directors. While directors' shareholding may help to align the conflicting interests between directors and shareholders, its effect on the market for corporate control in the UK is worth a second thought.

It is widely claimed that the market for corporate control is shareholder-favored as it is shareholders, not directors, who will decide the fate of any potential offer. In comparison, directors are marginalized to play a role of loyal consultants in the decision making process. However, director shareholders can vote for their own interests as shareholders *per se*. It is thus hard to eliminate the concern of the interest conflicts between director-shareholders as significant block holders and other non-director-shareholders. Thus, the observed blockholding by directors may partially discount the decision-making role of shareholder on the market for corporate control.

[125] Grossman, S., and Hart, O., *Takeover Bids, the Free-Rider Problem and the Theory of the Corporation*, (1980), *Bell Journal of Economics*, 11: 42-64.
[126] Goergen and Renneboog, (2001), at 271.

2. Institutional Shareholders' Activism-- A Substitute for the Market for Corporate Control?

As discussed, dispersed shareholding in individual companies in the UK is overshadowed by a concentrated shareholding by institutional shareholders in the corporate sector. Since coalitions among institutional shareholders are well established, it is thus reasonable to project that proactive voices from institutional shareholders may settle the governance concern from within. In that case, will the market for corporate control be superfluous?

The answer to that question is a conservative no. It is true that the current promotion of shareholders' activism, especially the proactive role of institutional shareholders, has been widely supported even from the institutional shareholders themselves. However, as discussed, institutional shareholders have their own insurmountable agency concerns. Moreover, non-interference is a cost-benefit selection for institutional shareholders, whose shareholding in any individual company is very small. In fact, most empirical evidence testifies little, if any, positive effects of institutional shareholders in corporate governance at the company level.[127]

Besides, it seems persuasive to argue that proactive interventions by institutional shareholders at individual companies is only possible when "*institutions come to perceive it to be in their own self-interest to intervene more extensively or legal or regulatory controls require such intervention on the part of the institutions.*"[128] Accordingly, Davies has linked the less hospitable environment for sale, rather than the initiative of these institutional shareholders, with the transitory spate of institutional shareholders' activism in the 1990s in the UK.[129] If this is the case, the claimed institutional shareholders' activism may just be promoted at a right time rather than be adopted as the right solution to the agency problem inherent in the management of institutional shareholders.

On the other hand, even if institutional shareholders play their due role as

[127] See relevant discussion in B2 of Part I of this chapter.
[128] Davies, P., *Institutional Investors in the United Kingdom*, in Baums, T., *et al*., (eds), *Institutional Investors and Corporate Governance*, (1993), Berlin Walter de Gruyter & Co., 257-286, at 279.
[129] Davies, (1993), at 279-80.

active monitors, they are not necessarily the opposite pole to the market for corporate control. An active internal monitoring is a good choice during peaceful years as it is more assuasive and less destructive than the external monitoring of the market for corporate control. However, the potential loss arising from the failure of the internal governance scheme is so grave, as what happened in the Enron and WorldCom cases, that a total reliance on it is inadvisable. Given these considerations, some other mechanisms to discipline those unscrupulous directors are still in need.

Indeed, if an over-reliance on the court or the regulatory authority is not preferable, a reliance on the market for corporate control can be an expedient. For one thing, the threat and the replacing effects of the market for corporate control are non-comparable. For another, institutional activism and the market for corporate control can well function complementarily as monitoring tools of the discretion of the management.

In addition, the market for corporate control has other functions than monitoring, such as the entrance to another market or the merger of another competitor in the same line, which cannot be substituted by the internal governance scheme. Hence, as for the relationship between the rise of institutional shareholders and the market for corporate control, Carleton *et al.* provide us with a rather fair view:

> *"Institutional activism …… is not a substitute for the hostile takeover market …… that results in large operational changes, but rather a way in which institutions spend small quantities of resources to achieve modest goals."*[130]

3. Sources of Gains for Offeree Shareholders

Gains or losses for shareholders are usually assessed in terms of the change of stock prices. An undisputed fact is that takeovers generate substantial gains to offeree shareholders.[131] All studies, whatever the time period or acquisitive form, find

[130] Carleton, *et al.*, *The Influence of Institutions on Corporate Governance Through Private Negotiations: Evidence from TIAA-CAEF*, (1998), *Journal of Finance,* 53(4):1335-1362, at 1337.
[131] Jensen, M., and Ruback, R., *The Market for Corporate Control: The Scientific Evidence,* (1983), *Journal of Financial Economics,* 11: 5-50,and Jarell, G., *et al., The Market for Corporate Control: The Empirical Evidence since 1980,* (1988), *Journal of Economic Perspective, (winter)* 49-68. Shleifer, A., *et al.*, *The Aftermath of Hostile Takeovers,* (1990), LSE Financial Market Group Research Discussion

statistically significant positive abnormal returns to offeree shareholders on the announcement of an offer. In comparison, the evidence on returns to offeror shareholders is less clear-cut: depending on the time period and the company sample, offeror shareholders experience positive, negative, or statistically insignificant abnormal returns. Several studies of offeror companies in the US and UK have found that offeror shareholders exhibit a negative drift in their abnormal returns in the post merger period over the long-run.[132] In the UK, the study by Sudarsanam *et al.* shows that offeree shareholders report a general gain of 30% while those of offeror companies report losses around 5% and that shareholders in general are reported with an overall return at 2%.[133] Given the usually bigger size of the offeror company compared with that of the offeree company, the net gain to shareholders in general, if any, is small.[134]

However, explanations for the potential sources of gains for offeree shareholders are diverse and indeterminate. Positive studies indicate that the gain derives from the reduction of agency costs, or from synergistic effect of takeover activities.[135] In contrast, other studies show that gains for offeree shareholders are merely wealth redistribution among participants. For example, some scholars have posited that takeover gains may be a wealth transfer from labour.[136] Alternatively, Cosh and Guest notice that the significant improvements in profit returns in the post-hostile-takeover period are associated with significant asset disposals, potentially prejudicing the interests of creditors, or employees who are employed for the reason of the existence of those assets.[137]

Paper DP87, available at *http://fmg.lse.ac.uk/publications/searchdetail.php?pubid=1&wpdid=110*.

[132] Agrawal, A., *et al.*, *The Post-merger Performance of Acquiring Firms: A Re-Examination of an Anomaly*, (1992), *Journal of Finance* 67:1605-1621; Franks, J, *et al.*, *The Post-merger Share-price Performance of Acquiring Firms* (1991), *Journal of Financial Economics*, 29:81-96; Gregory, A., *An Examination of the Long Run Performance of UK Acquiring Firms*, (1997), *Journal of Business Finance and Accounting*, 24(7 & 8):971-1001; Limmack, R., *Corporate Mergers and Shareholder Wealth Effects: 1977-1986*, (1991), *Accounting and Business Research*, 21:239-252.

[133] Sudarsanam, S., *et al.*, *Shareholder Wealth Gains in Mergers: Effect of Synergy and Ownership Structure*, (1996), *Journal of Business Finance and Accounting*, 23 (5 and 6): 673-698.

[134] Morgan, V., and Morgan, A., *The Stock Market and Mergers in the UK*, (1990), Hume Occasional Paper No.24.

[135] Bradley, M., *et al.*, *Synergistic Gains from Corporate Acquisitions and Their Division between the Stockholders of Target and Acquiring Firms*, (1988), *Journal of Financial Economics*, 21(1):3-40.

[136] Shleifer, A., and Summers, L., *Breach of Trust in Hostile Takeovers*, in Auerbach, A., (ed), *Corporate Takeovers: Causes and Consequences*, (1988), Chicago IL: University of Chicago Press, 33-67; Coffee, J., *Shareholders Versus Managers: The Strain in the Corporate Web*, (1986), *Michigan Law Review*, 85:1145.

[137] Cosh, A., and Guest, P., *The Long-run Performance of Hostile Takeovers: UK Evidence*, (2001),

In terms of contracts, negative evidence almost all points to the externality effect of the contracts between offeree shareholders and the offeror company. Still, the co-existence of the losses suffered by different participants and the gains for offeree shareholders is too weak a support for the theory of wealth transfer theories. In fact, gains for offeree shareholders may only be a response of the securities market to the management efforts, the end result of which cannot be predicted accurately but can only be reflected in the short term fluctuation of share prices. Such gains may not necessarily come from other stakeholders in the offeree and/or the offeror company but from arising demands of the shares of the offeree company (for example, merely due to the speculation of the shares of the offeree company on the securities market). In other words, gains for offeree shareholders may just be the result of a reallocation of assets in society as a whole rather than a wealth transfer or redistribution between offeree shareholders and stakeholders within either the offeree company or the offeror company.

So we need more sound and direct empirical evidence to support the causal relationship. To negate the positive effects of the market for corporate control on the basis of the co-existence of gains for shareholders and loss of stakeholders may unduly exaggerate the conflict between shareholders and other stakeholders at the company level and thus may only be misleading.

B. THE ROLE OF LAWS AND REGULATIONS

1. Shareholders of the Offeree Company

(a) Shareholders' Decision Making Power

i) Justifications for Shareholders' Decision-making Power

In essence, the rules settle the conflicts of interests between shareholders and the board by putting the decision right in the hands of shareholders. If the offer succeeds, it is the private contracts between individual offeree shareholders and the

ESRC Research Paper No.215, available at *http://www.cbr.cam.ac.uk/pdf/wp215.pdf*.

offeror company that will take effect. Indeed, such a legal scheme sidesteps the usual decision-making process by directors, a process in which stakeholders may have opportunities to claim their interests. Shareholder primacy at least partially supersedes director primacy in case of takeovers.

However, would a sharing of decision-making power between shareholders and other stakeholders in case of takeover be more efficient? Here, we should refer to the inhuman nature of shareholders.[138] The rather uniform interests among shareholders simplify their decision making processes, aligning well with the rapid nature of takeover transactions. In comparison, other participants do not have similar efficient voting systems to make decisions for the company in cases of takeovers. In fact, considering the customary contents of the company law and the routine decision making process, stakeholders' direct intervention in decision making is not the norm even when companies are going concerns. Thus, an abrupt intervention by stakeholders in takeovers may not seem consistent. For this, the argument of Davies is pertinent:

> "*Probably, effective stakeholder protection requires general corporate mechanisms for building their interests into the governance of the company, which mechanisms continue to operate into the bid situation, rather than ad hoc amendments to the principle of shareholder control which are triggered only when a takeover is in prospect.*"[139]

On the other hand, while it is right to say that the ultimate objective of the interests of shareholders is financially orientated, it is hardly so to say that the decision making process is a purely financial one. It should be remembered that the interests of all stakeholders may have to be considered by directors when they present their view on the takeover offer to the decision makers, *i.e.*, shareholders. Moreover, even though mere consideration of financial concerns for shareholders may be feasible in some individual transactions, it may not be the case if a series of transactions occur or if the effect on the stakeholders as classes in society is so grave that such transactions may engender intensive social political conflicts in the wider

[138] Greenwood argues that "*fictional shareholders of all varieties are supremely inhuman in their indifference to particularity within the corporation,*" see Greenwood, (1996), at 1100.
[139] Davies, P., *Shareholder Value, Company Law and Securities Markets Law A British View,* (2003b), in Hopt, K., and Wymmersch, E., (eds), *Capital Markets and Company Law,* (2003), OUP, 261-289, also available at *http://ssrn.com/abstract=250324*, at 24.

society.[140] In other words, shareholders' pure financial decision making process is largely not possible in modern society.

ii) The Receding Status of Directors

In stark contrast to the great discretion usually conferred on directors through Article 70 in Table A, General Principle 3 of the Takeover Code, in combination with the more concrete contents in Rules 21, retain in the hands of offeree shareholders the decision making rights of the takeover bids. Moreover, anti-takeover measures are extremely restricted by the Takeover Code and no such steps can be taken by the board of the offeree company without prior approval from its shareholders.[141] This is the case even when the board of the offeree company has reason to believe that a *bona fide* offer is imminent. Also, the non-frustration principle must be understood bearing in mind that it is the effects, rather than the intention or the reasonableness, of the directors' action that the Takeover Code regulates.

In addition, the non-frustration principle for directors must be considered with the proactive role of directors to seek professional advice on the takeover offer and provide offeree shareholders with a fair and objective view of the offer.[142] The preliminary review of directors' response to the offer by offeree shareholders as a class largely reduces the complex relationship between the offeror company and the offeree company into that between the offeror company and the offeree shareholders.[143] Viewed from this perspective, the implication of the non-frustration principle for directors is that directors are relegated to the status as information-providers or proposal persuaders.[144]

Contrariwise, anti-takeover measures are not without benefits to shareholders. It is true that anti-takeover measures adopted after takeover bids can significantly

[140] See relevant discussion of recent private equity and hedge funds supported buyout transactions in Chapters 2 and 5.
[141] Takeover Code r. 21.
[142] Takeover Code r. 3.1.
[143] Davies, P., *The Notion of Equality in European Takeover Regulation*, in Payne, J., (ed), *Takeovers in English and German Law*, (2002c), Hart Publishing Oxford and Portland, Oregon, at 10.
[144] Davies, (2003b), at 280.

lower the probability of the success of an offer.[145] However, it has also been observed that the market for corporate control plays its due role of monitoring as successful resistance in takeover battles is usually followed by measures to remove inefficiency in the internal governance structure.[146] If this is the fact, anti-takeover measures may in some cases be adopted for the mutual benefits of both shareholders and the incumbent management, or in other words, a kind of coalition between shareholders and incumbent management may in fact be a possible projection.

Still, anti-takeover measures in the UK must be considered with the dominant promotive attitude to takeover transactions. It is the strong monitoring role of the market for control that compels internal governance improvements. Alternatively, the potential coalition between shareholders and the incumbent management may only be a reflection of the lack of confidence of shareholders in the management in general. In such cases, newcomers may not be better than the acquaintances for existing shareholders. Thus, except for an attractive financial gain through the gimmick of takeovers, shareholders may instead prefer incumbent management to the newcomers.

iii) Shareholders' Information Right

Even though directors are required to provide valuable information to shareholders in takeovers, information flow to shareholders is in fact a continuing process, as evidenced by the continuing obligation of the company to communicate information to shareholders by circulars as set out in the Listing Rules.[147] Thus, shareholders can decide the fate of an offer on the basis of a chain of information disclosed by the company. Besides, shareholders are also granted adequate time to make informed decisions.[148]

On the whole, it is clear that corporate rules in the UK aim to facilitate the occurrence of takeovers in the first place. To lay the decision rights in the hands of

[145] Holl, P. and Kyriazis, D., *Agency, Bid Resistance and the Market for Corporate Control,* (1997a), *Journal of Business Finance & Accounting,* 24(7):1037-1066.
[146] Holl, and Kyriazis, (1997a), and the same authors, *Wealth Creation and Bid Resistance in UK Takeover Bids,* (1997b), *Strategic Management Journal,* 18(6):483-498.
[147] LR10 (Significant Transactions); LR11 (Related Party Transactions); LR 12 (Dealings in Own Securities); LR 13 (Contents of Circulars).
[148] Takeover Code r. 31.1 requires an offer must remain open for at least 21 days.

shareholders, rather than the other stakeholders, is to limit the discretion of directors and to meet the requirement of economic efficiency. In other words, shareholders' decision-making rights in cases of takeovers are parts of the mechanism to strengthen the accountability of directors rather than to establish the superiority of shareholders to other stakeholders. Moreover, shareholders' decision making process should not be bluntly identified with a pure financial decision making process. In fact, a due consideration of the potential feedback from other stakeholders may well transform shareholders' decision-making process into a mutli-criteria decision making process.

(b) Minority Shareholder Protection

Once a person controls a company when he, and his concerted party, holds "*an interest, or interests, in shares carrying in aggregate 30% or more of the voting rights of a company, irrespective of whether such interest or interests give de facto control*,"[149] General Principle 1 of the Takeover Code requires that "*the other holders of securities must be protected*." Protections for shareholders are thus of special importance in the Takeover Code.

i) Equality Principle in the Takeover Code

Since takeover offers are actually made individually to each offeree shareholder, the resulting atomized decision-making process provides the offeror company with opportunities to differentiate shareholders by offering different terms of transaction to shareholders in different classes. On the other hand, even though the majority rule can decide the fate of the offer, minority shareholders should have equal opportunities to tender their shares and acquire their parts of the premium. We thus observe another principle central to the Takeover Code, *i.e.*, the equal treatment of shareholders in the same class, the aim of which is to preclude exploitation of minority shareholders.[150]

The equality principle is indeed a 'sharing' rule, which requires premiums payable for the transfer of the control of the offeree company to be shared

[149] Takeover Code C6.
[150] Takeover Code General Principle 1.

proportionately among different classes of shareholders.[151] Within the same class, this principle dictates equality among all class members. Hence, in case of takeover offers, all members of the same class must be offered the same terms, both as regards price and methods (the availability of the cash alternative or share alternative). This applies equally to shareholders who decline the original offer but later sell as a result of the exercise of squeeze-out rights by the offeror or sell-out rights by minority shareholders of the offeree company. Through these stipulations, minority shareholders are given a chance to exit from the company with a fair compensation.

The equality principle can also be reflected in the cautionary attitude of the Takeover Code to the partial bid.[152] A partial bid may transfer the control of the company secretly, with the result that outside shareholders have no knowledge of such a transfer or have to receive less benefit at a later stage, or have to accept the status as minority in the company under a new control. Thus, a strict vetting by the Panel will be expected and a prior approval from the Panel is required. For example, a partial bid made after a secret stake building within the preceding 12 months which grants the offeror company a strategic advantage on the corporate control will be denied by the Panel as the Panel assumes that the ensuing partial bid to the outside shareholders is unfair.[153]

ii) Mandatory Bid Rule

The Takeover Code imposes on the offeror company a mandatory duty to make an offer for all the other shares in the company if the offeror company acquires 30% or more of the voting shares in the offeree company.[154] In case of a mandatory offer, the price must be at least as high as the price at which the offeror company acquired the shares over the past twelve months. If there are different classes of offeree shareholders, the Code requires of a separate and comparable offer for each class of shareholders.[155] This may entail a compulsory bid for shares in different

[151] Davies, (2002c), at 11-2.
[152] Takeover Code r. 36. But subject to certain safeguards, partial bids are generally unobjectionable to the Takeover Panel. See Weinberg, M., *Weinberg and Blank on Takeovers and Mergers* (5th edn), (2001), London Sweet & Maxwell in §5 of the Part 2.
[153] Takeover Code r. 36.2.
[154] Takeover Code r. 9.
[155] Takeover Code r. 9.5.

classes on totally different acquisition terms.

The mandatory bid rule is important for those minority shareholders who do not accept the offer.[156] According to this rule, disaffected minority shareholders will still enjoy a unilateral exit right at fair terms for their shares if they do not want to retain in the new company as minority under the new control. More broadly, the mandatory bid rule is also beneficial to the interests of the whole company. Since the mandatory bid rule targets the transfer of control over the whole assets of a company by acquiring only a proportion of shares, it can effectively curb the discretion of controllers to misuse their control status for private purposes and also help to distribute the control of the assets to better users.

iii) The Duty of Controlling Shareholders

Moreover, as control is defined in the Takeover Code in terms of voting rights,[157] the role of the fund managers, who usually control a special block of voting rights through their control of several institutional shareholding in the offeree company, is of special importance in takeover transactions. In order to constrain the discretion of fund managers, voting rights under the control of a fund manager are calculated cumulatively.[158] Thus, coalitions among institutional shareholders are under strict review of the Takeover Panel.

iv) Other Regulations

Minority shareholders in takeovers are protected not only by the Takeover Code but also by the Companies Act 2006. Once the offeror accumulates 90% in value of the offer, the offeror has a right to purchase the 10% remaining.[159] Correspondingly, a minority shareholder may also ask the offeror company to buy out his shares once the offeror company has accumulated 90% of the value of all the

[156] But notice that though the mandatory bid rule can provide benefits to minority shareholders ex post, such a rule may decrease the initiative to value-enhancing takeover ex ante. For a discussion of the rationale of mandatory bid rule for minority shareholders, see Enriques, L., *The Mandatory Bid Rule in the Takeover Directive: Harmonization without Foundation?*, (2004), *European Company and Financial Review*, 4:440-457, especially Part 2 and relevant references.
[157] Takeover Code C6.
[158] Takeover Code r.8 Note 8.
[159] CA 2006 s979 (replacing CA 1985 s429).

shares of the company or that of all the shares in the class the minority shareholder belongs to.[160] Such stipulations thus provide minority shareholders a chance to select to stay put or to exit.

Besides, a dissenting shareholder who receives a compulsory acquisition notice can also, within six weeks from the date of the sell-out notice, apply to the court for an order that the offeror should not be entitled and bound to acquire the shares or request the court to specify terms of the offers.[161] Since the court usually do not reduce the consideration of the offer, a dissenting minority shareholder who can successfully show that the offer value is unfair can accordingly apply for a consideration above the offer value.[162] An offeror who receives a notice from such applicants may in fact stop the squeeze-out as the offeror has to inform such a situation to the other shareholders being squeezed out or who are exercising their selling-out rights.[163]

(c) Stake Building in Offeree Companies

Balanced with the promotive attitude to takeover transactions is the stringent disclosure requirement of the stake building of potential offeror companies. With the abolition of the Substantial Acquisitions of Shares in late 2006, the speed of acquisition of voting rights with a result of less than 30% of the total voting rights is largely out of the control of the Takeover Code.[164] However, a change of voting rights to 30% or over 30% of the total voting rights is still in need of prior approval of the Takeover Panel.[165] Besides, such offers must normally be conditional on having received acceptance, including agreement to be acquired, of over 50% of the voting

[160] CA 2006 s983 (replacing CA 1985 s430A).
[161] CA 2006 s986 (1) (2).
[162] CA 2006 s986 (4). But this may potentially conflict with the Rule 35.3 of the Takeover Code, according to which the offeror is generally prohibited from acquiring shares on better terms than those in the offer during a six-month time period.
[163] The law does not require a mandatory stop of the squeeze-out procedure if the offeror has not received such a notice. But this may be still be the case in practice as application to the court may have a similar legal effect to the notice. See relevant discussion in Hannigan, B., and Prentice, D., (eds), *Hannigan and Prentice: The Companies Act 2006 – A Commentary*, (2007), LexisNexis Butterworth, para. 8.75.
[164] See the Public Consultation Paper (PCP) 2005/4 and the Response Statement RS 2005/4 issued on 21 April 2006, by the Takeover Panel.
[165] Takeover Code r. 5 and for exception see Takeover Code r. 5.2.

rights not held by the offeror and persons acting in concert with it.[166] If the offeror already holds a significant voting right in the company before the offer, the effect of the abovementioned requirement will be very stark because the higher percentage of voting the offeror already holds, the considerably higher degree of positive actions from outside shareholders is needed.

As prescribed in the definition of control, the threshold of 30%, which is lower than 50% as the majority rule implies, "*to a large extent stops the management being hamstrung by a large shareholder who obstructs without controlling.*"[167] Indeed, this threshold is just the threshold which initiates the mandatory bid rules. The chilling effect of the mandatory bid rule on stake building is apparent as empirical evidence has documented that some shareholders just limit their control stake right below the threshold in order to avoid the initiation of the mandatory purchase bid.[168]

In addition, legal rules on the maintenance of the percentage of the shares in which a person has already been interested is still in place. Indeed, any change of 1% or more of any class of relevant securities of an offeror or offeree company during an offer period is required to be disclosed.[169] Thus, the speed of stake building is still subject to disclosure, though no longer control, during the offer period.

The exposed and restricted stake building in the UK can in fact work as deterrents to the occurrence of takeovers. Additionally, special consideration—cash or cash alternative in transactions may also impose a further financial impediment on offeror companies.[170] Thus, the disclosure scheme in takeovers in reality provides the offeree company an opportunity to identify potential offeror companies and also in some way an opportunity to seek self-defence or favourable white knights.

Alternatively, the stringent restriction on stake building can substantially increase the cost of block holding, a situation which may help to form the dispersed

[166] Takeover Code r. 9.3.
[167] Charkham and Simpson, (1999), at 93
[168] Goergen and Renneboog, (2001), at 258-84
[169] Takeover Code r.8.3 (a).
[170] General Principle 5 states: "*An offeror must announce a bid only after that he/she can fulfil in full any cash consideration, if such is offered, and after taking all reasonable measures to secure the implementation of any other type of consideration*." And Takeover Code r. 2.5 (c) and r.11.1.

shareholding.[171] Thus, stringent disclosure of interests and that of the change of interests in shares in takeovers not only constrain the observed pro-takeover stance widely recognized in the regulation of takeovers but also help to shape the dispersed shareholding structure in the corporate sector in the UK. In other words, regulations specific to takeover transactions may produce ripple effects on corporate governance practices when companies are in their normal life.

2. Shareholders of the Offeror Company

Empirical evidence in the second chapter has shown us that even though takeovers may bring a premium to offeree shareholders, returns to offeror shareholders are modest or negative. As Gregory summarized, post-takeover performance is '*not compatible with shareholder wealth maximising behaviour on the part of acquiring firms' management*'.[172] Thus, it is precarious to draw the conclusion that takeover transactions help to align the interests of the management with those of shareholders at least from the perspective of the offeror company.

Generally, the Takeover Code does not pay attention to offeror shareholders. However, general corporate rules on shareholders' approval of the issued share capital incremental and any delay of the payment of dividends declared[173] may be relevant. Moreover, company law stipulations on financial assistance for purchases of own shares may be of special importance if the takeover transaction is made on a share-for-share transfer.[174]

Besides, if the offeror company is of a similar size to or a smaller size than that of the offeree company, *i.e.*, when a "reverse takeover" arises, the offeror board may face conflicts of interests if there are significant cross-shareholdings between the

[171] Black, B., *Shareholder Passivity Reexamined*, (1990), *Michigan Law Review*, 89:520.
[172] Gregory, (1997).
[173] For the former, see CA1985 Table A Article 32, but notice that no provision in the articles can fetter the power of the company to increase its share capital, see *Russell v Northern Bank Development Corpn Ltd* [1992] 3 All ER 161, [1992] 1 WLR 588, HL; *Bond v Barrow Haematite Steel Co* [1902] 1 Ch 353 and for the latter, *Re Accrington Corpn Steam Tramways Co* [1909] 2 Ch 40, where declared dividends are debts payable to shareholders.
[174] See CA 2006 ss677-683 (replacing CA 1985 ss151-158), and Takeover Code r.8.1 on disclosure of dealing on own shares) and 3.37.4 on redemption or purchase of securities by the offeror company.

two companies, or an overlap of directorship, or if a person has a substantial interest in both companies.[175] The Takeover Code accordingly requires the offeror board to obtain competent independent advice on such issues. In addition, financing for the offeror company may be inevitable in reverse takeovers. If the offeror company further wants to raise capital through a rights issue, existing shareholders may enjoy the benefits of the mandatory pre-emptive rights if such rights are not defaulted.[176] Accordingly, minority shareholders can be protected in proportion to their original shareholding.

Alternatively, Listing Rules also stipulate that shareholders' approval is required if the transaction may lead to a reverse takeover or if the value of the assets of the proposed acquisition or disposition exceeds 25% of the assets, profits, turnover, market capitalization, or gross capital of the offeror company.[177]

C. SHAREHOLDERS IN GOING PRIVATE TRANSACTIONS

Once an offeror acquires or agrees to acquire 75% or more of the voting rights of the offeree company, the offeror must notify the circumstance to offeree shareholders so that remaining offeree shareholders can decide whether to continue their holding of the shares of the company.[178] As the percentage of the shares of the offeree company in public hands falls below 25%, the listing status of the offeree company will be cancelled.[179] The end result of such transactions is usually that the public company will be transferred into a private company. We will discuss this type of transactions in this section.

1. Vote Trading

The current resurgence of private equity and hedge fund backed 'going private' transactions has already changed the vista of shareholders' voting activities.

[175] Takeover Code r. 3.2.
[176] See discussion in Part II B.1. (c).
[177] LR 10.2 (significant transactions); LR 10.5 (class 1 transactions); LR 10.6 (reverse takeovers).
[178] LR 5.2.10R and LR 5.2.11R.
[179] LR 5.2.1R.

Taking advantage of creative financial derivatives, such funds can exercise abnormal voting rights at shareholders' meetings. For example, by using short selling, pension funds can borrow shares and the attached voting rights before the meeting and exercise those voting rights for their specific strategic purposes.[180] Thus, these funds are distinctively active compared with traditional institutional shareholders.[181]

The essence of vote trading is the transfer of voting rights which are separated from the co-existing cash flow rights. In practice, some votes are even sold for zero, indicating that some sellers just want to transfer the vote to others, who may exercise them more effectively and efficiently due to, for example, buyers' information advantage.[182] Given the recent success of such funds, an important implication of vote trading is the potential widespread action in concert among other shareholders.[183] As a result, shareholders with disproportionate voting rights may distort the vote control structure of a company as implied in the one-share-one-vote and dispersed shareholding norm.

The Takeover Panel, after consultation, decided not to deem share borrowing and lending *per se* as dealings for the purpose of acting in concert though a person will be treated as interested in the securities he has lent but not in those securities he has borrowed.[184] Such regulations, again, prioritize the self-regulatory role of market itself. The end result of such regulations is still too early to tell.

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[180] FSA, *Short Selling*, (2002), Discussion Paper 17. Short selling usually involve four transactions 1) securities are sold short; 2) same number of securities is borrowed to meet the requirement of the buyer; 3) same number of securities are purchased at some later date; and 4) the purchased securities are returned to the lender. The artificially designed separation of the shares with voting rights from the economic owner may help borrower achieve its own agenda on the shareholders meeting. See Geczy, C. , *et al.*, *Stocks Are Special Too: An Analysis of the Equity Lending Market*, (2002), *Journal of Financial Economics*, 66:241-269; and Hu, H., and Black, B., *Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership*, (2006), *Journal of Corporate Finance*, 13(2-3):347-367, also available at *http://ssrn.com/abstract=874098*.

[181] Kahan, M., and Rock, E., *Hedge Funds in Corporate Governance and Corporate Control*, (2006), University of Pennsylvania Law Review, 155(5): 1021-1093, also available at *http://ssrn.com/abstract=919881*.

[182] This is testified by the less vote trading in the UK (compared with that in the US) where governance standards warn of misuse of votes. See Christoffersen, S., *et al.*, *Vote Trading and Information Aggregation*, (2007), *Journal of Finance*, forthcoming, ECGI Working Paper No.141/2007, available at *http://ssrn.com/abstract=686026*.

[183] FSA, *Private Equity*, para.4.35.

[184] Takeover Code r. 8, also see the Takeover Panel, *Dealings in Derivatives and Options*, PCP 2005/2, issued on 13 May 2005, para.6.37.

2. Fair Treatment of Shareholders in Going Private Transactions

The proactive role of hedge funds and private equity can be apparent on both the selling side and the buying side. With their voting rights, such funds can either argue for a much better price by rebuffing an offer so that other offeree shareholders can benefit from the premium or facilitate a takeover offer to displace the incumbent management. Alternatively, if they hold shares of the offeror company, they may force the offeror company to reconsider an excessive bid price.[185]

Despite the positive evidence on going private transactions, fair treatment of dissenting shareholders is of special importance in such transactions. It is true that dissenting shareholders in such transactions can get a fair price for their shares. Still, the disapplication of relevant Listing Rules may deprive them of the benefits of mandatory information disclosure and much worse their shares can no longer enjoy the liquidity provided by the stock exchange. Accordingly, it may be more advisable for dissenting shareholders to exit than to remain in the private company. However, the justice of this process is worthy of a second thought since the positive financial gains may well be achieved through alternative routes.[186]

Moreover, buyout transactions are also a menace to the check and balance mechanism implicit in the governance scheme.[187] For one thing, minority shareholders are deprived of a right to pursue their own economic benefits. Vote-controlling shareholders can take advantage of their legal control of the board to influence the biding policies. Viewed from this perspective, vote-controlling shareholders' exercise of their voting rights impinge upon the property rights of the minority shareholders and lead to unfair dealing by breaching the free consent rule. For another, even though directors are agents of the company, their fiduciary duty to the company is dramatically distorted by the existence of the vote-controlling

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[185] Bratton, W., *Hedge Fund and Governance Targets*, (2007), ECGI Law Working Paper, No.80/2007, available at *http://ssrn.com/abstract=928689*, a similar argument is also applicable to private equity funds.
[186] Bierman, H., *Legal Highway Robbery: The MBO Strategy*, (2006), Cornell University Johnson School Research Paper Series #05-06, available at *http://ssrn.com/abstract=904663*.
[187] Kahn, F., *Freezeout Doctrine: Going Private at the Intersection of the Market and the Law*, (2007), *Business Lawyer*, 62(3):775-912, also available at *http://ssrn.com/abstract=952331*.

shareholders, who can re-elect board members to their own interests. In other words, "*the controllers' powers defeats the system of checks and balances established in the system of corporate governance.*"[188]

D. SHAREHOLDER SUPREMACY IN TAKEOVERS?

It is true that the City Code did state that "*it is the interests of shareholders as a whole that directors shall take care of*".[189] This focus created by the City Code and other rules relevant to takeovers has been challenged by scholars with a stakeholder orientated view of corporate governance. Even though the evidence regarding the overall effect of hostile takeovers is still inconsistent, "*What can be said with some confidence is that the City Code sets up a regime that focuses director attention in the conduct of a bid on the immediate question of whether it is in shareholders' best interests to accept a tender offer.*"[190]

However, the City Code does not compare supremacy of the interests of shareholder with those of the other stakeholders. Furthermore, it is necessary to understand the difference between the means and the ends. What the Code stated was not the objectives of the regulation but the means to regulate the behaviour of directors. To take care of the interests of shareholders as a whole has special meanings in the City Code: 1) equal treatment among shareholders, *i.e.*, shareholders should not be treated differently within the same class, and 2) directors are required to put the interests of shareholders, collectively, before their own interests. Since the former point is to avoid the potential coalition between some shareholders and directors, it can be concluded that the promotion of shareholders' interests in takeovers is a safeguard against the discretion of self-interested directors.

Recently, in alignment with s172 of the Companies Act 2006, the General Principles of the Takeover Code restate that "*the board of the offeree company must act in the interests of the company as whole*" and the board of the offeree company

[188] Kahn, (2007), at 108.
[189] General Principle 1 of the City Code 2002.
[190] Armour, J, *et al.*, *Shareholder Primacy and the Trajectory of UK Corporate Governance*, (2003), *British Journal of Industrial Relations*, 531-555.

must also present its own view on the potential effects of the bid on "*employment, conditions of employment and the locations of the company's places of business.*" In other words, even though shareholders are still the cynosure of the Takeover Code, the Takeover Code expressly states that shareholders are not the only consideration for offeree boards, more or less mitigating the claim of supremacy of shareholders in takeovers. This is, however, largely a legal recognition of the management reality of directors' multi-criteria decision making process.

PART V. SHAREHOLDERS IN INSOLVENCY

Shareholders' interests in insolvency are clearly determined by the stance of corporate insolvency law. A legal scheme which aims to save a company as a going concern is totally different from a legal scheme that aims to wind up a distressed company so as to distribute anything left. With the former being the objective of insolvency law, it will be hard to deny the role of shareholders in the rescue process. This is especially the case where a strong pro-management attitude is adopted. For instance, the insolvency procedure under Chapter 11 of the US bankruptcy law is initiated by the incumbent management, with whom shareholders can accordingly press creditors to accept some compromised terms either by delaying the legal procedure or by asking for a judicial evaluation, the result of which may be different from that made by the creditors alone. Indeed, according to one study, shareholders in the US actually never end up with nothing.[191]

For an insolvency system with the latter objective, the liquidation scheme is accentuated and the interests of creditors are prioritized. Interests of shareholders are considered with the ultimate objective to safeguard the interests of creditors. However, a promotion of the corporate rescue culture with adherence to the pro-creditors principle can also benefit shareholders. This is because on the one hand shareholders will not be in a worse condition than otherwise if the company goes into liquidation while on the other hand, if the company is saved, the increasing share price will reflect the real value of the company, benefiting shareholders.

[191] LoPucki, L. and Whitford, W., *Bargaining over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, (1990), *U. Pa. L. Rev.*, 139:125.

In the UK, the current insolvency scheme is still forcefully pro-creditor even though corporate rescue is promoted. Rights of shareholders have to be considered bearing in mind the predominance of the interests of creditors, an overriding principle of corporate insolvency law in the UK. Indeed, except for the Company Voluntary Arrangement under the Insolvency Act 1986 and the statutory arrangement under s425 of the CA1985,[192] shareholders in the UK are subject to stringent statutory restrictions and enjoy less discretion compared with their counterparts in the US. For example, in the quite often adopted Administration, shareholders have no decision-making rights in approving the administrator's proposal.

A. THE ROLE OF CONTRACTS

As said, the role of insolvency law is to provide a statutory mechanism to govern the interests of insolvency participants. Contractual rights of participants, including shareholders, are strictly constrained. Still, insolvency may not only be initiated when the company is in distress but also when the company is still healthy as a going concern. In law, both the Company Voluntary Arrangements under Part I of the Insolvency Act 1986 and statutory arrangements under s425 of the Companies Act 1985 are initiated without the requirement that the company falls into insolvency. Shareholders can accordingly play an important role through voting rights attached to shares in these two rescue processes.

However, to discuss the role of contracts in insolvency, we may have to include arrangements under s110 of the Insolvency Act 1986. Since arrangements under s425 of the Companies Act 1985 and s110 of the Insolvency Act 1986 are both statutory arrangements, this author will categorize them under a separate rubric. This said, it must be realized that contractual arrangements in insolvency, either relevant to shareholders directly or indirectly, are stringently regulated by law. Besides, due to the strong negotiating power of institutional shareholders in corporate rescue especially when a company can still be deemed as a going concern, institutional shareholders in insolvency is discussed as a separate issue in this section.

[192] To be replaced by Parts 26 and 27 of the CA 2006.

1. Company Voluntary Arrangement

Section 1(1) of the Insolvency Act 1986 provides that if the company is a going concern and neither an administration order nor an order of winding up is in force, directors can initiate such arrangements. Under this condition, shareholders' proposal to initiate a CVA may only be meaningful if they can persuade the board to do so.

However, directors must acquire approvals from both shareholders and creditors. While a three quarter approval by creditors voting by proxy or in person, with reference to the value of their claim, is required,[193] a minimum of 50% approval is needed of members who vote in person or by proxy.[194] Once approved by both the shareholders and the creditors, the arrangement is binding on all parties who in accordance with the rules had notice of, and who are entitled to vote at, the meeting.[195] The discrepancy of the minimum quota thus indicates that interest conflicts among creditors are prioritized rather than those among shareholders in CVAs.

In the case of any arising conflicts between the decision of creditors and that of members, the former prevails over the latter though shareholders entitled to vote at the meetings may challenge such a decision at the court on the basis of "*unfair prejudice*" or "*material irregularity*".[196] Moreover, the right of secured creditors to enforce their security cannot be compromised by a CVA.[197] It can thus be seen that although shareholders' voting rights function as constraints on the discretion of the directors, they are effectively constrained by the interests of creditors.

[193] IR 1986 r.1.19(1).
[194] IR 1986 r.1.20(1).
[195] IA 1986 s5.
[196] IA2000 Sch. 1 para. 36.
[197] IA1986 s7(2). Also, see Finch, V., *Corporate Insolvency Law Perspective and Principles*, (2002), CUP, at 354-5.

2. Institutional Shareholders in Insolvency

In exercising their contractual voting rights, fund managers of institutional shareholders must ensure that they meet their trust law duties to their beneficiaries. In *Bartlett v. Barclays Bank Trust Company Ltd.*, [198] the beneficiaries of a trust fund successfully sued the trustee who held shares of a company for its approval of the bankruptcy of the company without due consideration of the prospects of the company. Though the company in that case was a private company where shares do not have a liquid market to exit, a similar line of reasoning can be extended to institutional shareholders in public companies due to the lock-in effect of institutional investment. Thus, fund managers of institutional shareholders in exercising their voting rights in insolvency must take due care of their duty under the trust law.[199]

Still, it must be realized that corporate rescue may also be carried out without recourse to creditors. Instead of negotiating with creditors, a company may alternatively make a rights issue to existing shareholders for the continuing operation of the company. Unless the pre-emptive rights of existing shareholders are defaulted, shares thus issued must first be issued to existing members of the company. But in such cases, institutional investors may require in the first instance a shake-up of the incumbent management before agreeing to participate in the rescue efforts.[200] In other words, institutional shareholders can take advantage of their negotiating power to improve the governance efficiency.

B. THE ROLE of LAWS AND REGULATIONS

1. Shareholders in Administrative Receivership and Administration

Even with the modification of the Enterprise Act 2002, administrative receivers are assigned mainly for the interests of floating charge holders though with a

[198] [1980] Ch 515
[199] Charkham and Simpson, (1999), at 144-5.
[200] Armour J., *et al*., *Corporate Ownership and the Evolution of Bankruptcy Law Lessons from the UK*, (2002), *Vand. L. Rev*., 55:1699-1786, at 1761.

due consideration of the interests of the company.[201] Shareholders have little say in administrative receivership.

Alternatively, corporate rescue can be pursued through administration. The court order of administration can only be made for one or more of the following purposes: 1) to save a company as a going concern; 2) to achieve a CVA; 3) to achieve an arrangement under s425 of the Companies Act 1985;[202] and 4) to more advantageously realize the assets than otherwise under a winding up.[203] The appointment of an administrator is accordingly intended to turn around the distressed company, interests of which overlap those of shareholders.

The statutory framework does stipulate that shareholders may claim to have an interest in the company so that their opinions can be heard on the petition regarding the appointment of an administrator.[204] However, shareholders may find it hard to establish their *locus standi* in challenging the appointment of an administrator. In *Re Chelmsford City Football Club (1980) Ltd.*,[205] such a claim was refuted, as the interest claimed by the shareholders is an interest in the future if the company goes on satisfactorily, rather than a "*tangible interest*"[206] in the company.

Interests of shareholders in administration are further marginalized as shareholders are generally not involved in approving the administrator's proposal. Indeed, the decision power is given to creditors alone[207] though the law does stipulate that shareholders have the right to be informed of the potential changes[208] and may apply to the court if they find that the proposal of the administrator, if implemented, will compromise their interests either generally or partially.[209]

The marginal consideration of the interests of shareholders in administration is

[201] Goode, R., *Principles of Corporate Insolvency Law*, (student edn), (2005), Thomson Sweet Maxwell, at 22-3.
[202] To be replaced by Parts 26 and 27 of the CA 2006.
[203] IA 1986 Sch B1 para. 3.
[204] IR 1986 r.2.9(1)(g).
[205] *Re Chelmsford City Football Club (1980) Ltd.*, [1991] B.C.C. 133 (Ch D).
[206] *Re Rica Gold Washing Co*. (1879) 11 ChD 36, per Jessel, M. R., at 43.
[207] See IA 1986 Sch B1 paras. 50, 51 and 56.
[208] IA1986 Sch B1 para. 49(4).
[209] IA 1986 Sch B1 paras. 74(1) and (2).

largely made out of a concern of fairness.[210] Considering the usual assumption that interests of shareholders usually give way to those of creditors in insolvency, the procedural protection set up for shareholders is especially important in establishing an environment of co-operation, which '*an efficient system of administration vitally requires*.'[211] Nevertheless, the role of shareholders in administration is supplementary to that of creditors and, as said, is largely marginalized.

2. Shareholders in Liquidation

Liquidation in law includes the winding-up, the gathering of assets and the ensuing distributions though it is usually identified with the winding up. The law stipulates that liquidation can happen in three forms 1) Members Voluntary Liquidation (MVL), 2) Creditors Voluntary Liquidation (CVL), and 3) Compulsory Liquidation (CL). A CL is mainly made from the perspective of the creditors' interest and the result is often the dissolution of the company. In CLs, courts play a predominant role in the whole process and distribution to shareholders is rare since CLs occur almost always when there are not enough assets to meet the company's liability. Thus, CL will not be the main topic in the following discussion.

(a) Shareholders in MVLs and CVLs

Member's Voluntary Liquidation (MVL)[212] allows a solvent company to end its life and distributes its surplus assets to its members either through paying final cash dividends or by distributing *in specie* of the assets. An MVL may happen when the purpose of the company has been achieved or the conflicts among shareholders develop to the extent that only liquidation of the company is appropriate to exploit the value locked in the company.

Generally, an MVL is member focused and controlled and thus is beneficial to the members. Creditors are excluded from the decision making process but fully

[210] Finch, (2002), at 294.
[211] *ibid*.
[212] IA 1986 ss91-96.

protected because an MVL is initiated on the basis that any debt will be repaid in full. Also, strict rules are imposed on the declaration of solvency.[213]

Furthermore, if the liquidator finds the company cannot pay its debts in full within the stated period, he has the right to convert an MVL to a CVL.[214] Given the strong role of reputation played among insolvency practitioners, it will be rare that liquidators will not make an announcement of a CVL once the legal conditions are met. Again, shareholders' discretion in MVLs is under strict control of insolvency practitioners directly and that of creditors indirectly.

In comparison, it is usually directors who initiate the proposal in a CVL though approvals from both members and creditors are necessary.[215] Moreover, even though both shareholders and creditors can appoint the liquidator, it is the creditors' appointment which has the priority in CVLs.[216] Accordingly, a CVL is an end result of negotiations between the company and its creditors. Shareholders may have their interests considered by the incumbent management but it is creditors who decide the fate of such proposals.

(b) Shareholders' Liabilities in Liquidations

In liquidations, shareholders who have subscribed to shares have to pay up their subscription if any amount remains outstanding. [217] In addition, shareholders may also bear responsibilities to third parties even after the dissolution of the company. For example, if a later judgment (as in a tort case involving product liability) requires the company to compensate for the loss of the third parties, shareholders may be sued for their shares of the distribution of the dissolved company. Shareholders' liabilities, in such a situation, may "*[arise] because the shareholders possess the distributed assets to which an equitable lien has attached*."[218]

[213] IA 1986 s89(1)-(4).
[214] IA 1986 s96.
[215] IA1986 s98(1).
[216] IA 1986 s100.
[217] See IA 1986 s74.
[218] Friedlander, G. and Lannie, A., *Post-Dissolution Liabilities of Shareholders and Directors for Claims against Dissolved Corporations*, (1978), *Vand. L. Rev*., 31:1363, at 1368.

(c) Distribution to Shareholders in Liquidation

The law expressly states that shareholders are the group that will share any assets left after the company meets its liabilities owed to the other non-shareholder stakeholders.[219] In fact, shareholders are unlikely to get anything in compulsory liquidations.

While shareholders in their capacity as shareholders are legally put at the end of the queue, it is possible that shareholders may still claim something in other capacities. An interesting issue is whether shareholders who are promised declared but unpaid dividends can be seen as unsecured creditors. On the one hand, dividends are a distribution to shareholders in their capacity of shareholders, whose claims thus should be met last. But on the other hand, common law has also established that shareholders can sue the company for any unpaid but declared dividends.[220] In that case, are unpaid declared dividends shareholders' loans to the company?

Case law tells us that to succeed in such claims shareholders must provide additional evidence that such dividends have been employed by the company as such. In *Re L. B. Holiday & Co. Ltd*.[221], the argument by the main shareholder that unpaid declared dividends which have been used as working capital should be deemed as a loan to the company was denied. Though the company's account had labelled the unpaid dividends as working capital, the court still found that the evidence was not conclusive as there was no interest paid on these "loans". However, in *Re Rural and Veterinary Requisites Pty Ltd*.[222], the court accepted the evidence contained in the company's accounts and tax returns as sufficient to support the claim that unpaid but declared dividends can be deemed as loans to the company and shareholders accordingly enjoy a similar protection to that for unsecured creditors. Thus, to claim unpaid declared dividends as loans to the company, shareholders must provide

[219] See IA 1986 s107 and s154. No exactly corresponding provisions exist for compulsory winding up, however, the same rules apply, see IR 1986 r. 4.181(1).
[220] *Bond v Barrow Haematite Steel Co.* [1902] 1 Ch 353; *Re Accrington Corpn Steam Tramways Co.* [1909] 2Ch 40.
[221] [1986] 2 All E.R. 367.
[222] (1978) 3 A.C.L.R 597.

additional evidence to show that such dividends have been employed as loans rather than merely labeled as loans. Otherwise, it is hard for shareholders to get paid.

The specific case of dividend distribution in liquidation in effect further sidelines the consideration of the interests of shareholders. In fact, declared dividends should be seen as a contract between the company and shareholders and unpaid dividends are deferred contractual debts of the company. The intentional marginalization of shareholders' claim for the declared but unpaid dividends is thus "a *rare example of a deferred debt arising in corporate insolvency law*."[223]

3. Shareholders in Statutory Arrangements

(a) Section 425 of the Companies Act 1985

The low rate of adoption of s425 of the Companies Act 1985[224] has long been attributed to its prolonged and complex procedure.[225] However, the scheme under s425 of the Companies Act 1985 has its own merits in that incumbent management may still be in control of the company.[226] Under such arrangements, a company can make compromises or arrangements with either creditors or shareholders, or classes of them. Still, intervention from the courts is mandated to ensure a "*fair and reasonable*" scheme.[227] An approval at meetings is required from 75 percent in value of members, creditors or classes of them.[228] Moreover, the law also requires the company to notify debenture holders of the company if the interests of the latter are affected.[229] In other words, shareholders' decision making rights are subject to the court approval and a consideration of the interests of debenture holders under the arrangement of s425 of the Companies Act 1985.

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[223] Milman, D., and Durrant, C., *Corporate Insolvency: Law and Practice*, (2nd edn), (1994), London Sweet and Maxwell, at 126.
[224] To be replaced by Parts 26 and 27 of the CA 2006.
[225] Both the Cork Committee (*Bankruptcy: Interim Report of the Insolvency Law Review Committee*, (1980), Cmnd 7968 para 406) and the DTI (the Company Law Review, *Final Report*, para. 13.10) notice the problem.
[226] For advantages of the scheme, see Finch, (2002), at 326.
[227] *Re ABgki-Continental Supply Co. Ltd* [1922] 2 Ch 723; *Re RAC Motoring Services Ltd* [2000] 1 BCLC 307.
[228] CA 1985 s425(2) replaced by CA 2006 s899.
[229] CA 1985 s426(4) replaced by CA 2006 s897(3).

Considering that the management in distressed companies may more often lose interests in any recovering activities,[230] the constraints by either creditors or shareholders are important. Again, shareholders' contractual voting rights are employed to constrain the discretion of the board. Moreover, the law clearly prioritizes the interests of debenture holders. Thus, the grant of decision-making rights to shareholders is still considered within the general pro-creditor stance of insolvency.

Alternatively, minority shareholders may get relatively better protection under s425 of the Companies Act 1985. It is true that shareholders' apathy is advantageous to the offeror company in the statutory arrangement because only shareholders present and voting at the meeting or those voting by proxy are calculated. However, holders of 25% or more in value of the shares can effectively initiate opposition to the view of the majority. In comparison with the usual requirement of 50% or more in value under the other types of transactions, arrangements under s425 of the Companies Act 1985 thus provide minority shareholders a better opportunity to uphold their own interests.

2. S110 of the Insolvency Act 1986

In conjunction with a voluntary winding up, a sale or a transfer of a company's undertaking may be proposed. Such transactions are covered under s110 of the Insolvency Act 1986. If such a transaction is the result of a MVL, a special resolution of the company is required. Alternatively, if such a transaction is the result of a CVL, the approval of the court or the creditors is required.[231] Such arrangements are binding on all members of the company. Nevertheless, power authorized in the memorandum cannot be designed in such a way to avoid compliance with s111 of the Insolvency Act 1986,[232] which aims to protect disaffected minority shareholders. Thus, it can be seen that once interests of shareholders are considered, minority shareholder protection is almost always an accompanying concern.

[230] Cork Report, para. 417.
[231] IA 1986 s110 (3).
[232] *Bisgood v Henderson's Transvaal Estate* [1908] 1 Ch 743. But notice that s111 applies when s110 is used in a MVL but does not in a CVL.

CONCLUSION

This chapter starts with the discussion of social political issues relevant to shareholders. The implication of social political issues is multifarious. First, since a company as an organizational form developed from partnership, shareholders are historically vested with rights to appoint members on the board and to vote on corporate strategic issues in law. Second, the promotion of social democracy in the UK paves the way for protecting minority shareholders. Third, despite the dispersed shareholding structure and the one-share-one-vote business norm at the company level, the institutionalized shareholding structure indicates that voting power controlled by institutional shareholders in the corporate sector as a whole is of importance. However, we should note the difference between shareholder activism in individual companies and that in the corporate sector. The observed nonchalance of institutional shareholders in the governance practice in individual companies is not a surprise but a cost-efficient option which is selected partly due to the diversified investment policy and partly due to the agency costs inherent in the management of institutional shareholders in individual companies. The role of institutional shareholders' activism is more likely to be expressed in the general governance issues across all the companies rather than in any specific individual company even though the potential legal intervention can partly explain the current activism of institutional shareholders.

We then discuss how interests of shareholders are protected in the life cycle of corporate governance. In general, shareholders establish a legal relationship with a company through contracts by purchasing shares. Interests of shareholders are in essence the interests attached to shares. Our discussion shows that the interests of shareholders can be distinguished into internal and external parts. For the internal part, I mean the conflict between majority shareholders or block voting rights holders and minority shareholders. In this regard, legal protection for minority shareholders is highly promoted in the UK though shareholders' litigation has long been constrained by the principles established in *Foss v Harbottle*. For the external part, we see that the right of shareholders to vote differentiates them from the other stakeholders. This however can be justified by shareholders' rather unified profit oriented objective and the inhuman nature of shareholders, characteristics which facilitate their decision making process. Admittedly, the right to displace directors with no reason can lead directors to prioritize interests of shareholders in practice. However, we must realize that this right must first be understood as a counterbalance to the discretion of directors. Moreover, shareholders only exercise this right when the performance of the company is far below the benchmark of peer companies. The performance of a company, however, is determined by several factors, one of which is the use of other kinds of inputs, including those from both creditors and employees, in the company. This in turn refers to the multi-criteria decision making process of directors and also that of shareholders. In other words, shareholders' single-minded settlement on financial interests does not indicate that their decision making process is also a purely financial matter. In sum, shareholders' decision rights should be seen more as a counterbalance to the directors' discretion than as a tool to prioritize the interests of shareholders among those of the stakeholders.

In Part III, I discuss shareholders in flotations. In flotations, existing shareholders in private companies going public play their governance role mainly through their voting rights. The main governance issue for companies going public is rather outward than inward due to the conflict between the strong role of outside capital providers through their prior contractual arrangements with the company and the founders' intention to retain the control. Moreover, by discussing the contractual activities in share allotment in the flotation process, I argue that financial intermediaries such as underwriters, in coalition with institutional shareholders, may transfer wealth from the existing shareholders in private companies and directly make a difference to the resulting shareholding structure in the public company. Thus, despite strict mandatory information disclosure requirements, the institutionalized shareholding structure of public companies may have already been in place before the birth of such companies. Another implication of the share allotment process is that minority shareholders may suffer from the combined effect of underpricing in the share allotment process and the underperformance after flotation. However, the interests of minority shareholders are not particularly protected by law in flotations but by laws applicable to those companies in the normal life. Still, once companies go public, they are subject to more stringent governance rules than rules for private companies. Interests of shareholders can partially be enhanced by more stringent information disclosure and the requirements of the Combined Code.

Part IV covers the issue of shareholders in takeovers. In general, the UK adopts a pro-takeover stance, which, however, must be considered bearing in mind the stringent disclosure of changes in interests in shares and voting rights. Shareholders in takeovers are intentionally prioritized under the Takeover Code despite a modification in alignment with the enlightened shareholder value model in company law. The dual principles of the Takeover Code, *i.e.*, the non-frustration of the offeree board and the equality principle among offeree shareholders, ensures that offeree shareholders receive due and fair protection. However, shareholders' primacy in takeover rules may have to be discounted by directors' blockholding.

Also discussed in Part IV is the source of financial gains for offeree shareholders. The widely observed gains for offeree shareholders, however, cannot simply be explained by the co-existent losses for some other stakeholders. Other factors such as the synergistic gain or simply the fad for target shares may all contribute to the increasing price. To employ such evidence to claim for better protection for other stakeholders or to change the current governance structure is inadvisable.

In addition, I also examine vote trading activities in the recent resurgence of going private transactions backed by private equity and hedge funds. While vote trading can strengthen the negotiation power of funds, such activities also attract similar voting in concert among other shareholders. Given the non-interventionist view of the Takeover Panel and the FSA, the end result of such transactions is hard to tell. Moreover, though minority shareholders also share the premium arising from such transactions, they are passive followers in such transactions and are deprived of opportunities to exercise their voting rights. The implication of such transactions on the check and balance scheme implied in the governance institution is important.

I then discuss shareholders in insolvency in Part V. Given the strong pro-creditor insolvency scheme in the UK, shareholders are largely and effectively marginalized by laws and regulations. However, when corporate insolvency is initiated when the company is a healthy going concern, shareholders can play an important governance role through their voting rights. Where a company cannot be deemed as a going concern, protection for shareholders is minimal. Nevertheless, the current corporate rescue culture may partly demand proactive participation of shareholders. However, again, we observe that they are employed as the counterbalance to the discretion of directors and interests of shareholders are still constrained by the interests of creditors.

In sum, by employing their unique voting rights throughout the life of the company, shareholders can be differentiated from the other stakeholders. However, as observed, corporate governance rules relevant to all these three thresholds do not compel or require the supremacy of shareholders among stakeholders. But rather, *"the rule has been directed solely at constraining the impetus for decision-making, not at prescribing the outcome."*[233]

What these arguments boil down to is that shareholder primacy may not be an accurate description of the internal governance structure. In fact, more evidence supports the view that shareholders' voting rights are set up as a mechanism to constrain the discretion of directors. Viewed from this perspective, shareholders' voting rights are only a means to the end—to promote the interests of the company as a whole. In other words, shareholders may not be different from other stakeholders in that their main function is to constrain the discretion of directors.

Moreover, consideration of the social political issues introduces new elements into the understanding of the relationship between law and contracts. As background information, social political issues, as discussed, influence both the contractual process and the extent of the legal intervention. Still, the legal recognition of the contractarian view informs corporate rules relevant to shareholders. This device is important as "*little scope is given for the government intervention to protect shareholders*."[234] Law should only intervene when the market and the social institution do not work effectively. This said, the author does not intend to deny the distributive effects of law, which is not only an integral part of justice but also a precondition for economic efficiency. However, distributive effects of law should be

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[233] Worthington, S., *Shares and Shareholders: Property, Power and Entitlement Part* I1, (2001), *Company Lawyer*, 22(10):307-314, at 310.
[234] Hill, J., *Vision and Revision of the shareholders*, (2000), *Am. J. Com. L.*, 48:39, at 59.

achieved by the legal institution as a whole rather than in any specific law. Thus, shareholder-oriented corporate rules cannot be simply identified with a shareholder-oriented governance institution. A holistic approach to the corporate governance study is thus entailed.

CHAPTER 4. CREDITORS

INTRODUCTION

In addition to shareholders, creditors are also important finance providers. However, the role of creditors as stakeholders in the discussion of corporate governance is often understated. Indeed, creditors are often ignored other than in insolvency law.

One possible explanation is that creditors may well protect themselves through contractual arrangements when companies are going concerns. Once companies go into distress, interest conflicts intensify among different groups of stakeholders and different subgroups of creditors, a situation which necessitates strong legal intervention. Thus, the combination of contractual arrangements and contingent control rights in insolvency is a feature of the constraints on the interests of creditors.

As usual, I will discuss first in Part I the social political issues relevant to creditors. And then I put the protection of creditors into the perspective of the life cycle of corporate governance from Part II to Part V. A conclusion is given at the end of this chapter.

PART I. SOCIAL POLITICAL ISSUES

A. DISPERSED SHAREHOLDING BUT CONCENTRATED DEBTHOLDING

In the UK, the system of dispersed shareholding did not develop in tandem with the debt-issuance market. Even though dispersed shareholding can arguably be claimed to have come into shape in the UK in the years following the end of WWII,[1] the inflationary economic environment around that time made preferable bank loans

[1] See discussion in the former chapter.

with a floating interest rate.[2] High interest rates until the end of the 1990s further entrenched the primary status of banks in corporate finance by "*compelling companies to resort increasingly to borrowing from banks.*"[3] In comparison, the bond market has not developed to the same degree. It is true that concentrated bank loans are not the norm for public companies. However, the syndicated bank loans still cannot be comparable to the dispersed debt holding structure. Thus, the relatively limited development of the public debt market in the UK highlights the dominance of bank lenders as the main external financial source.

The end result of this historical development is that the usually observed dispersed shareholding in co-existence with dispersed debt structure is not the case in the UK.[4] Rather, dispersed shareholding at the level of individual companies co-exists with concentrated debt holding by banks. Such a concentrated debt holding by banks enhances the negotiating power of bank creditors both at the company level through private contractual arrangements and as a social class in the society to claim their due legal rights. For instance, an immediate effect of the concentrated debt holding structure is the outgrowth of a pro-creditor and management-displacing insolvency scheme. This is not only true in law in general but also the case in privately arranged corporate rescue efforts. In practice, the so-called "*London Approach*" can only be initiated by banks, who, rather than the management with the coordination of the creditors, have the right to approve the work-out plan proposed by the management and to decide the fate of the company and the incumbent management.[5]

B. THE STRONG MONITORING ROLE OF BANKS IN THE UK

Even though the UK and the US are similar in their dispersed shareholding structure, the financial market in the UK is comparatively less open and less market-

[2] Decisions to issue debentures are usually made on the basis of a fixed interest rate. A fluctuating interest rate, as in an inflation period, will bring too much uncertainty and unbearable loss to the corporate debtor on the public debt market. This in effect led to a preference for bank loans with floating interest rates. See Armour, J., *et al*., *Corporate Ownership and the Evolution of Bankruptcy Law Lessons from the UK*, (2002), *Vand. L. Rev*., 55: 1699-1786, at 1772-4.
[3] *ibid.*, at 1773.
[4] *ibid*.
[5] Brierley, P., and Vleighe, G., *Corporate Workouts, the London Approach and Financial Stability*, (1999), *Fin. Stability Rev.*, 7:168 and discussion in Part V of this Chapter.

oriented. In fact, companies seeking capital more often resort to the debt market for funds rather than raising new equity capital.[6] Thus, the strong stock market in the UK has often overshadowed the fact that debt is a more important financial source for companies than share issuance.[7]

One important characteristic of such reliance on banks is that UK companies rely very heavily on banks' short-term loans.[8] The usage of short-term loans indicates more frequent renegotiation and recontracting, which may help outside banks monitor the performance of the company on a continuing basis. As a bad reputation on the debt market will increase the cost of capital for the debtor company, the company must be careful about its credit history and avoid a reputation for imprudence.[9] It is in this sense that some argue that market discipline plays a more important role in protecting the interests of creditors than those of shareholders.[10] In consequence, where creditors have long-term interactions with a company, it is justified that creditors should be included in the corporate governance structure.[11]

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[6] Bevan, A., and Danbolt, J., *Dynamics in the Determinants of Capital Structure in the UK*, (2000), University of Glasgow Dept. of Accounting & Finance, Working Paper Series, available at *http://ssrn.com/abstract=233551*; Cosh, A. and Hughes, A., *British Enterprises in Transition*, (2000) ESRC Centre for Business Research, available at *http://www.cbr.cam.ac.uk/pdf/BEITexec.pdf*; Franks, J., and Sussman, O., *Financial Distress and Bank Restructuring of Small to Medium Size UK Companies*, (2005a), *Review of Finance*, 9(1):65-96, also available at *http://ssrn.com/abstract=428042*.

[7] Prowse, S., *Corporate Governance in an International Perspective: A Survey of Corporate Control Mechanisms Among Large Firms in the US, UK, Japan and Germany*, (1995), *Fin. Markets, Institutions, and Instruments*, 4:1.

[8] Spencer, P., *The Structure and Regulation of Financial Markets*, (2000), OUP, Ch12.

[9] Morris, R., *Directors' Duties in nearly Insolvent Corporations: A comment on Creditor Lyonnais*, (1993), *Journal of Corporation Law*, 19:61, at 66.

[10] Tauke, D., *Should Bonds Have More Fun? A Reexamination of the Debate over Corporate Bondholder Rights*, (1989), *Colum. Bus. L. Rev.*, 1-136, at 30.

[11] Stiglitz, J., *Credit Markets and the Control of Capital*, (1985), *Journal of Money, Credit and Banking*, 17:133-52.

PART II. CREDITORS IN THE NORMAL LIFE

A. THE ROLE OF CONTRACTS

1. Contractual Terms

The formulation of debt contracts in the UK is normally standardized.[12] The standardization is effective in maintaining coherency in loan contracts and saving costs of financial management for both sides.[13] However, it must be realized that the standardized boilerplate in the debt contracts can only be seen as a balance reached between the contractual parties in the long-term development of market practice. A loan contract with a worse protection to the creditors than that provided generally by the market may well be forced out of the market.

In practice, debt contractual terms can largely be categorized into three groups. Terms in the first group are regarding the mechanics of the debt itself, including the term, the amount, the interest, *etc*. of the loans to be issued. These technical terms are case-sensitive and market-dependent and are thus out of the scope of this thesis. Terms in the other two groups are about the legal protections and legal liabilities of the creditor and the corporate debtor respectively. Important for creditors are covenants to constrain the discretion enjoyed by the debtor and various forms of security.[14] We will discuss them in sequence.

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[12] Day, J., and Taylor, P., *Evidence on the Practices of UK Bankers in Contracting for Medium-term Debt*, (1995), *Journal of International Banking Law*, September: 394-401; *Bankers' Perspectives on the Role of Covenants in Debt Contracts*, (1996a), *Journal of International Banking Law*, 5:201-205; *Loan Contracting by UK Corporate Borrowers*, (1996b), *Journal of International Banking Law*,8:318-325; *Loan Documentation in the Market for UK Corporate Debt: Current Practice and Future Prospects*, (1997), *Journal of International Banking Law*, 1:7-14.

[13] Kahan, M. and Klausner, M., *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, (1997), *Virginia Law Review*, 83(4):713-770.

[14] Lehn K., and Poulsen, A., *Contractual Resolution of Bondholder-Stockholder Conflicts in Leveraged Buyouts*, (1991), *Journal of Law and Economics* 34: 645-673; Smith, C., and Warner, J., *On Financial Contracting: An Analysis of Bond Covenants*, (1979), *Journal of Financial Economics*, 7:117-130.

(a) Covenants

Covenants are widely used in debt contracts in the UK.[15] Generally, covenants can be distinguished as negative covenants and positive covenants.[16] Negative covenants preclude debtors from doing something that will dilute the interests of creditors, like the disposition of the debtor's assets. Positive covenants are those covenants through which a certain situation of the debtor must be maintained. This category may include keeping the legal status of the company, keeping certain staff, or some other positive performance by the corporate debtor. Both are important in protecting the interests of creditors.

The constraining effect of covenants functions mainly through the potential exit of creditors in cases of defaults of covenants. Creditors' exit can take multiple forms: they may stop any further financing; they may accelerate the maturity of any existing debt contracts, or enforce its security imposed on the assets of the company. By threatening to enforce these multiform exits, a company debtor may either strive to avoid any default of the contract or to redress any deficiency in existence in order to retain these capital providers. The impact of bank exit upon management, as one scholar has already observed, "*is a function of the amount of indebtedness to the bank and the abruptness of the bank's exit.*"[17] Indeed, this effect may be amplified if a company has more than one major creditor since the exit of one creditor may engender a chain of exits from the other creditors, thus accelerating the speed of the collapse of the company. As initiating events in the covenants are always less serious than the judging criteria of solvency status employed in insolvency law, covenants first work as signals and then grant creditors with real power in renegotiating and designing new contractual terms.

Debt financing can thus be seen as a way to implement contingent control allocation, by which the control of the company will be transferred to creditors under

[15] Day and Taylor, (1995).
[16] Day, J., and Taylor, P., *The Role of Debt Contracts in UK Corporate Governance*, (1998), *Journal of Management and Governance*, 2:171-190, at 174.
[17] Triantis, G., and Daniels, R., *The Role of Debt in Interactive Corporate Governance*, (1995), *California Law Review*, 83:1073, at 1085.

certain conditions such as defaults or insolvency of the debtor.[18] The effectiveness of such covenants, however, is constrained by the incompleteness of the contract due to the substantial cost of writing, monitoring and enforcing the contract. Nonetheless, as creditors' interests are single-mindedly settled on the financial interests, a premium charged by creditors can thus help to mitigate or even cover all these potential concerns or dilution of their interests. For instance, one study finds that "*[A]ll the interviewees confirmed the existence of an unquantifiable but systematic relationship between covenants (and the stringency of their values) and the size of the risk premium incorporated in a loan's interest rate.*"[19] Indeed, some corporate debtors can even buy out these financial covenants.[20] In other words, there are clear indicators that risks involved in debt contracts can be compensated in financial tangibles. Therefore, covenants can be accredited as an effective method to safeguard the interests of creditors.

(b) Security

Creditors can also protect their own interests by setting up collaterals on their loans. Collateral has at least three legal functions for secured creditors.[21] First, it limits the debtor's property right over the collateral, encumbering the free transfer of the collateral in concern. Second, the secured creditor has priority to the other creditors on the collateral in meeting his particular debts. Third, the existence of collateral also provides an efficient and cheap enforcing method regarding the secured debt. Thus, a security not only grants secured creditors the control on the assets of the property but also entitles the secured creditors a first claim on the collateral in cases of insolvency or defaults and a right to the proceeds of the disposition of the collateral. As a result, the setting up of collaterals separates secured creditors from the collective distribution regime that usually controls the individual claims of unsecured debtors in insolvency.[22]

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[18] Aghion, P., and Bolton, P., *An Incomplete Contracts Approach to Financial Contracting*, (1992), *Review of Economic Studies*, 59:473-494.
[19] Day and Taylor, (1995), at 398.
[20] *ibid*.
[21] Lopucki, L., *The Unsecured Creditor's Bargain*, (1994), *Virginia Law Review*, 80:1887.
[22] But, secured creditors' claims may be suspended under CVAs and administrations under the IA1986. For a more detailed discussion, see Part V of this Chapter.

In a word, by inserting covenants and establishing security, creditors can effectively safeguard their interests at least for those emergencies expected *ex ante*. Given the fact that such clauses are usually written with the acceleration of the debt and/or a prohibition on any further financing, interests of creditors may have to be seriously considered by corporate debtors who keep reverting back to the credit market for additional financial support.

(c) Others

Creditors may also have a contractual right to nominate directors to the board. This is especially the case where creditors occupy a disproportionate negotiating power, such as venture capitalists in entrepreneurial financing. However, it should be noticed that even though creditors have the right to appoint directors to the board, shareholders have the right to remove them. Moreover, directors nominated by creditors, like other directors, can only act for the interests of the whole company rather than for their nominators. Besides, as will be discussed, legal prescriptions on the liabilities of shadow directors may well constrain creditors' active voice in corporate governance. Thus, even though contractual arrangements can grant banks opportunities to play their governance role either by voice, *i.e.*, active participation in the governance mechanism or by a threat to exit, the governance role of creditors' exit through contingency clauses and covenants in the loan contracts is worthy of special attention.

2. The Efficacy of Contractual Protection

(a) The Positive Side of the Argument

i) The Monitoring Role of Bank Creditors

Monitoring by bank creditors has several benefits. Usually banks make loans to their existing depositors or may require corporate debtors to open an account with them. By keeping a record of the current account, banks may notice both positive and negative signals of the financial situation of the company earlier than the other stakeholders.[23] For example, a delay of payment to customers or employees is an indicator of potential financial distress of the company. In addition, bank creditors usually invest in certain specific industries, a situation which makes them a good evaluator of the performance of a company within the industry. Thus, banks' possession of the credit history of potential debtors helps creditors to locate potential abnormal changes and to alert the company to improve its governance practice.[24]

Moreover, as a financial intermediary, a bank can act as a delegated monitor for other investors.[25] Covenants in debt contracts can effectively restrict the discretion of the management either for their own benefits or for the benefits of the shareholders at the cost of the other stakeholders, as happens in discretionary dividend payment or in takeovers. Also, creditors' exit from the company may send a negative signal to and thus enhance the opportunity and power of the voice of other stakeholders in the company. The signaling to other stakeholders of the reaction of creditors to company debtors may thus facilitate to set up an interactive governance structure,[26] benefiting all stakeholders.

In addition, compared with the mandatory public disclosure on the public debt market, private disclosure within the context of loan contracts may be preferred by the company debtors. For one thing, contractual parties can sign confidential agreements on relevant information corporate debtors do not want to disclose to the public. For another, banks have long owed a common law duty to keep confidence of their customers' account information.[27] Viewed from this perspective, information disclosure with the private creditors may be more efficient than mandatory disclosure on the public debt market.

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[23] Stiglitz, (1985).
[24] Black, F., *Bank Funds Management in an Efficient Market*, (1975), *Journal of Financial Economics*, 2:323.
[25] Campbell, T., and Kracaw, W., *Information Production, Market Signalling, and the Theory of Financial Intermediation*, (1980), *Journal of Finance*, 35:863.
[26] Triantis and Daniels, (1995). What the theory of interactive corporate governance refers to is that the voice and exit decision of any one stakeholder may work as either a positive or negative signal to the other stakeholders, thus the relationship between stakeholders may not necessarily be in conflict but may be complementary.
[27] *Tournier v. National Provincial & Union Bank of England*, 1 K.B. 461 (1924).

ii) Intentional Ambiguity and Lacuna in Incomplete Contracts

Admittedly, contracts cannot be complete. However, the admission of the incompleteness of contracts is not in conflict with the recognition that incompleteness may be intentional and preferable in practice.[28]

On the one hand, such ambiguity or incompleteness may be required or intentionally approved by contractual parties. For one thing, doing so may leave room for trust and reputation building. In fact, contractual parties seldom use all the extreme powers granted under the contracts. Terms granting such rights may more rightly be seen as threatening than penalizing. For another, some lacuna in contracts only reflect the reluctance of both contractual parties to negotiate and reach a contractual term either because of the low possibility of a distant happenstance or because of the extremely high negotiation costs compared with the potential benefits which might be achieved from such efforts. In such cases, contractual parties rationally approve such incompleteness in the contracts. For example, a credit ceiling, which is usually inserted in loan contracts to set a boundary to the potential loss to creditors normally co-exists with a clause of renegotiation between creditors and the debtor company. This is because exceeding the credit ceiling is not necessarily a bad indicator for creditors. For an expanding company, such exceeding can only be interpreted as a higher growth rate the company. Thus, a renegotiation of the contractual terms keeps both sides in a dynamic and mutually beneficial relationship.

On the other hand, designing other routes to eliminate the potential loss arising from incomplete contracts may also bring similar or even more costs. A pragmatic approach may be to improve the existing alternatives. The loss so incurred by the contractual parties or the wider society should be deemed as the cost we have to suffer, *i.e.* the loss is a deadweight loss.[29] A relevant example is the current debate on directors' fiduciary duty to creditors as an alternative to the current contractual protection to creditors. Admittedly, imposing on directors a fiduciary duty to creditors may help to strengthen the current protection for creditors. However, it may also bring similar or even more costs, such as the delay in decision making process, the disguise

[28] Tauke, (1989), at 45.
[29] This economic term has been widely used to describe permanent losses of well being to society if there is an inefficient distribution of resources, or the Pareto standard of efficiency is not met. See Posner, R., *Economic Analysis of Law*, (6th edn), (2003), Aspen Publishers, at 278-281.

of directors to claim the interests of creditors for their own interests, and possible restraints on reasonable risk taking by the companies, *etc.* Accordingly, improving the current contractual protection is preferable in most jurisdictions to imposing an additional fiduciary duty on directors.

iii) Neo-Classical Interpretation of the Ambiguities by Courts

Alternatively, improper protections for creditors arising from the incompleteness of contracts may more or less be redressed by the courts, which play a more important role than before in filling the gaps of incomplete contracts when interpreting the contractual terms.[30] Traditionally, courts follow the classical approach of the "*four corners of the contract*", within which parties have expressed their intentions, and cannot impose contractual terms contradictory to the intentions of the parties. Recently, the neo-classical approach predominates, which requires "*good faith*" from the contractual parties to achieve a result of fairness so that the contract will not destroy or injure the rights of contractual parties.[31] The invocation of good faith in the modern approach to the interpretation of contracts thus extends far beyond the literal language meaning of contractual terms as adopted by the traditional approach.

Indeed, except for the deadweight loss of the incompleteness of the contracts, the concern of the incompleteness of debt contracts for creditors centres on unexpected emergencies, against which the court will have to decide how creditors can be fairly protected on the basis of the existing contractual terms. Accordingly, by considering the entire context, courts will reconsider the ambiguity or lacuna in the debt contracts and imply terms into the contract, where necessary, for the underlying purpose of fairness to contractual parties and the wider public interest. That is, by interpreting the contracts to meet the fairness requirement, modern courts will at least relieve some concerns of the protection to creditors arising from the incomplete

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[30] Tauke, (1989), at 78-9 and Smith, S., *Contact Theory*, (2004), OUP, at 278-9.

[31] Smith argues: "*…part of the context in which many (though not all) contracts are formed is a set of (objectively) shared normative expectations about the fairness of the parties' respective obligations. It is part of the public meaning of many contracts, in other words, that vague terms should be reading a way that treats both parties according to ordinary ideas of fairness. The extent and significance of such expectations depends on the context in which the contract is signed; … In most contracts, however, such understandings are at least a part of the shared public meaning of the contract.*" See Smith, (2004), at 279.

contracts.

(b) The Negative Side of the Argument

i) The Incompleteness of the Contract

A contract cannot be complete at least because contractual parties cannot predict every exigency or happenstance in the future. Moreover, even if agreed in the contract, creditors' contractual protection, however, can still be subject to various limitations in performing the debt contract. For example, the difficulty in assessing the materiality of the defaults, which is usually stipulated as initiators of the acceleration of the maturity or the stoppage of further financing, may attenuate the intended protection provided by these covenants. Besides, information asymmetry between corporate debtors and creditors may engender 'hold-up' problems at the end of corporate debtor, who fails to disclose relevant information, exacerbating the situation of creditors.[32]

On the other side of the coin, the incompleteness of contracts also indicates that debt contracts have their own costs, such as the investigating, negotiating, monitoring, and performing costs. In order to safeguard their interests, creditors usually ask for a higher interest rate to compensate for such costs.[33] Thus, debt contracts suffer from their inherent deficiency of the incompleteness and the accompanying costs.

ii) The Competition on the Credit Market

Usually, companies resort to banks or other lenders when the accrual of their own profits cannot meet the demand of the development of the company, or if no alternative financial resources are available. In both cases, lenders enjoy a negotiating

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[32] Simply put, the hold-up problem will arise where investors tend to underinvest once they realize they only receive a partial return of their investment. See Grossman, S., and Hart, O., *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, (1986), *Journal of Political Economy*, 94:691-719 and Tirole, J., *Incomplete Contracts: Where Do We Stand?*, (1999), *Econometrica*, 67:741-81.

[33] Titman, S., and Wessels, R., *The Determinants of Capital Structure Choice*, (1988) *Journal of Finance* 43:1-20 and Smith Jr., C., and Watts, R., *The Investment Opportunity Set and Corporate Financing, Dividend and Compensation Policies*, (1992), *Journal of Financial Economics*, 32:263-292.

advantage, as it is the company who asks for help and accordingly the monitoring role of creditors may be apparent or easily achieved.

However, this advantageous position enjoyed by the lenders is not always the norm. Lenders with idle capital may be eager to lend it out since capital within their own hands will have costs. Companies with a prosperous future, for example, in a given industry or market, or well-established companies with a commendable historical record may thus be targets of these lenders. A creditor may thus often be trying to stand in the front of the queue of potential creditors. Overconfidence in the performance of the company among creditors may overshadow the inefficiency in the corporate debtor. As a result, the intensive competition on the credit market will make a difference to the relation between companies and financial institutions[34] In such situations, it is hard to be optimistic about the negotiating advantages of the creditors to insert effective covenants to safeguard their own interests.

iii) Special Cases of Involuntary creditors

In contrast with voluntary creditors, involuntary creditors get involved in the contractual relationship with a company passively rather than actively. Two often cited examples are tort creditors and employees. For tort creditors, the usual contractual protection is out of the question because they do not have the chance to negotiate, to monitor, and to avoid the risk.[35] Alternatively, employees may be involuntary creditors of the company when their wages are not paid in time and when their firm-specific human capital investment is not duly compensated. Contractual protection for involuntary creditors is thus far from satisfactory.

In sum, the freedom of the contractual parties to design their own contractual terms is one of the main benefits of the contract. By contracting, parties "*could adjust the legal framework to the content of their economic arrangements, rather than*

[34] Mayer, C., *New Issues in Corporate Finance*, (1988), *European Economic Review*, 32:1167-89; and Petersen, M. and Rajan, R., *The Effect of Credit Market Competition on Lending Relationships*, (1995), *Quarterly Journal of Economics*, 110:407-443.

[35] Leebron, D., *Limited Liability, Tort Victims, and Creditors*, (1991), *Columbia Law Review*, 91:1565; Villiers, C., *Employees as Creditors: A Challenge for Justice in Insolvency Law*, (1999), *Comp. Law.* 20(7):222-232; and Keay, A., *Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors*, (2003), *M. L. R.*, 66:665-699.

having to adjust their transaction to the requirements of the law."[36] However, such discretion of the parties must be considered bearing in mind the information asymmetry and disproportionate negotiating power existing between contractual parties. In both cases, distorted contractual terms may prejudice the interests of one contractual party. Moreover, an uncontrolled contracting may also bring about externality, economic inefficiency imposed on a third party. Such considerations thus entail the public authority intervention, an issue to be covered in the following section.

B. THE ROLE OF LAWS AND REGULATIONS

1. Company Law Related

(a) Limited Liability and Separate Personality

The limited liability and the separate personality of a company as a legal organizational form play an important role in attracting investment.[37] However, the scheme can intentionally be employed by incorporators to avoid any future known risks because a company incorporated with a separate legal personality will be responsible for any liability only to the extent of its own assets rather than those of its incorporators.[38]

However, counterbalancing the limited liability and the separate personality of a company is the general safeguard for the protection of creditors. Such protections not only include statutory protections for creditors in company law and insolvency law but also common law rules on lifting the veil of the company, rules which can extend liabilities to individuals standing behind the veneer of the company.[39] However, cases initiating such a rule are not many and most of them involve only small private companies. In fact, for creditors of public companies or big private companies, veil

[36] Collins, H., *Regulating Contracts*, (1999), OUP, at 47.
[37] The introduction of limited liability by the Limited Liability Act 1885 facilitated the development of large transportation companies and bridge building companies, *etc*.
[38] Mr Salomon effectively took advantage of the limited liability of the separate legal entity to protect his own assets in *Salomon v A Salomon & Co. Ltd*, [1897] AC 22.
[39] Morse, G., *et al.*, (eds), *Palmer's Company Law*, (25th edn), (1992), London: Sweet & Maxwell, at para. 2.1521. This is a tricky issue in cases involving corporate groups, see *Adams v Cape Industries Plc* [1990] Ch 433.

piercing is not feasible due to the widely accepted separation of control and ownership in public companies.

(b) Capital Related

Relevant to the interests of creditors are corporate rules on the minimum capital and the maintenance of capital.[40] The former provides some kind of credit worthiness to creditors by stipulating a threshold of capital for establishing a company. This is because legal capital has little practical sense after the establishment of the company as the market value of the company changes during the life of the company. A claimed minimum capital at the time of foundation may only be a veneer for creditors. Instead, such an arbitrarily imposed threshold may only unduly restrict competition by tightening the requirements of market entrance. Moreover, it is true that public companies, since the implementation of the Second Company Law Directive,[41] have been required to have allotted shares with a minimum nominal value of £50,000, one quarter of which have to be actually paid over to the company, to set off their business. However, it is also the fact that public companies are well-established companies with good historical records and future prospects. In comparison, private companies in the UK have never been required to raise some amount of money for their establishment.[42] In other words, creditors for most companies are not protected by such corporate rules. Thus, corporate rules on the minimum capital have limited effects in safeguarding the interests of creditors.

Alternatively, creditors are also protected by corporate rules on capital maintenance, which is mainly achieved by imposing restraints on capital reduction. Indeed, capital maintenance is a long-established common law rule in the UK.[43] The main point is that shareholders' paid-up capital should not be returned to shareholders.

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[40] Armour, J., *Legal Capital: An Outdated Concept?*, (2006), *European Business Organization Law Review*, 7:5-27, who argues for the potential over-regulation of such rules.

[41] Formation of Public Companies and Maintenance and Alteration of Capital, 77/91/EEC, (1977), OJ L26/1.

[42] See CA 1985 s117, to be replaced by CA 2006 s761.

[43] *MacDougall v Jersey Imperial Hotel Co Ltd* (1864) 2 H&M 528, 71 ER 568 per Lord Watson; *Guinness v Land Corporation of Ireland* (1882) 22 Ch D 349, CA per Cotton LJ; *Berner v General and Commercial Investment Trust* [1894] 2 Ch 239 CA 264 per Lindley LJ; *Ammonia Soda Co Ltd v Chamberlain* [1918] 1 Ch 266, CA 292 per Warrington LJ.

The purpose is to protect creditors, who may deem the fund as their resource of repayment. In addition, capital maintenance is also an important part of the Second EC Company Law Directive.[44] In the UK, section 656 of the Companies Act 2006 requires that a shareholders' meeting should be convened where the net assets of a public company are half or less of its called up share capital. However, the effects on creditors of such a meeting, if held, are hard to tell. First, it is hard to tell the specific time when such situation comes into being. The reasons may spread from the highly changeable business environment to simply the difficulty in evaluating certain assets, such as intellectual property. Second, such a meeting sends a negative signal to other stakeholders, even though it is highly possible that it is still not certain whether such deduction is a temporary one or a permanent one. Given that the value of a company in distress is usually less than that of the company as a going concern, the situation may be disastrous to creditors.

In addition, capital maintenance can also be achieved through legal restrictions on dividend distributions, share buy-backs and redemption.[45] Also, creditors have a statutory right to object to capital reduction at the courts.[46] Still, the Companies Act 2006 permits a wide range of payment methods for the acquisition of shares.[47] Moreover, a private company no longer needs a court sanction for its capital reduction, making capital maintenance a weak rule for private companies.[48] Thus, the cushion effect provided by such a legal institution to creditors should not be overestimated.

[44] But see the recent proposal to regulate the ability of public limited companies to alter the size, structure and shape of their capital. See DTI Consultative Document, *European Company Law and Corporate Governance—Directive Proposals on Company Reporting, Capital Maintenance and Transfer of the Registered Office of a Company*, (2005b), available at *http://www.dti.gov.uk/files/file14584.pdf*. Also, these proposals have now been agreed and Directive 2006/68/EC, with an implementation date on 15 April 2008.

[45] Part 17 (changes to share capital), Part 18 (acquisition by limited company of its own shares) and Part 23 (dividend policy) of the CA 2006. But note that private companies may resort to a simple solvency-based procedure to reduce capital without approval, see CA 2006 s642.

[46] See CA 2006 s646, replacing CA 1985 s136.

[47] Shareholders can pay for their shares with non-cash consideration, ranging from good will, know-how, to an undertaking to perform service. Undertaking to perform a service, however, is only available to private companies, see CA 2006 s585 and Chapter 5 of Part 17 of the CA 2006 generally.

[48] CA 2006 s641 permits a private company to reduce its capital with a solvency statement. In comparison, CA 1985 ss135-138 required that courts confirm such reduction.

(c) Information Disclosure

According to the Companies Act 2006, limited liability companies must state clearly their limited liability nature in their documents.[49] A failure to do so may impose personal liabilities on those signing the document or authorizing such signatures.[50] Also, companies are required to publicize their profit and loss account and the balance sheet, both of which have to be audited by outside professionals though there are some relaxations for small private companies.[51] Moreover, any corporate group is further required to produce accounts of both the whole group and those individual subsidiaries within the group.[52] The legal mechanism of mandatory disclosure can thus assist creditors to enter into loan agreements, a role which is in contrast to the role of private information disclosure in contractual arrangements for creditors' strategy to exit.[53]

Still, in contrast to stringent regulations on public companies, relaxations exist for small companies which can provide abbreviated accounts and delay their reports for 10 months after the accounting year. Such relaxations do release small companies from a heavy regulatory burden but meanwhile do increase the monitoring cost of creditors.[54] The difference in legal treatment can be justified by cost-benefit analyses of the different situations of public companies and small private companies. Admittedly, public companies usually have good historical records and enjoy good reputations on the market. However, the market is not so efficient that it can dispense with a compulsory accounting disclosure. Indeed, potential losses to creditors of public companies are so grave that no authority wants to bear the risk. Conversely, the imposition of a compulsory disclosure duty may enhance both the creditworthiness of big companies and the integrity of the whole market in general. Thus, a cost-benefit analysis justifies the imposition of mandatory information disclosure for public companies.

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[49] See CA2006 s82.
[50] CA 2006 s83 (civil consequences) and s84 (criminal consequences).
[51] CA 2006 s477-s479.
[52] CA 2006 s398 and s399.
[53] Hertig, G., and Kanda, H., *Creditor Protection*, in Kraakman, R., *et al.*, (eds), *The Anatomy of Corporate Law: A Comparative and Functional Approach*, (2004), OUP, 71-100, at 79.
[54] CA 2006 s442.

In contrast, for small companies, the concern of flexibility overtakes that of the potential loss to creditors. This may also be reasonable in practice, as creditors may ask for more stringent security or ask for the guarantee from the owner or directors or more timely information disclosure. These financial safeguards may more effectively protect the interests of creditors than those compulsory disclosure requirements. More importantly, relaxations on small and medium sized companies do not necessarily mean that they are insufficiently regulated. In fact, "*the UK has the best record of enforcing the disclosure rules governing these [small] companies and sanctioning directors who breach their duties to creditors*."[55] In other words, relaxations for small companies can also be understood as a cost-benefit efficient selection.

Still, accounting figures are a presentation of what happened in the past, which is in stark contrast to what creditors need to know—the future solvency of the company. Moreover, creditors may require the disclosure of similar information in their contracts with the company. Indeed, a debt market is more often than not a capital supplier market, in which debtor companies may well prepare these documents themselves to acquire the loan needed. Nevertheless, a total reliance on the efficient function of the market is too risky. In other words, given the current situation, mandatory information disclosure of relevant accounting information is still a preferred solution to protect creditors' interests.

(d) The Relevance of Shadow Directors

i) General

The concept of directors in company law includes that of shadow directors, who are "*those in accordance with whose directions or instructions the directors of a company are accustomed to act.*"[56] The implication of such prescription is that a proactive creditor who intervenes by making his voice heard, however, must bear the risk of being treated as a shadow director in law. The additional liability of directors may thus frustrate creditors' active voice and press for a violent exit. Indeed, as long

[55] Hertig and Kanda, (2004), at 98.
[56] CA 2006 s251, replacing CA 1985 s741(2).

as the threat of exit is real, creditors can perform their monitoring role with immunity from being regarded as an insider, thus avoiding legal liabilities which otherwise have to be taken. Thus, it may be legally wise for creditors to adopt a strong stance in establishing "*exit*" rights in the contract while at the same time restraining the discretion to voice.

The potential identification of the status of creditors with that of directors should be understood with the fact that the court has long been reluctant to second-guess the management decision *ex post*. Thus, to be identified as a director does not necessarily signify to bear the responsibility of a business decision, the correctness of which can only be reviewed *ex post*. This indicates that creditors can tactfully influence the management for their own benefits.

ii) The Special Case of Corporate Groups

The legal stipulation on shadow directors may have another implication for creditors. Since directors are not limited to individuals as a legal personality can be a director as well, a parent company or a creditor company, if it is covered by the legal definition of shadow directors, may be legally recognized as a director. This device in the UK company law can accordingly play a parallel role to that of the veil piercing so that creditors' loss can be compensated through other routes.

In a corporate group, it is a usual practice that the parent company nominates the directors of the subsidiaries. The separate legal personality of the subsidiary from that of the parent company requires of directors of the subsidiary to make decisions in the interests of the subsidiary only. Directors of a subsidiary may accordingly breach their fiduciary duty to the subsidiary company if they sacrifice the interests of the subsidiary company for those of the parent or the group as a whole. However, it is also true that there is no legal constraint on subsidiaries' support of the activities of the group, whose failure may prejudice the interests of the subsidiary. Whether the influencing parent or the other company in the group[57] can be deemed as a director is a matter of fact. But, one thing is certain. If directors of a subsidiary company can successfully argue that the decision is for the interests of the subsidiary company, it

[57] The group itself does not have a separate legal personality in the UK law.

will be hard to establish the parent or the other company concerned as a shadow director.[58] Under this situation, the overlap of the interests of the subsidiary and those of the group can be appropriately explained as a coincidence. Indeed, s251(3) of the Companies Act 2006 expressly states that a parent company is not to be deemed as a shadow director only on the condition that "*directors of a subsidiary company are accustomed to act in accordance with its directions or instructions*."[59]

However, provided that the parent company has been successfully argued as a director of the subsidiary, can the directors of the parent company also be identified as shadow directors of the subsidiary and assume corresponding responsibilities? This issue was considered in *Re Hydrodan (Corby) Ltd*.[60] While the judge held that if the parent company gave directions to the board of the subsidiary and it is also a practice that the latter observes the direction, the parent company can be identified as a shadow director. However, as for the claim of the plaintiff to hold also as shadow directors the two directors on the board of the parent company, the judge rejected the application of a similar line of reasoning. This is because the directors are acting on behalf of the company and their actions can only make the parent company liable.

2. Others

As we will discuss, insolvency law in the UK has long been recognized to be pro-creditors by providing detailed protection for creditors in several statutory insolvency procedures. However, statutory protection for creditors in insolvency law can only be initiated when a company is in the vicinity of insolvency or insolvency is unavoidable. The inability of creditors to initiate litigation against a company when the company is a going concern may actually incite creditors to ask for a winding up order rather than endure the potentially unsuccessful rescue procedure.[61] Still, s213 of the Insolvency Act 1986 renders any person who deals with the company with the intent to defraud creditors liable for the loss of creditors if the company is liquidated. Creditors may accordingly have a bigger size of company's assets to be distributed.

[58] *Equiticorp Finance Ltd. v Bank of New Zealand* (1993) 11 ACSR 642
[59] Replacing CA 1985 s741(2).
[60] [1994] 2 BCLC 180, at 184.
[61] Prentice, D., *The Effect of Insolvency on Pre-Liquidation Transactions*, in Pettet, B., (ed), *Company Law in Change: Current Legal Problems*, (1987), Stevens, London, 69-89, at 82.

Other statutory protection relevant to creditors may include the regulation on the public debt market. Public debts like listed shares are financial products on the exchange. To protect the interests of these public investors is to maintain the integrity and the investors' confidence in the market. Thus, debenture holders on the public security market enjoy parallel legal protections to those offered to equity holders on the public securities market.[62] I will discuss these issues in the following Part.

PART III. CREDITORS IN FLOTATIONS

Our discussion in this Part will centre on one specific example of creditors—venture capitalists. While creditors for companies going public also include bank creditors and trade creditors, the role of VCs are more specific to and more active around the specific juncture of flotations. Moreover, in the previous chapter, we limited the concept of flotations to share issues. In this chapter, the concept will also include flotations of debt. We will discuss creditors in flotations of shares and flotations of debentures separately.

A. FLOTATIONS OF SHARES—VENTURE CAPITALISTS (VCS) AS AN EXAMPLE

1. The Role of Contracts

(a) Information Asymmetry and Information Disclosure

Entrepreneurs usually only have the human capital needed by the inchoate company. Pressed for financial resources, they may resort to venture capitalists at the price of a high return to venture capitalists. However, disproportionate information asymmetry can still be projected as the norm between entrepreneurs and VCs. First, since the enterprise is usually a high-risk project to which entrepreneurs may have a

[62] See FSMA 2000 Part VI; and DTR 6.1 (information requirements for issuers of shares and debt securities), LR 3.4 (listing application) and LR 17 (debt and specialist securities).

settled psychological or emotional attachment, entrepreneurs may well entrench themselves in the company by providing distorted information. Second, VCs can be disadvantaged by information asymmetry of both management and technical potentiality. On the one hand, as it is the entrepreneurs who will take control of the daily management of the new company, it is highly possible that entrepreneurs will misuse the credit for their own benefits. On the other hand, the intangible nature of most of the venture assets also brings high risks to VCs. Tangible assets at least can act as a form of security with a rather stable and detectable value. In comparison, intangible assets, such as patents, know-how, and the reputation of the innovator, are easy to transfer underhandedly and their value is more fickle than that of tangible assets.

In order to redress the information asymmetry, information disclosure by the entrepreneur is usually the main concern of the negotiation.[63] For example, it is usually stipulated in contracts that VCs have the right to review the accounts of the debtor company. Information disclosed may also be changed according to the staged review processes in venture capitalists' standard practice of staged financing. It is by these requirements of information disclosure that venture capitalists keep their due monitoring role in corporate governance of companies they invest in.

(b) Constraints on the Discretion of the Management

It is widely known that VCs not only provide necessary financial support to entrepreneurs but also widely participate in their management. The proactive involvement in the management of the company includes recruiting key new employees, replacing unsuccessful founders with professional CEOs on the board,[64] introducing and negotiating with suppliers and customers, and advising on mergers, acquisitions, and flotations. Contractual terms achieving these objectives actually vest

[63] Chan, Y., *et al.*, *Learning, Corporate Control and Performance Requirements in Venture Capital Contracts*, (1990), *International Economic Review*, 31:365, at 366.
[64] Hellman, T., and Puri, M., *Venture Capital and the Professionalization of Start-up Firms: Empirical Evidence*, (2002), *Journal of Finance* 57:169-197; Rosenstein, J. *et al.*, *How Much Do CEOs Value the Advice of Venture Capitalists on Their Boards?*, in Babson College, *Frontiers of Entrepreneurship Research*, (1990), 238-249, and Lerner, J., *Venture Capitalists and the Oversight of Private Firms*, (1995), *J. Fin.*, 50:301.

a great control right in the hands of VCs to constrain the discretion of entrepreneurs.

Alternatively, VCs can disarm the conflicting interests by introducing stocks or stock options into the compensation scheme for directors and key employees of the company. By binding the directors' and key employees' compensation with the performance of the company, such compensation schemes can align the interests and incentives of the management and key employees with those of the investors.[65] Further constraints on the discretion of management include the imposition on the management of a term to hold stocks or a specific period not to perform the stock options. Moreover, a pre-emptive right by VCs is usually inserted in the venture capital contracts to avoid the potential dilution of the control of VCs. Such measures not only constrain the discretion of the management but also strengthen the bonding effects between the management and investors.

(c) Control by Covenants

VCs usually insert many positive and negative covenants to constrain the discretion of entrepreneurs. For example, entrepreneurs are usually required to issue certain financial statements as well as other information for VCs to evaluate the development of the venture. Moreover, entrepreneurs are typically prohibited from changing the nature of the company. Self-dealing transactions, unauthorized dividend payments, substantial sales of stake in the company or merger with another company are all commonly included in the covenant clauses.

Besides, once VCs make their investment, entrepreneurs may threaten to quit if their new terms cannot be satisfied. This strategy by the entrepreneurs will be very effective if the return of the venture capital depends heavily on the entrepreneurs remaining in the venture. For these reasons, penalties for potential exit by the entrepreneurs and non-competing clauses are normal in venture capital contracts.

Empirical studies have found that the frequency of the use of covenants in

[65] Baker, M., and Gompers, P., *Executive Ownership and Control in Newly Public Firms: The Role of Venture Capitalists*, (1999), available at *http://ssrn.com/abstract=165173*.

venture capital loan contracts is decided by several factors, including the size of the fund, the reputation of the venture capitalists, the compensation scheme for venture capitalists, the types of the investment, and the sophistication of the investors.[66] A general underlying assumption is that the bigger the agency costs, the greater the frequency of the use of the covenants to safeguard those potential defaults.

(d) Two Specific Features of Venture Capital Financing

i) Staged Financing

Staged financing has been widely employed in venture capital contracts.[67] Simply put, under such an investment method, VCs will disburse funds over time in succeeding stages. At each stage, new interim information has to be disclosed by the debtor company to the VCs for the latter to evaluate the progress of the company and make decisions regarding further investments. By threatening to stop further finance, perform the option to sell and liquidate the inchoate company, staged financing effectively minimizes the discretion of entrepreneurs to misuse the venture capital.[68] One scholar has argued that: "*the role of staged capital infusion is analogous to that of debt in highly leveraged transactions, keeping the owner/manager on a 'tight leash' and reducing potential losses from bad decisions*."[69]

Moreover, staged financing grants venture capitalists opportunities to stop and see and accordingly change the intensity of their monitoring. By studying various financial covenants in venture capital loan agreement, one scholar observed that "*decreases in industry ratios of tangible assets to total assets, higher market-to-book ratios, and greater R&D intensities lead to more frequent monitoring.*"[70] Such changing monitoring, either more intensive monitoring with a reduced or reserved

[66] Kaplan, S., and Strömberg, P., *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts,* (2002a), *Review of Economic Studies,* 70(2):281-315.
[67] Sahlman, W., *The Structure and Governance of Venture Capital Organizations*, (1990), *Journal of Financial Economics,* 27:473-524.
[68] Power of the VCs can be further strengthened if stage review is held when the entrepreneurs' working capital is almost completely exhausted, and/or insert a provision of the off-limit to the other financial sources. See Utset, M., *Reciprocal Fairness, Strategic Behavior & Venture Survival: A Theory of Venture Capital Financed Firms*, (2002), *Wisconsin Law Review*, 45-168, at 66.
[69] Gompers, P., *Optimal Investment, Monitoring, and the Staging of Venture Capital,* (1995), *J. Fin*., 50:1461-1490, at 1462.
[70] *ibid*.

investment in response to the adverse information or more lenient financial investment in case of rosy prospects, can only be achieved by contractual terms.

ii) Convertible Securities

In combination with the staged financing, VCs also employ convertible securities to enhance their governance rights. By holding convertible securities, VCs are granted with an option to become the shareholders of the company at their own discretion if certain events occur. Accordingly, VCs who hold convertible securities can select at their own discretion either the benefits of debt or those of shares.

The beauty of convertible securities is that renegotiation is instituted into the contracts of the securities. Once the conditions for the conversion are met, convertible securities holders are in effect provided with another chance to review the specific situation and decide whether they are going to maintain or convert status. Convertible securities holders can thus have a contingent control around the occurrence of those moments they deem crucial. An exercise of the option to convert, however, can send important messages to the market. This is because VCs usually exercise the option to convert either when the company is in an upbeat health status, making a debt holding uneconomic compared with holding shares, or when a strong hand is necessary from outside as shares converted into by convertible debt holders usually carry the right to vote. Both may send positive signals to outside investors. Thus, the option to convert is important not only in showing the intention of involvement from the VCs but also in enhancing the control of VCs by mitigating the initiatives of a debtor company to look only at its own short-term interests without due consideration of the interests of VCs.

These two tools, convertible debt and staged financing, combined together can efficiently deal with the information asymmetry between debtors and creditors.[71] Moreover, the tools themselves imply flexibility as negotiations and renegotiations according to the requirement of the changing business environment are instituted in the tools. Thus, by a better information channel and a predetermined procedure to

[71] Brennan, M., and Schwarz, E., *The Case for Convertibles*, (1988), *Journal of Applied Corporate Finance*, 1:55-64 and Cornelli, F., and Yosha, O., *Stage Financing and the Role of Convertible Securities*, (2003), *Review of Economic Studies*, 70:1-32.

negotiate or renegotiate according to the newly acquired information, efficiency can be achieved.[72]

2. The Role of Laws and Regulations

While venture capitalists play an important role in transforming a private company into a public company, they may have to require such a change through or as shareholders. It is usually shareholders who decide, at least from the perspective of legal procedure (but an important and insurmountable step), to go public.[73] Directors may acquire such authorization but subject to stricter statutory limitation.[74] Indeed, if venture capitalists intervene in the management to such an extent that they are deemed as directors, either shadow directors or *de facto* directors,[75] they may additionally assume fiduciary duties of directors, a situation which may conflict with their investment policy. In that sense, it should be conceded that under current institutions of governance, at least some creditors' demands may have to be realized through shareholders in the meetings. But, considering the preponderant negotiating power of venture capitalists, the contractual binding force of the venture capital investment contract and other possible relations in the future between venture capitalists and the company, the importance of shareholders in deciding the interests of venture capitalists may have to be discounted.

In addition to company law, securities regulation is also relevant. In the UK, the grant of venture capital is often made in the form of trust.[76] If financing is made in the form of Venture Capital Trust (VCT), additional regulations in the Listing Rules

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72 Aghion, P., *et al*., *Renegotiation Design with Unverifiable Information*, (1994), *Econometrica*, 62:257-282.

73 See s90 (re-registration of private companies as public) and s617 (alteration of the capital of limited company) of the CA 2006 (replacing CA 1985 s121). Moreover, Table A of the CA1985 also provides for such an entitlement.

74 CA2006 s551(4) (replacing CA 1985 s80 (4)) stipulates that this authority cannot last more than 5 years either from the date of incorporation or the date of resolution passed.

75 See CA2006 s250 (replacing CA 1985 s741 (1)). Moreover, common law has also implied that *de facto* directors will bear the same duties as directors in s741 (1) of the CA1985. For *de facto* directors, see *Re Lo-Line Electric Motors Ltd* [1988] BCLC 698 and *Re Kaytech International plc* [1999] 2 BCLC 353; for shadow directors, see *Re Hydrodan (Corby) Ltd* [1994] BCC 161

76 Entrepreneurial financing in the UK is mainly in two forms, *i.e.*, the Venture Capital Trust (VCT) and the Enterprise Investment Scheme (EIS). Both aim to attract investment in SMEs by providing tax relief. See Boyns, N., *et al*., *Research into the Enterprise Investment Scheme and Venture Capital Trusts, A Report Prepared for Inland Revenue*, (2003), London: H.M. Inland Revenue

have to be observed.[77] Moreover, if convertible securities are issued, Listing Rules require that convertible debt holders receive a parallel legal treatment to that for shareholders.[78] In essence, such regulations target issuers of securities rather than providing protection to creditors.

In addition, information disclosed to shareholders in the public securities market can also be taken advantage of by creditors. For example, a public company is required by the Listing Rules to disclose to shareholders any transaction involving 25% or more of the assets or turnover of the company.[79] Creditors may well be informed of such information to safeguard their own interests. However, viewed from this perspective, the protection of securities regulations to creditors in flotations of shares is only of a general and indirect sense.

3. The Role of VCs in Corporate Governance around Flotations

Contractual control by VCs includes greater access to information and multiple channels to penalize errant entrepreneurs. Empirical evidence has already shown that VCs have the necessary power to insert into contracts clauses vesting them with complex control rights at the time of their investment and more importantly to establish an extensive monitoring system once they make their investment in the company.[80]

As stocks of private companies usually lack liquidity, VCs may find it difficult to exit by transferring their stocks. Moreover, even if VCs can find a possible exit on the open market once the company goes public, an immediate sale or transfer of their shareholding may be disastrous to their own interests. This is because they are often deemed as insiders by public investors, and a sale of their stakes in the company itself may accordingly be deemed by some investors as clear evidence of their lack of confidence in the future of the company. In turn, a sale or transfer like this may

[77] LR 16.
[78] LR 2.2.12R, LR 3.3.2R to LR 3.3.7R and LR 3.4.
[79] LR10.
[80] Kaplan and Strömberg, (2002a).

precipitate the price of the stocks of the company in concern.

To solve these concerns, VCs usually retain their equity holding in the company for some years after the company goes public.[81] For VCs, since the liquidation of their interests in the company and the flotation of the company do not necessarily happen at the same time, they may well accept such an obligation in their contracts with the entrepreneur. For outside investors, VCs' retention of shareholding may send positive signals that VCs hold confidence in the company going public. In addition, as said, VC's retention of shareholding may help to keep share price, a result beneficial to all shareholders including VCs.

Still, a noticeable by-product of VC's retention of shareholding is that the interests of VCs are in close alignment with those of shareholders. As observed by Hochberg, it is easier for venture-backed companies than those non-venture-backed to adopt a pro-shareholder governance scheme.[82] Indeed, due to the wide adoption of convertible securities by VCs, it is hard to deny the cohesion of the interests enjoyed by one person. Moreover, since empirical evidence from both the US and the UK shows that venture capital-backed companies do outperform their counterparts (comparable non-venture-capital-backed companies),[83] there are good reasons to argue that the mutual beneficial result may in the end help to establish a sound and lasting relationship among financial capital providers.

As VCs are usually locked up in the company going public for several years, the finance oriented governance structure set up by the VCs may persist long after the VCs exit from the company. In other words, we may observe a strong blue-print effect of the financial oriented corporate governance around flotations at the company level. Accordingly, a change of this financial oriented governance structure may at least be

[81] Barry, C., *et al.*, *The Role of Venture Capital in the Creation of Public Companies*, (1990), *Journal of Financial Economics*, 27:447-471.
[82] Hochberg, Y., *Venture Capital and Corporate Governance in the Newly Public Firm*, (2002), unpublished paper, available at *http://people.cornell.edu/pages/yvh3*.
[83] For the US, see Brav, A., and Gompers, P., *Myth or Reality?: Long-run Underperformance of Initial Public Offerings: Evidence from Venture Capital and Nonventure Capital-backed IPOs*, (1997), *Journal of Finance*, 52:1791-1821; for the UK, see Espenlaub, S., *et al.*, *Conflicts of Interest and the Performance of Venture Capital backed IPOs: A Preliminary Look at the UK*, (1999), *Venture Capital*, 1(4):325-349. It is also worth noting that the short-term performance of the companies after flotation is more related with the prestige of the sponsors rather than with others.

traced back to the period before flotations. An abrupt change of the governance structure of public companies alone is thus inadvisable.

B. FLOTATIONS OF DEBENTURES

1. The Role of Contracts

(a) Debenture Holders

Companies with a good credit history can lower their cost of capital by resorting to the public debt market rather than by asking loans from banks.[84] In the UK, a debenture issuance usually involves four parties: the company, the underwriter, the debenture trustee company and the debenture holders. Contractual terms of the debenture are negotiated by the issuer, *i.e.*, the company, and the underwriter. Debenture holders do not directly take part in the contractual relationship which the debenture intends to set up. Thus, some scholars have argued that the debenture contract is more appropriately to be understood as a contract that constitutes one party assigning terms rather than two parties negotiating terms.[85] Within this context, debenture holders are passive recipients of the contractual terms even though they have the selection between purchases and non-purchases.[86] It is thus doubtful that such a debenture contract can have a due consideration of the interests of the ultimate debenture holders. Moreover, due to the privity of the contracts, remedies available for the usual negotiating contractual parties may appear to be inadequate to protect the interests of the debenture holders.

In addition, compared with bank lenders or the other financial institutional lenders or specialist lenders, public debt holders may at least suffer the following problems in negotiating their rights under the debenture contracts:[87] 1) a lack of

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[84] Diamond, D., *Monitoring and Reputation: The Choice between Bank Loans and Directly Placed Debt*, (1991), *J. Pol. Econ.*, 99:689.
[85] Riger, M., *The Trust Indenture as Bargained Contract: The Persistence of Myth*, (1991), *J. Corp. L.*, 16:211
[86] Mitchell, L., *The Fairness Rights of Corporate Bondholders*, (1990), *N. Y. Uni. L. Rev.*, 65:1165, at 1180.
[87] *ibid*.

financial expertise; 2) the difficulty in setting up an appropriate monitoring mechanism to investigate possible opportunistic behaviour by the debtor company; 3) the potential free rider problem as happens in case of a large number of negotiators on one side; 4) contractual protection as the main method to safeguard their interests; 5) courts' traditional rigid interpretation of the debt contracts and their reluctance to imply broader terms than expressed in the contracts. While the first three factors relate to the hardship or impossibility of writing in advance a complete contract which envisions all the possible defaults, the latter two factors leave debenture holders in a more difficult situation even when they want to protect their unduly protected interests under the contract they signed.

(b) The Special Role of Underwriters

Admittedly, an argument can be made that monitoring through trustees without even a contractual participation by debenture holders is precarious due to the agency problem. However, underwriters play a totally different role in flotations of shares from their role in flotations of debenture stocks. In flotations of shares, underwriters almost play no role in the drawing up the contractual terms attached to shares while in the latter situation it is the usual practice that underwriters negotiate with the debt issuer, *i.e.*, the company, on the terms of the debt contract.

Underwriters, in this process, need to balance at least two competing interests. On the one hand, underwriters have to attract the attention of the management. After all, it is usually the power of the management that will decide which underwriter the company is going to select. On the other hand, underwriters must be attentive to the marketability of the securities. Since it is not the intention of these underwriters to be debt holders of the company, the terms negotiated by underwriters must be attractive to the ultimate debt holders. Indeed, underwriters in debt issuance can be vividly compared to the agents of the future debt holders, as their interests are closely linked with their reputation established in sequential transactions. In other words, underwriters' financial stake in negotiating an optimal contract surely provides future debt holders a shield of protection.

The decision-making process of underwriters is thus a delicate balance-striking process. It may be too hasty to say that underwriters' incentive to attract the management to conclude the contract of underwriting will easily override their objective to attract the ultimate debt holders to buy the debt they agree to underwrite. Alternatively, to satisfy the favour of the management is not necessarily in conflict with the requirement of the marketability as it is hard to argue that the management team, which is eager to attract capital, will not consider the suggestion of the underwriters.[88] Thus, the abovementioned pessimistic understanding regarding the less-respected debenture stockholders overlooks the role of the decision-making process of underwriters in protecting public debt holders.

(c) Special Features of Debenture Stock Contracts

Two prominent features of contractual terms of debenture contracts require further discussion. One feature is that negative covenants, which are usually employed in the private debt contracts, are not similarly evidenced in debenture contracts. Viewed from this perspective, it is tempting to conclude that debenture holders can be less protected than bank creditors.

Nevertheless, the lack of financial covenants cannot be cited as evidence that public debt holders have been insufficiently protected.[89] First, such deficiency may well be understood as a cost-efficient solution to the potential renegotiation with numerous debenture holders.[90] In fact, empirical evidence indicates that there is no positive relationship between the number of financial covenants and financial gearing.[91] Second, the reputation of the corporate debtor plays a more important and apparent role on the public debt market than on a private debt market. A debtor with a bad reputation can only exit the public market or increase the cost of raising capital on the public market. Third, few public debt holders are not portfolio investors, who can diversify their investment risk through other methods than merely through inserting in the contract those financial covenants. Fourth, the lack of financial covenants may be

[88] So the claim of the Mitchell may be too hasty or single-minded. See Mitchell, (1990), at 1183.
[89] Tauke, (1989), at 47-51.
[90] Citron, D., *The Incidence of Accounting-based Covenants in UK Public Debt Contracts: An Empirical Analysis*, (1995), *Accounting and Business Research*, 25(9): 139-150.
[91] *ibid*.

justifiable considering the thresholds already set up in the public capital market. Companies issuing public debt have either a good profit history or a recommendable profit expectation. Thus, if companies issuing debentures publicly are doing well, the covenants may seem unnecessary. And if they are doing poorly, these negative covenants may just exacerbate the bad situation by limiting the financial flexibility which may otherwise be available to the company.[92]

Another feature of the debenture contracts is that the contents of such contracts are almost standardized due to the widely adopted boiler-plates. An immediate response may be that rigidity implied in the standard contracts may destroy the flexibility provided by contractual negotiation. However, standard contracts do not necessarily indicate rigidity and cost-benefit-inefficiency.[93] In fact, standard contracts can avoid repetitive negotiation and save transaction costs. They may let the contractual parties pay attention only to those core contractual terms and solve their main disputes quickly. A standard contract also avoids some concerns of interpretation, as business practices in the industry will be highly regarded by the court. Moreover, the boilerplate may just be the market response to the specific situation of debenture holders, implying that a significant underlying review is performed by the market. For one thing, the market may be strong enough to address the abovementioned agency concerns.[94] For another, professional financial market intermediaries, such as credit rating agency and underwriters, will surely review these terms in order to decide their pricing or rating. Other individual investors can accordingly free ride on this market review process. What all these indicate is that non-mandatory standard contracts do provide the flexibility demanded by the real world business life.

Therefore, even though debenture holders do not have a parallel protection to that for bank creditors, the public debt market plays a strong monitoring role through reputation of underwriters and corporate debtors, business norms in debenture stock contracting and the monitoring of other financial intermediaries. Moreover, self-

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[92] McDaniel, M., *Are Negative Pledge Clauses in Public Debt Issues Obsolete?,* (1983), *Bus. Lawyer,* 38:867.

[93] Bratton, W., *The Interpretation of Contracts Governing Corporate Debt Relationships,* (1984), *Cardozo L. Rev.,* 5:371.

[94] Say, if one underwriter enjoys a good reputation on the security market, a company in need of money will, in contrast to what we have discussed, try to meet the requirements of the underwriter. In this case, it is the strong position of the underwriter in the market that decides the contractual terms.

protection through portfolio investment also diversifies the risk for debenture holders. Besides, according to the theory of interactive corporate governance, the inefficiency of debenture stock holders' monitoring can more or less be redressed by the monitoring of other creditors, like that of bank creditors.[95] In other words, protection for debenture holders must be considered within the context of the specific features of the public debt market.

2. The Role of Laws and Regulations

Debenture issues on the open market are subject to strict information disclosure as required in the issue of new shares.[96] Importantly, s80 of the FSMA 2000 requires of disclosure of any information which the market reasonably needs and expects to receive in order to make an 'informed assessment' of information of the issuer. In addition, an approved prospectus may also be required if transferable securities are to be offered to the public or traded on a regulated market in the UK.[97] Criminal liabilities may arise if there is contravention of the statutory requirement of prospectus.[98] Any misstatement or omission in the prospectus may also give rise to civil compensation to those investors.[99] Public debenture holders are thus protected as investors, the protection of whom is to enhance the integrity of the whole capital market.

Moreover, until quite recently, there had long been a legal requirement that at least one trustee company was needed for listed debt securities.[100] The interposition of a trust company between the company debtor and the ultimate debenture holders may more or less disarm the concern of the free rider problems among numerous debenture holders. For one thing, the trust company can more easily be charged with a

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[95] Triantis and Daniels, (1995), at 1090.
[96] LR 2, LR 17, FSMA 2000 s79 and also FSMA 2000 (Official Listing of Securities) Regulation 2001, SI 2001/2956 and the Prospectus Regulation (EC) No1606/2002.
[97] See the Public Offer of Securities Regulations 1995 SI 1995/1537, but now s85 of the FSMA 2000 due to the implementation of the Prospectus Regulations 2005 SI 2005/1433.
[98] See FSMA 2000 s85(3)(4).
[99] See FSMA 2000 s90 and s397; the Misrepresentation Act 1967.
[100] Listing Rules (2002) Chapter 13 Appendix 2 and also Davies, P., *Gower and Davies' Principles of Modern Company Law*, (7th edn), (2003a), London Sweet & Maxwell, at 811. No corresponding requirements are found in the current version of the Listing Rules by this author. However, the argument is still valid as it has long been a practice that "*where large-scale borrowing by companies from the public is in question, a trust deed is commonly used.*" See Morse, *et al.*, (1992), para. 13.146.

monitoring role for dispersed debenture holders. For another, a small number of trust companies can also facilitate the establishment of charges on a company debtor's land or the creation of a floating charge,[101] providing additional protections for debenture holders.

Thus, protection for public debenture holders may well be a combination of contractual arrangements, legal stipulations and commercial norms. On the one hand, market discipline through reputation and practice norms may mitigate the agency concerns involved in the public offer of debentures. On the other hand, the legal stipulation of public information disclosure and the formation of a trust company can also help to redress the information asymmetry and the free-rider concern among debenture holders.

PART IV. CREDITORS IN TAKEOVERS

Creditors' financial support in takeover transactions is indispensable. Indeed, few takeover transactions cannot be called leveraged. The difference is really an issue of degree rather than that of kind. Moreover, due to the current resurgence of LBOs, especially those supported by private equity and hedge funds, we will discuss creditors in such transactions as a separate issue.

A. THE ROLE OF CONTRACTS

1. Covenants Related

(a) Covenants Employed

Debt holders have long been inserting "*change of control covenants*" to avert the potential loss relevant to a change of corporate control. Triggering points for these covenants may spread from a certain percentage of the share acquisition by a third party to a merger of two companies into either one existing company or a newly

[101] Morse, *et al.*, (1992), paras. 13.020 and 13.147 and Davies, (2003a), at 810.

created company. Once these conditions are triggered, creditors may require an acceleration of the maturity of the loan contract, or sell back these debts to the corporate debtor, or ask for a revision of the contractual terms especially the interest rate so that additional risks will be appropriately considered.

Other covenants relevant to takeover activities include the maintenance of financial condition and engagement in the same business. To maintain a certain financial condition is usually achieved by keeping certain financial ratios above a certain threshold. For example, the debt/equity ratio is often employed to safeguard any potential wealth transfer from creditors to equity holders. Thus, additional debt may be strictly prohibited or reviewed. Alternatively, to stay in a certain line of business is also very important at least to small companies, which may otherwise dispose of their main assets without the approval from the creditors.

Or, creditors may select a decline of credit rating as the main trigger of the remedy. This trigger starts from the basics of the interests of the creditors and may thus provide ideal protections for creditors in takeover transactions. However, a categorical acceptance of the usefulness of such a clause is also dangerous as a decline in rating may well be caused by some other factors unrelated with takeover transactions. For example, a covenant linked with a decline of credit rating will only aggravate the distress suffered by the company when the drop of the credit rating is caused by intensive competition on the market rather than by the impending takeover transactions. In such cases, such covenants may only do a disservice to the interests of creditors.

(b) Protections Provided by Covenants

Debt holders are offered many choices in cases of defaults of the above contractual terms. They may either sell debts back to the company at a predetermined price or continue their holding of the debt but at a revised interest rate for the decline of the credit rating. Furthermore, remedies can also be provided in tandem with the development of the takeover transaction.

The effectiveness of these covenants especially those control covenants largely depends on the specific contents of such covenants. In fact, debt holders with strong covenant protection may not suffer loss but rather acquire gains in cases of takeover transactions.[102] One American study further reveals that convertible security holders earn extremely large and significant wealth gains in stock-for-stock mergers.[103] While financial gains to offeree shareholders partially contribute to the gains to convertible security holders, the main driving force, however, is favourable contractual conversion terms, or the attached option values, in such debentures.

On the other hand, covenants can never cover all situations. For instance, in order to raise as much capital as a company can, a corporate debtor may be extremely creative in designing a complex structure of debts. Creditors may accordingly bear some initial sufferings as covenants may not cover such financial innovations. However, it is hard to believe that such inequality may last long in commercial practices. This is because the market may have not prepared fully for a new financial innovation the time when it arises. The insertion of a covenant in the debt contract around this time may thus seem repulsive to both contractual parties or may be at odds with market practices thus inducing reluctance from either side of the contractual parties. However, if similar losses occur to other participants, or potential losses are perceived real by more participants as the market develops, a due introduction and assessment of a corresponding covenant may be rightly made or be readily accepted by all contractual parties on the market.

The law largely stands outside this process unless the bottom-line — fairness — is touched. For Tauke, the concept of fairness, an important principle in contract formation *ex ante*, is indirectly identified by reference to unfairness. He argues:

> *"What is needed to establish unfariness is a demonstration that investors are not compensated ex ante for the extra risks they bear as a result of the debtor corporation's retention of the ability to engage in many types of actions detrimental to the debenture holders' interests. Unless there is some reason to believe that investors are unaware that a bond contract lacks protection, it is hard to understand why investors are not compensated by a market price determined in light of the absence of*

[102] Asquith, P., and Wizman, T., *Event Risk, Covenants, and Bondholder Returns in Leveraged Buyouts,* (1990), *Journal of Financial Economics,* 27:195-213.
[103] Maquieira, C., *et al*., *Wealth Creation versus Wealth Redistribution in Pure Stock-for-Stock Mergers,* (1998), *Journal of Financial Economics,* 48:3-33.

the contractual protections."[104]

In other words, unfairness cannot be established if no contractual party has the prior knowledge of the occurrence of the later event or either party, who already projects the rare existence of the possibility, reasonably disregards it. Only when one party intentionally take advantage of the opportunity that the other party has no knowledge of can unfairness be established. Accordingly, if financial innovation is created after the contracts are in place, it may be too hasty to conclude that such contracts are doomed to be unfair to creditors.

Control covenants in takeover transactions, however, may help entrench the incumbent management. This is especially the case where management can exercise its discretion in deciding the fate of takeover bids, as what happens in the US.[105] In such a context, debt holders do not have the opportunity to touch the trigger. Instead, the initiation of the trigger is predominantly decided by directors, who may well serve their own interests by staving off hostile bids.

In comparison, boards in the UK do not enjoy a similar advantage as defensive measures against an impending takeover offer must be approved by shareholders. The prior review of shareholders however does not target those covenants in existence long before the impending takeover transactions. In that case, the existence of control covenants can increase the cost of takeover transactions, thus decreasing the initiative of those potential bidders to initiate such transactions in the first place.[106] Accordingly, covenants for the purpose of protecting creditors may indirectly entrench the incumbent board.

[104] Tauke, (1989), at 49-50.
[105] Kahan, M., and Klausner, M., *Antitakeover Provisions in Bonds: Bondholder Protection or Management Entrenchment?*, (1992), *UCLA L. Rev.* 40: 931; Clemens, R., *Poison Debt: The New Takeover Defense*, (1987), *Bus. Law.*, 42:747.
[106] As discussed in the foregoing chapter, takeover defense at flotation stage is not popular in the UK for the pressure from institutional investors.

2. The Differentiation between Existing Creditors and New Creditors

(a) Existing Creditors

Protection for existing creditors depends on their pre-takeover contractual rights. For pre-takeover secured creditors, they at least have some proprietary claim against the assets of the company.[107] For unsecured creditors, we may have to separate trade creditors from the other unsecured creditors.[108] This is because trade creditors can still control the upstream or downstream of the production of the company. Since a company in takeover transactions almost always wants to be transferred as a going concern for a better price, directors usually permit payments to trade creditors. In other words, the pre-takeover contractual rights of secured creditors and the special strategic position of trade creditors to the company in takeovers may provide them due protection.

However, in contrast with creditors in the above two categories, other pre-takeover unsecured creditors may suffer the most. They are not voluntary high risk takers. Nor are they compensated with a high return. Companies thus do not have incentives to care for their interests as they are not essential for the company's running. Usually, pre-takeover unsecured creditors can only accept one of the two results: either to accept a substituting equity stake but still bear the risk of being worth nothing if the transaction fails, or to sell their debt at a substantial discount.

Nevertheless, protection of pre-takeover unsecured creditors must be viewed in perspective. The high occurrence rate of takeover transactions may invalidate any claim that takeover transactions are not taken into consideration in creditors' autonomous decision-making process. Moreover, it is highly possible that an unexpected takeover transaction is not the reason for the downgrade of the credit status of a company in the takeover transaction.[109] In addition, unsecured creditors can still rely on control covenants or simply the decline of credit rating as initiators for

[107] Stilson, A., *"De-leveraging" the Leveraged Buyouts of the 1980s: A Prisoner's Dilemma for Unsecured Corporate Bondholders in the 1990s*, (1991), *Denv. U. L. Rev.*, 68:331-386.
[108] *ibid.*, at 335-6.
[109] For instance, takeovers can well be used as rescue efforts.

potential remedies or to have a chance to renegotiate their contractual terms.

(b) New Creditors

Capital needed in takeover transactions may also come from new creditors. These newcomers join the transaction with due consideration of the risk of their credits. The conclusion of their loan contracts is more often than not a result of their evaluation of the investment opportunity, a result which is an outgrowth of their long-term expertise in a specific line of industry or just their individual reliance on the management of the company. In practice, most creditors of this group also perform a comprehensive prior investigation before their investment. For example, an objective and comprehensive audit report is usually a necessary document needed for their investment decision. Moreover, a strict continuous monitoring is also ensued. More detailed disclosure in shorter periods and more stringent observance of the contractual terms than normal are also required. Last but not least, their assumption of the high risk is usually compensated by the higher interest rates. In sum, their decision to bear the risk is a result of their own business judgment. This realization is important in that laws and regulations usually do not want to interfere in the business judgment process by market participants, much less the reluctance of the court to second guess the business judgment *ex post*.

While new creditors join just for the purpose of the intended takeover transactions, their participation may, however, menace the interests of existing creditors. Still, existing creditors can stipulate that no other loan can be made with the same order as or superior to theirs in getting repayment (*i.e.*, the negative pledge).

In sum, contractual protections can largely play their due role in safeguarding the interests of creditors in takeovers. For existing creditors, the adoption of such covenants as control covenants and a decline of credit rating may provide them with a due protection. Even though unsecured creditors may suffer from a relatively disadvantaged negotiation position compared with secured creditors and trade creditors, their interests may either be justified by their own decision or be protected by contractual laws. For new creditors, their investment decision is made with the potential high risk in mind. So, given the strong negotiating positions of most creditors and the high occurrence rate of takeover transactions, contractual arrangement can fairly protect the interests of creditors.

B. THE ROLE OF LAWS AND REGULATIONS

Laws and regulations specifically targeting creditors in takeovers are rare. However, we still can find some relevant. Indeed, the law on capital maintenance is a relevant example. The initiation for legal constraints on financial assistance to share buybacks originated from the concern that the offeror may raise huge debts to buy the offeree shares on the basis of the assets and credit rating of the offeree company and then sell the assets of the offeree company to pay back their loans.[110] If no covenants restricting such transactions exist in the contracts between existing creditors and the offeree company, existing creditors may find themselves '*suddenly exposed to a firm whose controllers have much greater incentives to gamble with their money than the one they lent to.*'[111] The law on financial assistance can thus fill the gap of the incomplete contracts.

Moreover, if a takeover transaction leads to the insolvency of a company, insolvency law will come into play when the company is in the vicinity of insolvency. The underlying theme of relevant laws is that it is illegal and void to make any transfer for the purpose of hindering, delaying, or defrauding creditors.[112] Besides, if convertible debentures are issued, as often occurs in MBO transactions, relevant laws on convertible debentures must be observed. In that context, creditors may well enjoy the protection provided to shareholders.

[110] See Report of the Company Law Amendment Committee, (1926), Cmd 2657 London HMSO, para. 30.
[111] Armour, J., *Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law,* (2000), *M. L. R.*, 63(3):355-378, at 369-370.
[112] See s 206 (personal liabilities of past or present officers); s242 Gratuitous Alienation (Scotland), and s243 Unfair Preferences (Scotland) of the IA 1986.

C. CREDITORS IN BUY-OUT TRANSACTIONS

Given the gravity of the moral hazard problem, it is not strange that MBO loan agreements were observed to have more covenants than general corporate lending agreements.[113] For example, dividend restrictions are more likely to be found in loan contracts in MBOs and MBIs[114] than in other types of bank loans, where the existence of relevant statutory stipulations on dividend distribution in the UK may already provide creditors with sound protection.[115] Moreover, cash flow restrictions are also often located in loan contracts of MBOs and MBIs.[116] These covenants at least indicate that creditors have accepted the negotiating cost in order to avoid the potential larger loss arising from agency costs.

Empirical evidence has shown that over 60% of the secured creditors who provide finance for MBO/LBO transactions may recover their debts.[117] In comparison, unsecured creditors may not be as lucky as secured creditors. However, it should still be noted that buyout transactions are usually made at a time when the company is a going concern. The disposition of assets or the insolvency of relevant companies is more often than not a step after compensations for creditors of the offeree company have already been met.[118] In other words, the implications of MBO transactions on unsecured creditors should not be overrated.

Alternatively, creditors in the current resurgence of buyout transactions have new features. Indeed, one important factor contributing to the current wave of buyout transactions is the existence of large amount of institutional capital which provides financial sources for private equity fund managers and hedge fund managers.[119] The

[113] Citron, D., *et al*., *Loan Covenants and Relationship Banking in MBOs*, (1997), *Accounting and Business Research*, 27(4):277-296.
[114] Kahan and Klausner, (1992) and Day and Taylor (1995).
[115] See CA1985 Part VIII (to be replaced by CA2006 Part 23). Also, Leuz, C., *et al*., *An International Comparison of Accounting-Based Payout Restrictions in the United States, United Kingdom and Germany*, (1998), *Accounting and Business Research,* 28: 111-129.
[116] *ibid*.
[117] 62% in Citron, D., *et al*., *Secured Creditor Recovery Rates from Management Buy-outs in Distress*, (2003), *European Financial Management*, 9(2):141-161, also available at *http://ssrn.com/abstract=313963*.
[118] Jensen, M., *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers*, (1986), *American Economic Review*, 76(2):323-329.
[119] FSA, *Private Equity*, para 3.18.

availability of such a large amount of idle capital produces two important implications. On the one hand, it makes possible the high gear ratio in the current buyout transactions. In fact, empirical evidence reveals that among the five largest LBO transactions in the 12 months to June 2006, the average share of equity was just 21%.[120]

But on the other hand, the existence of so large amount of idle capital implies intensive competition among creditors for good projects. In turn, it is not a surprise to find in practice relaxations of contractual terms, such as covenant waivers, amendments and short-term refinancing.[121] Moreover, debts in going private transactions are designed in very complex structures and are also distributed to other market participants.[122] In turn, the increased use of variety of financial derivatives has already resulted in unclear ownerships of the credit risks involved in private equity deals.[123]

The incompleteness of loan contracts, either individually or collectively, may in the end lead to a systemic disaster in the capital market and compromise the interests of creditors in general. In fact, if the current low interest rate is no longer the case, the increasing short-term exposure in the current private equity backed LBO transactions may result in numerous defaults of the current loan contracts, impairing the stability of the whole capital market. In a word, the potential losses to creditors and the implications on the capital market may be too large to be overlooked.[124]

However, the Financial Services Authority also acknowledges that the market has responded to that risk by "*setting up distressed investment funds*" and "*staffing restructuring teams*".[125] Moreover, although short-term exposure is increasing, the medium and long-term exposure is decreasing or becoming widely distributed. Accordingly, the dark side of these transactions may well be mitigated by the market.

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[120] *ibid.*, para. 3.57. This figure is in stark low compared with historical figure and the FSA attributed to this result the increasing use of subordinated debt which has equity-like characteristics.
[121] *ibid.*, at para. 4.14 on the negative view of the institutional debt market.
[122] *ibid.*, at para. 2.29.
[123] For example, as a result of the increasing use of sub-participation and derivative hedging. *ibid.*, para. 3.115 and paras. 4.23-4.26.
[124] *ibid.*, at paras. 4.19-4.20.
[125] *ibid.*, at paras. 3.116-3.117 and 4.15.

Besides, creditors involved in such transactions are mostly active capital market participants with incomparable and sophisticated financial expertise. It is hard to deny that no other participants can provide better protection than themselves. In other words, the effectiveness of the dominant contractual protection for creditors will still be evident.

PART V. CREDITORS IN INSOLVENCY

Financial pressures from creditors, especially when companies are in financial distress, can have a positive effect on productivity growth.[126] In other words, creditors' pressure in insolvency may in turn produce positive governance effects when companies are going concerns, indicating that insolvency can be understood as just a part of the continuum of the development of corporate governance.

A. THE ROLE OF CONTRACTS

To understand the role of contracts in protecting the interests of creditors, we may have to start from the role of insolvency law in creditors' contract design prior to insolvency. A creditor-orientated insolvency legal institution may facilitate debt finance, decreasing the debt cost to the company and increasing the ratio of debt in the capital finance structure. In contrast, a debtor-orientated insolvency legal institution may first frustrate the initiatives of creditors to lend. If loans are made in this context, higher interest rates will be expected to compensate for the potential defaults of the company debtor and the difficulty in enforcing creditors' rights. Once defaults do occur, renegotiations can solve some conflicts though many cases may have to go to courts, which have a strong propensity to enforce the pre-insolvency negotiated contracts between debtors and creditors in the UK.[127]

[126] Köke, J., *Corporate Governance, Market Discipline and Productivity Growth*, (2002), in Batten, J., and Fetherston, T., (eds), *Corporate Governance and Social Responsibility*, JAL Amsterdam, also available at *http://ssrn.com/abstract=292199*.
[127] Franks, J. and Sussman, O., *Financial Innovation and Corporate Insolvency*, (2005b), *Journal of Financial Intermediation*, 3:283-317.

(1) Small Companies

According to the review of the Association of Business Recovery Specialists, insolvency predominantly affects small companies.[128] A study of corporate governance of small companies in insolvency is thus of special importance in the UK.

Small companies in the UK rely more on debt finance through a main bank creditor along with many trade creditors.[129] Compared with bank creditors, who usually have a substantial control of the company in distress through their highly collateralized debt, including setting up a floating charge, trade creditors are at a disproportionate risk. However, the existence of a leading bank creditor also facilitates the rescue process because small companies as going concerns are of special importance for banks' future profits. Banks' lending to small companies is usually made at lower rates with the hope that future growth of small companies will generate more business for the bank.[130] Alternatively, the liquidation of a company will affect the level of customer deposits and other business for a regional bank.[131] In addition, a bank active in liquidation may have a reputation among potential customers, who may simply avoid it and go for other banks. In turn, such factors may accumulatively produce a pro-rescue culture among creditors for small companies.

Within this context, the leading bank creditor can play an important role in corporate rescue. Indeed, the normally inserted restrictive covenants and collateral rights can grant bank creditors a meaningful control in distressed companies.[132] In addition, such pre-insolvency contractually designed control rights in the hands of creditors are further enhanced by the contractualist-oriented courts in the UK.[133] In

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[128] R3, *Corporate Insolvency in the UK: A Decade of Change, (*the 10th annual company survey), available at *http://www.r3.org.uk/publications*, at 8. The survey finds that 85% of insolvency cases involved companies with fewer than 30 employees.
[129] Franks, J., and Sussman, O., *Resolving Financial Distress by Way of a Contract: An Empirical Study of Small UK Companies*, (2000b), AFA 2001 New Orleans Meetings, Presented at Tuck Contemporary Governance Conference, available at *http://ssrn.com/abstract=236098*.
[130] Petersen, M., and Rajan, R., *The Benefits of Lending Relationships: Evidence from Small Business Data,* (1994), *Journal of Finance*, 49:3-37 and Petersen and Rajan, (1995).
[131] Jog, *et al*., also finds that employees are willing to sacrifice in order to prevent liquidation. See Jog, V., *et al*., *Stakeholder Losses in Corporate Restructuring: Evidence from Four Case Studies in the North American Steel Industry,* (1993), *Financial Management*, 22(3):185-201.
[132] Gilson, S., *Bankruptcy, Boards, Banks and Blockholders,* (1990), *Journal of Financial Economics* 26:355-387.
[133] Franks and Sussman, (2005b).

fact, banks in the UK often adopt a tough attitude in rescuing a company in distress[134] as about 75% of the cases studied turnaround without going through the legal insolvency procedures.[135] Private rescue through contractual arrangements thus plays an important role in rescuing small companies in distress in the UK.

(2) Large Companies

The debt structure of large companies is different from that of small companies. Due to the size of the loan and the specific banking regulations, loans to large companies are generally syndicated. However, compared with diffused public bond holders, bank creditors in syndicated bank loans are still relatively concentrated. Thus, private corporate rescue efforts through contractual arrangements are still a possible solution for large companies in distress in the UK.[136]

In fact, private contractual 'workouts' for large UK companies have long been established in the banking community as the "*London Approach*", which has been described as: "*a non statutory and informal framework introduced with the support of the Bank of England for dealing with temporary support operations mounted by banks and other lenders to a company or group in financial difficulties, pending a possible restructuring*"[137] Two phases are involved in the rescue process. First, a standstill agreement among lending banks is reached. An unpromising report after investigation will initiate the administrative process. If a viable business is still within reasonable hope, the second phase comes in. Coordinated efforts are organized by the lead bank with the largest exposure in order to reach a work out plan for the company in distress. Either debt will be restructured or the operation of the company will be reorganized at this stage.

Work-out plans in the London Approach are usually negotiated in private with confidential agreements being signed among rescuing banks. The secrecy in effect saves the potential loss in reputation once the distress of the public company is leaked

[134] Franks and Sussman, (2005a).
[135] Franks and Sussman, (2000b).
[136] Armour, *et al.*, (2002), at 1757.
[137] British Bankers' Association, *Description of the London Approach*, (1996), mimeo, London, at 1.

to the market.[138] Given the strong role of the Bank of England and the culture in the City, work-out contracts may have a strong power of enforcement and binding commitment from the participating banks.[139] In fact, a survey in 1999 showed that large UK based companies rarely entered legal insolvency proceedings.[140]

It is true that changes in the commercial environment have already destabilized the original context within which the London Approach operated. For example, one important implication of the current resurgence of buyout transactions is that the traditional syndicated bank loan with a leading bank is no longer the case. Rather, the broadening institutionalization of the debt market means that a broad and diverse creditor base is more often observed in current leveraged transactions. The implication is that the traditional private rescue efforts through the London Approach may no longer be feasible.[141] However, the commercial norm of the London Approach may not disappear quickly,[142] and contractual workout plans may still be a feasible solution for public companies in distress for some time.

B. THE ROLE OF LAWS AND REGULATIONS

While contractual solutions are feasible, there are still many companies entering into legal insolvency proceedings. Private solutions through contractual arrangements suffer their own shortcomings of privity as only contractual parties are bound by the contracts signed.[143] Moreover, since private rescues are usually made in secrecy, creditors outside the workout plans may have to price their terms for the worst-cases. As a result, transaction costs as a whole may be large.[144] Legal intervention is thus necessary.

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[138] Armour, J., and Deakin, S., *Norms in Private Insolvency Procedures: The 'London Approach' to the Resolution of Financial Distress,* (2001b), *Journal of Corporate Law Studies*, 1:21-51, also available at *http://www.cbr.cam.ac.uk/pdf/wp173.pdf*, at 2.
[139] Armour and Deakin, (2001b), at 16-20.
[140] R3, Society of Practitioners of Insolvency, *8th Annual Survey of Company Insolvency,* (1999), available at *http://www.r3.org.uk/pdf/8th_Corp_survey.pdf*.
[141] FSA, *Private Equity*, paras. 3.115 and 4.27.
[142] Armour and Deakin, (2001b).
[143] LoPucki, L., *The Case for Cooperative Territoriality in International Bankruptcy,* (2000), *Mich. L. Rev.,* 98:2216, at 2244-45.
[144] Adler, B., *A Theory of Corporate Insolvency,* (1997), *N.Y.U. L. Rev.*, 72:343.

The pro-liquidation insolvency law in the UK has long been deemed as creditor-favorable. Empirical studies also show that creditors are provided with more favorable protection in the UK than they are in other developed economies.[145] However, the current promotion of corporate rescue has important implications for creditors, whose interests may at least be suspended for the purpose of corporate rescue.

1. Legal Procedures

(a) CVA

In order "*to make company rescue simpler, cheaper and more accessible, particularly for the smaller company,*"[146] a moratorium is introduced to provide the distressed company with a breathing space, during which no proceeding or execution or legal process can commence without a court's leave.[147] A court's leave will only be granted if the proposed action is in the benefit of the company.[148] Once the proposal initiated by the director is passed at the meeting of creditors, the voting result is binding on those unsecured creditors who had received the notice.[149] However, there must be a majority of more than 75% in value of the creditors present in person or by proxy and voting for the proposal.[150] Even though secured creditors are not bound by such a proposal, floating charges cannot be crystallized as the moratorium, which may last up to 28 days and possibly be extended for another 2 months,[151] is binding on all creditors.

In this process, the court plays an important role in supervising the process and implementing the agreement. Moreover, fresh funds are also available through the DTI's Small Firms Loan Guarantee Scheme or through negotiation with existing creditors to dispose of assets or to rearrange for new credit. However, the end result of

[145] The US is more debtor friendly while the protection provided in Germany and France is still less than that in the UK. See Hertig and Kanda, (2004).
[146] DTI/IS, *Revised Proposals for a New CVA Procedure: A Consultative Document*, (1995), at 2.
[147] IA 1986 Sch A1 para. 12 (1).
[148] IA 1986 Sch A1 paras. 18, 19.
[149] IA 1986 s5(2)(b).
[150] IR 1986 r. 1.19.
[151] See IA 1986 Sch A1 paras. 8 and 32.

such corporate rescue procedures may just be to postpone the inevitable—the liquidation of the company. In this context, protection for creditors is subjugated to the superior objective of the rescue of the company.

(b) Administrative Receivership and Administration

The current marginalized receivership in the UK can be seen as a virtual abolition of the contractualist insolvency system in the UK.[152] The administrative receivership has long been criticized for its favours to floating charge holders, who had the right to appoint an administrative receiver only for the interests of the appointer. Such a legal result has its justification because an administrative receiver acquires his rights from the debenture deed and he thus must act for the interests of the creditors without considering those of the other stakeholders or shareholders of the company. Since a floating charge is only feasible for small and medium sized companies, administrative receivership is mainly applicable to small and medium sized companies. The concentrated debt structure and the priority of floating charge holders in appointing administrative receivers may produce an efficient insolvency scheme because the decision making by a privately appointed administrator on the basis of the property right attached to the floating charge can be more efficient than that by an insolvency practitioner who may have to spend time in collecting information about the debtor. Thus, the intentional marginalization of receivership in the UK has arguably deprived companies in distress a benefit from private contractual arrangements with the bank or the leading bank in negotiating for favourable outside finance.[153]

Nevertheless, the predominant concern for the interests of the appointing debenture-holder led the Cork Committee to worry about administrative receiver's lack of consideration of the interests of the other stakeholders, *e.g.*, unsecured creditors, company members, and the wider public interests.[154] Under the new scheme introduced by the Enterprise Act 2002, Qualifying Floating Charge Holders (QFCHs),

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[152] Armour, J., and Frisby, S., *Rethinking Receivership,* (2001), *Oxford Journal of Legal Studies,* 21(1):73-102.
[153] *ibid*.
[154] Cork Report, Cork Advisory Committee, *Bankruptcy: Interim Report of the Insolvency Law Review Committee,* (1980), Cmnd 7968, paras. 437-9.

the company and the directors all have the right to appoint an administrator without petitioning the court.[155] This procedure has a strong accent of corporate rescue which is explicitly expressed in Schedule B1 of the IA 1986. Any application for an administration order cannot be withdrawn except with the approval of the court.[156] After the appointment of the administrator, a court officer,[157] there is a main moratorium, during which it is mainly the responsibility of the administrator to rescue the company.

However, a member or a creditor of the company is also entitled to challenge the administrator's conduct if he thinks that the conduct unfairly harms the interests of the applicant or that the administrator does not perform his functions as quickly or efficiently as is reasonably practicable.[158] Accordingly, members of the company and unsecured creditors can contest an administrator's unreasonable asset sale strategy or the decision not to rescue the company.

Nevertheless, it must be borne in mind that QFCHs have the final decision regarding the appointment of the administrator as they may replace the appointee of directors or other creditors.[159] Moreover, if a receiver has already been in office as a private agent of the charge holder rather than that for the company, the court cannot intervene.[160] Besides, once the process is underway, the end result for contestants is largely constrained by the subjective judgement of the administrator[161] and the courts' traditional deference to the expertise of the insolvency practitioners.[162] Thus, the newly reformed scheme may only represent '*a small victory for unsecured creditors in marginal cases*'.[163]

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[155] A QFCH is a creditor who has the benefit of a floating charge created after 15 September 2003. See para. 10 (by court order), para. 14 (appointment by floating charge holder) and para. 22 (appointment by the company or its directors) of the Sch B1 of the IA 1986.
[156] IA 1986 Sch B1 para. 12(3).
[157] IA 1986 Sch B1 para. 5.
[158] IA 1986 Sch B1 para.76.
[159] IA 1986 Sch B1, para. 36. But see Frisby, S., *In Search of a Rescue Regime: The Enterprise Act 2002*, (2004), *M. L. R.*, 67(2):247-272, at 2.
[160] In this case, a QFCH cannot appoint an Administrator if an Administrative Receiver is in place. See IA 1986 Sch B1, para. 17.
[161] IA 1986 Sch B1 para 3(3).
[162] Frisby, (2004), at 265.
[163] *ibid.*, at 266.

(c) Liquidation

While corporate rescue efforts are worthwhile, the end result is uncertain. Indeed, a delay in liquidation may further place recoveries to creditors at a greater risk than a timely liquidation.[164] This said, legal procedures of liquidation are also diverse. Protection of the interests of creditors thus entails separate considerations under different procedures.

Liquidation can further be divided into Members' Voluntary Liquidation, Creditors' Voluntary Liquidation and Compulsory Liquidation. In a Members Voluntary Liquidation, a resolution of the members and a declaration of solvency are required.[165] Creditors' interests in this situation are usually not prejudiced as the company must be a going concern and creditors' claims must have been met before the liquidation of the company.

In a Creditors' Voluntary Liquidation, a meeting of creditors must follow the meeting of shareholders. Though shareholders have the right to choose their own liquidator, creditors on the later meeting of creditors can replace the shareholders' choice with a nominator of their own.[166] Since the appointment of the liquidator is decided by the majority value of the debt, creditors may have to sacrifice their interests voluntarily or compulsorily for their collective interests.

Creditors' interests are at serious risk if the company is in a compulsory liquidation, as it is usually in such a case that the company is at the end of its life. In such a situation, secured creditors may get something based on their qua property rights on the security while unsecured creditors may be left with nothing. The role of law in this case is to arrange a distribution order among different groups of creditors. Thus, creditors' interests in such a situation may have to be discounted by the distressed financial situation of the company. Nevertheless, we may have to revert to the contractual arrangements of creditors, in which covenants or security interests, may well be triggered in advance of the occurrence of the compulsory liquidation and

[164] Frost, C., *The Theory, Reality and Pragmatism of Corporate Governance in Bankruptcy Reorganizations*, (1998), *Am. Bankr. L. J.*, 72:103, at 155.
[165] IA 1986 s89 and s91.
[166] IA 1986 s98.

provide creditors with a means to exit or sell secured property for their own benefits.

2. Residual Claimants and Priority to Shareholders

As expressed in *Brady v Brady*,[167] in the vicinity of insolvency or the time when a venture can only be carried out by relying totally on the loan from the creditors, "*the interests of the company are in reality the interests of existent creditors alone.*"[168] Similarly, in the leading case *Liquidator of West Mercia Safetywear Ltd. v. Dodd*,[169] the court expressed the view that creditors' interests overrode those of the shareholders when a company is insolvent. That is, after such a crucial point in the life of a company, creditors have supplanted shareholders as the residual claimants of the company.

It is known that the nearer a company is to insolvency, the more intensive the conflict between shareholders and creditors becomes. Both shareholders and creditors will race to retain their shares of the assets of the company, the value of which is declining as the company comes to the end of its life. The race is, however, mutually detrimental to both shareholders and creditors as it can speed up the rate of the demise of the company.

Insolvency law stipulations thus ensure that interests of creditors should be met before any consideration of shareholders can be taken in insolvency.[170] However, the residual value of the company in distress is often not enough to meet the total claims of creditors. In other words, the priority rule does not provide a complete solution to the question of protecting the interests of creditors.

Nevertheless, a creditor with a debt as little as £750 can petition a court to wind up the company.[171] By setting up a threshold as little as £750, the law enhances the protection granted to creditors. Even if creditors may not take advantage of such a

[167] [1987] 3 BCC 535
[168] *ibid.*, per Nourse LJ, at 552.
[169] [1988] 4 BCC 30, at 33.
[170] See IA1986 s176.
[171] See IA1986 s122 and s123. However, the debt must not be in doubt, see *Re Cooling Equipment Wholesale Ltd* [2002] 2 BCLC 745.

right as often as they can, the existence of such a right can still be a real restraint on the discretion of company debtors to misuse their loan.

Moreover, in the vicinity of insolvency, conflicts of interests exist not only between shareholders and creditors but also between secured creditors and unsecured creditors. Whereas most secured creditors can recover their investment through their security on the assets of the company,[172] unsecured creditors may be no better than shareholders in recovering their financial investment. The differentiation has an important governance implication that only unsecured creditors can fill in the post of residual claimants in insolvency.

3. Directors' Duty to Creditors

It has been widely accepted that directors owe a fiduciary duty to the interests of the company they serve. The real concern, however, is what the contents of the interests of the company are. When companies are going concerns, it can be argued that interests of shareholders are closer to those of the company. However, when companies are in the vicinity of insolvency, it is the interests of creditors that are closer to the interests of the company. Some scholars then argue that directors owe a fiduciary duty to the interests of creditors. We now turn to this issue in this section.

(a) A Contractual View from Case Law

In a series of cases, Lord Templeman tried to clarify the nature of the duty of directors to creditors. In *Re Horsely & Weight Ltd*,[173] creditors sued over a grant of a pension policy to directors, which was made two years before the insolvency of the company. The Court of Appeal ruled that directors did not breach any duty to creditors. While Templeman L. J. (as he then was) agreed that directors do owe duties to creditors under some circumstances, he continued:

"*[I]f the company had been doubtfully solvent at the date of the grant to*

[172] 62% in MBO transactions in Citron, *et al*., (2003) and 70% for non-MBO small and medium sized companies in Franks and Sussman, (2000b).
[173] [1982] 3 WLR 431

> *the knowledge of the directors, the grant would have been both a misfeasance and a fraud on the creditors for which the directors would remain liable.*"[174]

This decision shows the existence of a duty but with an "if" condition. The duty recognized in the hypothetical situation arises from an action termed as "*both a misfeasance and a fraud.*" It is not hard to follow the line of reasoning but it seems this opinion does not give us the answer to the question whether directors owe a general fiduciary duty to creditors. This question was further explored by Lord Templeman in *Winkworth v Edward Baron Development Co. Ltd.*[175] In that case, two director shareholders (a husband and wife) used the capital of the company to buy themselves a house. The House of Lords reached a unanimous decision against the directors. Lord Templeman stated that:

> "*A company owes a duty to its creditors, present and future. The company is not bound to pay off every debt as soon as it is incurred and the company is not obligated to avoid all ventures which involve an element of risk, but the company owes a duty to its creditors to keep its property inviolate and available for the repayment of its debts. The conscience of the company, as well as its management, is confided to its directors. A duty is owed by the directors to the company and to the creditors of the company to ensure that the affairs of the company are properly administered and that this property is not dissipated or exploited for the benefit of the directors themselves to the prejudice of the creditors.*"[176]

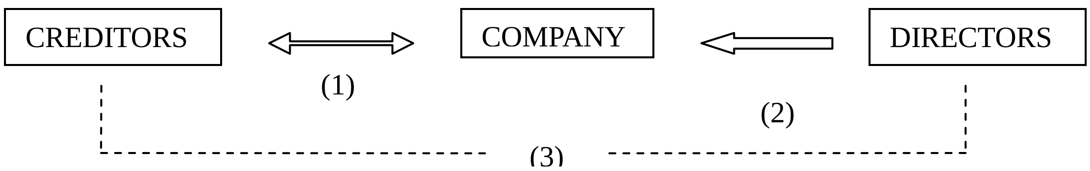
According to this decision, we can safely draw the following conclusions: 1) the company owes a continuous duty to creditors; (2) but this duty is indirect as "*the conscience of the company, … is confided to its directors.*"

But, is the duty owed by directors to creditors a fiduciary one? It is worth mentioning that the respected Lord did not express the duty as a fiduciary one, which he can easily and vocally employ if he thought so. While the failure to use the term of fiduciary duty is only a piece of negative evidence to the nonexistence of fiduciary duty, some positive evidence appears later in *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd.*[177] Lord Templeman concurred with Lord Lowry, who held that

[174] *ibid.*, at 443.
[175] [1987] 1 All ER 114.
[176] *ibid.*, at 118.
[177] [1990] 3 All ER 404.

> *"Although directors are not liable as such to creditors of the company, a director may by agreement or representation assume a special duty to a creditor of the company. A director may accept or assume a duty of care in supplying information to a creditor…"*[178]

Thus, it seems clear that the duty of directors arises not from a fiduciary relation but from *agreements or representation*. In other words, the duty is a contractual one.[179] The complex relationship between the company, directors and creditors can be easily summarized as following: directors only owe a fiduciary duty directly to the company, which owes a contractual duty to creditors. In other words, the nature of this duty may more easily be described as a contractual duty with the recognition that directors only owe a fiduciary duty to the company as a whole. This understanding is, however, in conformity with the separate personality of a company in law. Directors only owe a fiduciary duty to the company, the interests of which overlap the interests of creditors. Moreover, the weight attached to the interests of creditors in deciding the interests of a company is linked to the different phases of the life cycle of corporate governance. In insolvency, the weight attached to the interests of creditors is superior to that for shareholders, but still the interests of creditors cannot be identified with those of the company. For this, we have observed that the interests of creditors can statutorily be constrained for the purpose of corporate rescue. In other words, directors' duty to creditors has been filtered through the separate legal personality of a company. The link between directors and creditors is set up because the contractual relationship between creditors and the company rather than something like a fiduciary duty directors owed directly to creditors.



(1) Contractual relationship.
(2) Directors owe a fiduciary duty to the company.
(3) There is no direct relationship between directors and creditors.

Diagram 4-1 Directors' Duties to Creditors in the Normal Life

[178] *ibid.*, at 425.
[179] Hawke, N., *Creditors Interests in Solvent and Insolvent Companies*, (1989), *J. B. L.*, 54-60.

In sum, it is right to argue that "*there is a continuum of regard for creditor interests from being one interest amongst many competing interests to being the prime consideration*"[180] in the vicinity of insolvency. However, a duty to consider the interests of creditors is in stark contrast to a fiduciary duty to creditors.[181] The former duty cannot create a substantive right, *i.e.*, creditors can neither sue for the ignorance of their interests nor ask a court to enforce their rights, whereas the latter duty can. The above discussion can only tell us that directors owe a fiduciary duty to the interests of the company, which may in certain situations, such as insolvency or in the vicinity of insolvency, prioritize the interests of creditors among the other considerations. There is accordingly a big gap between the fiduciary duty to the interests of the company and the duty to creditors specifically.

Under the Companies Act 2006, creditors are separately considered from those factors enumerated in the list under s172(1) because the law recognizes that the duty of directors to promote the success of the company can be modified when the company is near insolvency and displaced when the company is insolvent.[182] Again, such expression is different from that of imposing a specific fiduciary duty to creditors. Indeed, the law intentionally leaves uncodified directors' duty to creditors and calls for further development in this area of the law.[183] The legal result of such expression is that it is directors who consider both the external and internal situation and will decide what the interests of a given company should be and interests of which stakeholders should be prioritized. As the above discussion shows, interests of creditors are prioritized in the vicinity of insolvency but they are never identified with the interests of a company.

(b) S214 of the Insolvency Act 1986

S214 of the IA 1986 stipulates that directors are personally liable for the losses

[180] Wishart, D., *Models and Theories of Directors' Duties to Creditors*, (1991), *New Zealand Universities Law Review*, 14: 323, at 331.
[181] Sappideen, R., *Fiduciary Obligation to Corporate Creditors*, (1991), *Journal of Business Law*, 365-397, at 391.
[182] See the Explanatory Notes to CA 2006 paras.331-2, available at *http://www.opsi.gov.uk/acts/en2006/ukpgaen_20060046_en.pdf*.
[183] *ibid.*, at paras. 306 and 332.

of creditors unless they have taken every reasonable step to avoid the losses.[184] This is a rather objective clause not only because of the introduction of a reasonable third person with the corresponding qualities and in a similar position but also because of the adoption of the concept of constructive knowledge. A real knowledge of insolvency may be too hard to establish. In contrast, it may be easier for a court to establish a constructive knowledge by an objective third party.

Directors' liabilities under s214 are joint and several, enhancing the deterrent effects by strengthening the incentives to perform peer monitoring among directors. The amount of the compensation by the directors to creditors is that by which "*the company's assets can be discerned to have been depleted by the directors' conduct*" after the date on which the directors should have recognized the unavoidable insolvent liquidation. Thus the maximum amount of such compensation from directors is the net loss to the creditors,[185] the loss which arises from the misconduct of the director.[186] Such stipulations accordingly provide creditors with an additional resource for their compensation.

It is important to realize that the lack of specific time in initiating s214 can be regarded as an intentional effort since "*[t]he purpose of s214 is to reverse the structural bias in favour of the shareholders by internalizing the risks of loss, as well as the chances of gain, in directors' decision-making process when their company nears insolvency.*"[187] In other words, the law extends the consistency of decision making power of directors during the solvency period to the insolvency stage and tries to structure the decision making process rather than designate an initiator. What the law here requires is that directors act with their skill and due care to make a decision that a reasonable third person would make. This good faith requirement also indicates the reluctance of the court to intervene *ex post* of the decision made by directors.

The chilling effect of s214 of the Insolvency Act 1986, however, should be properly evaluated. Cautious directors may ask for a premature liquidation and

[184] IA 1986 s214 (4) prescribes a dual test, which is usually referred to as both subjective and objective test.
[185] Accordingly, the more the liquidator can get for creditors from other resources, the less the compensation from the default directors.
[186] *Re Produce Marketing Consortium Ltd (No. 2)* [1989] BCLC 520
[187] Davies, P., *Introduction to Company Law*, (2002b), OUP, at 96.

transfer the liability to the liquidator. This is not beneficial to develop a corporate rescue culture and much worse may dampen the initiatives of appropriate risk taking, which are necessary for the development of the whole economy. Thus, what this clause requires should be understood as asking the management to make a good faith assessment of the situation.

Nonetheless, even this understanding may not be sufficient for practitioners to follow. Among the difficulties in making such decisions is the difficulty of deciding when is the specific time that the probability of solvency begins to be less than the probability of insolvency. A transition from a solvency status to an insolvency one may well occur rapidly. Also, even if the company is insolvent according to the balance sheet standard as prescribed in s214,[188] it may well be commercially solvent since the company may still have the ability to pay the debts when they fall due. Discussed from this perspective, s214 can be understood at best as discretion enjoyed by the court, which with no better knowledge of business judgment than directors will have to make the tricky judgment *ex post*.

While s214 provides creditors with an additional source of compensation, it must be noted that s214 of the IA1986 does not grant creditors a right to sue the company directly. It is the liquidator who has the right to sue directors for their misfeasance. However, a liquidator may be constrained by the already sliced pie to initiate such a suit.[189] Furthermore, even though s212 does provides creditors with a right to apply for a court order requiring directors to compensate for creditors' loss arising from directors' breach of duty, this right can only be available when the company is wound up, a time which may be too late for creditors to get some compensation.

[188] IA1986 s214 (6). Debts and liabilities under this article include both present and future debts and liabilities, and may also include liabilities in tort, see IR 1986 r13.12(2) and (3).
[189] Wheeler, S., *Swelling the Assets for Distribution in Corporate Insolvency*, (1993], *J. B. L.*, 256-269.

4. Recoveries for creditors

(a) The Issue of Priority

Within creditors, absolute priority among creditors has largely been observed in the insolvency as secured creditors are largely unhindered in performing their quasi-property rights to their collaterals which are not deemed as parts of the debtor's assets.[190] That means their claims will be first met by the proceeds of the security. If the proceeds are less than the amount of the credit, the discrepancy will join the other claims from the unsecured creditors on the *pro rata* basis.

Alternatively, the *pari passu* principle is enforced among unsecured creditors. However, the *pari passu* principle should at best be understood as a *pari passu* share of distress when the value of the company may well be worthless. Thus, as far as the unsecured creditors are concerned, the important issue in distribution is how to make the cake big enough with something left for all of them.

Nevertheless, the priority rule only "*partially*" decides the repayment order because English insolvency law does not adhere to a rigid priority rule. This is especially so in common law. Indeed, a strong consideration of distributive justice and fairness can be found in the relevant law. In *Re Kayford Ltd.*,[191] a mail order company in distress tried to set up a separate trust fund for clients who paid in advance for goods not delivered by the company. Upon liquidation, it was held that the trust did not constitute a part of the realizable assets of the company. While this case is special in that it is to protect the wider public consumers, what Megarry J. said in this case, however, may be applicable to other stakeholders in case of insolvency:

> "*Different considerations may perhaps arise in relation to trade creditors; but here I am concerned only with members of the public, some of whom can ill afford to exchange their money for a claim to a dividend in the liquidation.*"[192]

[190] *Re David Lloyd & Co.* (1877) 6 ChD 339. Indeed, except for a CVA and an administration order which may suspend the performance of the rights of secured creditors but only for a limited period, no other stumbling block exists for secured creditors in insolvency law.

[191] *Re Kayford Ltd* [1975] 1 W.L.R. 279.

[192] *ibid.*, at 282 but for a criticism, see Goodhart, W., and Jones, G., *The Infiltration of Equitable Doctrine into English Commercial law,* (1980), *M. L. R.*, 43:489, at 496-7.

In other words, interests of stakeholders can also be included to achieve the distributive justice and fairness in the special juncture of insolvency.

(b) The Source and Distribution of the Recovery

Apart from the issue of priority, distribution of recoveries around liquidation also depends on whether the recovered damages are vested in the company or not. If they are, the value of the insolvent company will be swollen. Since such recoveries are vested in the company, they are chargeable and in turn floating charge holders have seniority to other creditors regarding the recovery. Real world examples include the recoveries from voidable transactions within a certain period of the liquidation[193] or the disgorgement from a misplaced preferential creditor.[194]

However, the problem is a little tricky if the recovery is not vested with the company but instead with some other sources. One example is recoveries from directors who are personally liable for the loss of the company if they breach s214 of the IA 1986. Remedies recovered from actions initiated by the liquidator against directors on the basis of wrongful trading were originally held to be assets for the benefit of the general floating charge holder first.[195] Such a decision is apparently disadvantageous to unsecured creditors who seem to be real losers in case of directors' wrongful trading. Later cases show an opposite view on this issue. It has been held that recoveries under s214 of the IA 1986 are not a part of the property of the company [196] and accordingly secured creditors cannot claim seniority on such recoveries. Indeed, such recoveries will be assets for unsecured creditors, the distribution of which will be subject to the *pari passu* principle.[197]

The discussion in this section thus tells us that creditors enjoy a contingent control right in insolvency both in law and in contract. What insolvency law further

[193] See IA1986 s127 o and also *Mond v. Hammond Suddards* [1996] 2 BCLC 470.
[194] However, it should be noted that such disgorgement is only a return of what originally belongs to the company and thus cannot increase the total value of the distressed company. See Prentice, D., *Corporate Personality, Limited Liability and the Protection of Creditors*, in Rickett, C., and Grantham, R., *Corporate Personality in the 20th Century*, (1998), Hart Publishing Oxford, 99-126, at 100.
[195] *Re Produce Marketing Consortium Ltd.* (No. 2)[1989] 5 BCC 569, at 597.
[196] *Re Oasis Merchandising Services Ltd.*, [1997] BCC 282.
[197] *Re Purpoint Ltd.*, [1991] BCLC 491, at 499.

stipulates is the distribution scheme among different groups of creditors. However, the current promotion of corporate rescue culture in the legal institution may unduly constrain or delay the protection originally available to creditors. Still, contractual protections for creditors may function well before the insolvency criteria are met. The key element is thus the information disclosure when a company is still a going concern. It is reasonable to infer that given the negotiating power of creditors and the current improvement on information disclosure, contractual protection for creditors can play an undeniably important role.

5. Creditors in Statutory Arrangements

(a) S425 of the Companies Act 1985

According to a scheme under s425 of the CA1985,[198] creditors' original rights may be altered with the sanction of the court. The beauty of this arrangement, compared with that under s110 of the IA 1986, is that consideration of the interests of minority creditors or minority shareholders may be overcome. This is because a decision made with a required sanction of the court by a three quarter majority will bind the remainder minority of the creditors or any class of the creditors.[199] The implication of this section is that dissenting creditors may not have an opportunity to initiate a compulsory liquidation if the arrangement under s425 is made with a court sanction.

The fairness of the abovementioned majority rule thus depends on how the court makes the sanction. The usually adopted dual criteria include both procedural and substantive requirements. In detail, a resolution must first be passed with a statutory majority of three-quarters, and second, an honest and intelligent man, in capacity of either a creditor or a person representing his interest, might reasonably approve.[200] Moreover, if there is any change to the rights of the debenture holders of

198 To be replaced by CA 2006 Parts 26 and 27.
199 See s425(2), to be replaced by CA 2006 s899.
200 *Re Alabama, New Orleans, etc, Rly CO* [1891] 1 Ch 213 (CA); *Re English, Scottish 7 Australian Chartered Bank* [1893] 3 Ch 385 (CA); *Re National Bank* [1966] 1 WLR 819.

the company, a statement must be made to explain the potential effects.[201]

(b) S110 of the Insolvency Act 1986

If a company is in contemplation of or after the commencement of a voluntary liquidation, reconstruction can be made through arrangements under s110 of the IA 1986. A liquidator under s110 of the IA 1986 may be authorized to dispose of the assets of the company.[202] Consideration for the arrangement may include "*cash, shares, policies or other like interests (or in addition thereto) participate in the profits of, or receive any other benefit*".[203] If creditors agree to receive shares of the transferee company, they may further rely on s110(6) for redressing any unsatisfactory treatment to them within 12 months after the special resolution provided that the voluntary winding up of a company has been commenced. This means that protection for creditors under this section may be extended for another year after the special resolution. In effect, this protection may be important for dissenting minority creditors, who may well ask the court for a compulsory liquidation within one year. However, it must be remembered that s110 does not necessitate as much intervention of the court as in arrangements under s425 of the Companies Act 1985.

CONCLUSION

In this Chapter, I have discussed how the interests of creditors are shaped by the social political context and how they are protected by different combinations of legal regulations and contractual arrangements in the life cycle of corporate governance. We first discuss creditors in the social political context. We notice that the dispersed shareholding co-exists with a concentrated debtholding structure, a situation which historically granted creditors, especially bank creditors, a strong political power. Such a power is reflected not only in their legal interests as protected in the insolvency law but also in their strong negotiating power throughout the whole

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[201] CA 2006 s897(3), replacing CA 1985 s426(4).
[202] But, in case of a creditors' voluntary winding up, either the sanction of the court or the approval of the liquidation committee is required; in case of a member's voluntary winding up, only a special resolution conferring authority on a liquidator. See IA 1986 s110(1) and s110(3).
[203] See IA 1986 s110(4).

life cycle of corporate governance.

We then discuss creditors in the four capsules of the life cycle of corporate governance. In Part II, I discuss creditors in the normal life of corporate governance. I argue that creditors can effectively take advantage of their negotiating power to safeguard their interests through private contractual arrangements. The wide use of covenants and security in loan contracts may notify creditors of crucial points for the purpose of safeguarding their interests. Initiators for such covenants and security are usually triggered well before solvency criteria in insolvency law are met.

While it is true that contracts cannot be complete, however, it is also the case that such incompleteness may be intentionally taken advantage of by contractual parties. Moreover, competition on the credit market may also weaken the negotiating power of creditors, but this is uncommon in the corporate sector as a whole. What is noteworthy however is that contractual protection is not a good weapon for involuntary creditors to safeguard their interests. Legal intervention for involuntary creditors is thus necessitated.

Alternatively, legal stipulations work to counterbalance the implications for creditors of the introduction of the limited liability and the separate legal personality of a company in law. Still, the law emphasizes the information disclosure and does not prescribe the specifics of directors' decision-making process. Also, creditors' interests may be indirectly protected through legal stipulations on directors' liabilities to the company. Viewed from this perspective, the legal institution provides a set of default legal protections for creditors regarding the implication of limited liability and separate legal personality of a company.

In Part III, we subdivide the concept of flotation into flotations of shares and flotations of debentures. In both cases, we find that covenants in debt contracts play a prominent role in protecting the interests of creditors. By a further review of how Venture Capitalists (VCs) protect themselves through financial covenants, convertible debenture and staged financing in their contracts, we find that contractual protection does provide a valuable protection for creditors. In contrast, debenture holders in flotations of debentures may have a seemingly worse situation as debenture holders have no direct contractual relationship with the company debtor. However, this deficiency can largely be redressed by the market. In fact, due to the high financial stake of underwriters in the issuance of debenture, their short-term holding and their status as specialist investors, and the importance of reputation to their financial interests, and the role of debenture holders as ultimate consumers are all factors that cannot be overlooked. In addition, even though individual debenture holders may be too weak to protect themselves, they may well free ride with strong institutional investors with sophisticated expertise on the market, and also, as portfolio investors, they are stronger than some imagined. Besides, all these factors must be considered with the fact that public debenture holders also receive additional legal protection for investors in the public capital market. Thus, for VCs, they are mainly protected by private contractual arrangements with legal protection filling the gaps. For public debenture holders, they are protected more in the sense of public investors than in the sense of stakeholders of the company.

A notable observation of VCs is that financial oriented governance practices at the company level may begin at a very early stage when VCs make their investment decisions. The wide adoption of convertible securities by VCs in this stage in effect aligns the interests of creditors with those of shareholders. Empirical evidence also shows that such governance practices may persist for a reasonable period of time even after the company goes public. We thus observe a blueprint effect of the development of corporate governance. An inference can be drawn that governance reform targeted at big public companies may have to keep an eye on the governance practices around the birth of such a company.

Next, we discuss creditors in takeovers in Part IV. Strictly speaking, few takeover transactions cannot be called a leveraged transaction since debt has already been a necessary part of takeover transactions though with different importance. Creditors usually use, again, financial covenants and convertible debenture to protect their interests in takeover transactions. However, what is special in takeover transactions is that conflicts exist between existing and newly joining creditors. Such a differentiation duly provides us with an opportunity to explain the concept of fairness, which is important in the modern interpretation of contracts. We argue that unfairness cannot arise when both parties cannot project or intentionally and reasonably overlook the later occurrence of takeover transactions.

The strong role of private contractual arrangements overshadows the role of laws and regulations in protecting creditors in takeover transactions. In fact, legal protection for creditors in takeovers is mainly of an indirect nature or through contract laws. We mention the role of insolvency law and the potential role of company law and capital markets laws and regulations on creditors in takeover transactions. However, as said, the legal protection for creditors in takeover transaction can largely be marginalized.

Besides, we also discuss the role of creditors in the current wave of buyout transactions supported by private equity and hedge funds. The availability of large amount of idle capital searching for profitable projects has already modified the negotiating power of creditors in such transactions. In fact, we observe relaxations of traditional covenants and securities, indicating the contractual flexibilities in meeting the highly developing commercial practice. However, the complex structure of such financing has brought concerns to the stability of the capital market as a whole. We observed that the FSA stops short of further regulation but instead relies on traditional contractual arrangements and the market to counterbalance the potential risk.

In Part V, we discuss creditors in insolvency. It is here that the laws and regulations, and almost all in their mandatory form, play an important role in protecting the interests of creditors. It is argued that since creditors may become residual claimants in the vicinity of insolvency, mandatory protection is accordingly initiated from that point, the specific timing of which can only be an issue of fact. Moreover, we discuss that insolvency law not only decides the superiority of creditors to shareholders in such a crucial juncture but also provides rules regulating creditors from within. Such a differentiation is important from the perspective of governance as different groups of creditors play different governance roles. In addition, we discuss whether directors should owe a general fiduciary duty to creditors. The general principle that directors owe a fiduciary duty to the company is still applicable here. A fiduciary duty to creditors is in conflict with this general principle and also contravenes the case law. In turn, directors' duty to creditors in the vicinity of insolvency can only be understood as indirect through directors' duty to the interests of the company as a whole. We then explore the issue of how much creditors can get at the end of insolvency. Such a discussion further indicates the intensive conflicts among creditors. Indeed, given that only unsecured creditors are at serious risk in insolvency, the claim that creditors in general are residual claimants in insolvency may be an inaccurate description without due consideration of such intensive conflicts within the creditor group.

The above analyses thus illustrate that contractual protection for creditors, although not complete, is wide-ranging and effective in most of the time of the life cycle of the company. It is true that their interests may be jeopardized by the financial and other commercial innovations. However, given their expertise and commercial judgment, creditors are no worse than others to safeguard their own interests regarding these innovations. [204] Furthermore, the modern approach to contract interpretation and other legal techniques may further enhance contractual protection for creditors. It is safe to say that the scheme of contractual protection for creditors is generally responsive and effective.

Still, the Achilles' heel of the contractual protection is that contracts cannot be complete. But the problem is more how we can control and allocate that risk than how we can eliminate the risk. A complete contract may be unnecessary or more costly than the business world dictates. For companies in need of finance infusion, creditors really enjoy a special advantageous bargaining position. It is the heavy demand of finance that strengthens and the intense competition among financial providers that mitigates the control of creditors. Such considerations thus revert to the power of the market. That is, the market decides the negotiating power of the participants in certain phases of the life of a company. This power, in turn, decides the contractual terms reached at last. The ensuing question is whether legal regulation of contracts can solve all the problems in the contracting processes.

Viewed from this perspective, the law can only be deemed complementary to the role contracts play for the interests of creditors. As argued, the law at least

[204] Covenants can help creditors to protect their interests within the boundaries of their business judgments.

provides a background basic expectation of contractual parties.[205] The law has the potential to meet (1) those gaps in contracts which have happened so often that standard contractual terms may thus save negotiation costs (through default rules); (2) those gaps in contracts which come into being due to the lack of sufficient negotiation, either because of naivety or because of disproportionate negotiating powers of the contractual parties (through mandatory rules to achieve fairness or social justice); (3) those gaps in the contracts arising from a potential prejudice to the collective interests by conflicting individual strategic behaviours within one side of the contract, for example, the mandatory disclosure of certain financial information or the registration of security, such as the floating charge, or the distribution in insolvency law in the UK. Still, it is worth reminding that undue regulation involves additional costs of writing and performing those rules, those of increasing litigation and those of the ensuing judgment-making and judgment-performing. Thus, legal intervention must be prudent with due consideration of arguments on both sides.

On the whole, even though legal intervention in the UK is generally very cautious, creditors still enjoy strong contingent control rights in insolvency law. More importantly, under the current (most common) situation where financial capital still dominates the other concerns, creditors' self-protection through contracts cannot be underestimated.

[205] Hertig and Kanda, (2004), at 72.

CHAPTER 5. EMPLOYEES

INTRODUCTION

While the interests of shareholders and creditors can simply be categorized in financial terms, the interests of employees include both a financial component and a non-financial component. The former is the financial compensation for employees' firm specific investment in the company. The latter refers to fair treatment for employees both physically and psychologically due to their status as citizens with dignity in a welfare state. Discussion of the interests of employees entails considerations from both perspectives.

We first discuss the social political issues in Part I. We will see how workplace democracy makes a difference to the governance rights of employees. Also covered in this Part are the issue how the social policy within the EU makes a difference to the legal development in the UK and how finance, corporate governance and labour relationships interact with each other.

We then discuss how the combination of contractual arrangements and laws and regulations protect the interests of employees throughout the life cycle of corporate governance. As usual, employees in the normal life, flotations, takeovers, and insolvency are discussed in sequence. A conclusion is given at the end.

PART I. SOCIAL POLITICAL ISSUES

A. WORKPLACE DEMOCRACY

Employees as human persons with dignity should have a right to decide what will make a difference to their own interests. Accordingly, employees' participation in corporate decision-making process is an end itself.[1] As Allan writes:

> *"A person's participation in a decision affecting his interests affirms his dignity as a citizen—one whose cooperation is sought with the public purposes in view, rather than someone treated essentially as an object of administration."*[2]

The complete form to achieve workplace democracy is employee ownership, which, however, due to the financial constraints, high monitoring costs arising from the peer review and the lack of liquidity of the membership in employee-owned-firms, exists across different industries but never dominates any given industry.[3] The importance of this form of employee participation is thus of little importance and will not be further discussed.

Except employee ownership, employee participation can also be achieved at two levels in other organizational forms. One is the operational participation, which refers to employees' involvement in the daily working operation, whereas the other is the strategic participation, which refers to employees' participation in corporate major policy issues. Because employees' operational participation does not prejudice the shareholder primacy while at the same time a company can make the most use of employees' firm specific investment, it can safely co-exist with the predominant shareholder orientated corporate governance. In contrast, employees' strategic involvement will inevitably dilute the control of shareholders, so this is an issue which deserves our discussion.

1. Employees' Participation

(a) Employees' Board Representation

One important method to materialize employees' strategic participation is through sitting on the board. Since the legal fact in the UK is that employees' participation in decision making process is neither promoted nor negated by the

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[1] Budd, J., *Employment with a Human Face: The Author Responds*, (2005), *Employee Responsibilities and Rights Journal*, 17:191-9, at 193.
[2] Allan, T., *Fairness, Equality, Rationality: Constitutional Theory and Judicial Review*, in Forsyth, C., and Hare, I., (eds), *The Golden Metwand and the Crooked Cord*, (1998), Clarendon Press, 15-38, at 30.
[3] Cheffins, B., *Company Law: Theory, Structure, and Operation*, (1997), Clarendon Press, at 556.

company law, a transplant of the legal codetermination experience in Germany is widely claimed for the purpose of promoting workplace democracy. This view, however, entails a reconsideration of governance practices within the wide social political context.

It is true that employees in Germany, through representatives on the supervisory board, have much greater decision making rights than their counterparts in the UK. However, employee representation is of sense and importance in Germany in that employees are represented, as required by law, on the supervisory board, which is entitled with a veto right over management board decisions, and they are represented as employees.[4] Moreover, the mandatory employees' participation in corporate decision making must also be understood within the specific social political context of Germany, where labour has enjoyed a much better political position than its counterpart in the UK ever since World War II.[5] Indeed, employees' status in corporate governance in Germany can only be rightly understood as an outgrowth of the political process, in which "*it was not intended to produce improved employee attitudes or greater productivity, but rather to redistribute power within firms, putting labour on a more equal footing with managers and shareholders.*"[6] Besides, cooperation between employees and managements is the norm at the company level in Germany. All these factors are in harmony with the two-tier board structure in Germany.

Conversely, we cannot observe a similar picture in the UK. In the UK, employees are excluded from the decision making process not by law but in practice. Employment relationship has been more of an adversarial and antagonistic nature than of cooperation.[7] In fact, opposition to employees' board representation from conventional directors and company financial capital providers can readily be

[4] Hopt, K., *The German Two-Tier Board: Experiences, Theories, Reforms*, in Hopt, J., *et al.*, (eds), *Comparative Corporate Governance – The State of the Art and Emerging Research*, (1998), OUP, 225-258, at 228.
[5] Davies, P., *Introduction to Company Law*, (2002b), OUP, at 274.
[6] Bainbridge, S., *Corporate Decision Making and the Moral Rights of Employees: Participatory Management and Natural Law*, (1998a), *Vill. L. Rev.* 43(4):741-828, at 795.
[7] Cheffins, (1997), at 592. A recent study also shows that monitoring employers' obligations towards their employees has been documented as the main duty of workplace trade unions. Brown, W., *et al*., *The Employment Contract: From Collective Procedures to Individual Rights*, (2000), *British Journal of Industrial Relations*, 38(4):611-629, also available at http://www.cbr.cam.ac.uk/pdf/wp171.pdf, at 9.

detected.[8] Indeed, the failure of the proposed scheme of employee representation on the board in the 1970s[9] has already been attributed to the specific "*social structure and tradition of corporate finance*", which make it easy for shareholders and business interests to resist successfully such a proposal.[10] Moreover, the historically established antagonistic relationship between employees and employers and the dominant market contracting approach to settle the conflicts between shareholders and employees only reinforces the governance practice of the single-tier board structure in the UK.[11] A mandatory replacement of the current single-tier board with a two-tier board or other forms of employee codetermination may be disastrous in that the change of the decision making scheme may destabilize the current economy.

Such considerations thus place in doubt a mandatory board representation of employees in the UK at least for the time being. This said, it must be realized that board representation is not the only way to achieve workplace democracy. Employees may also participate in the decision making process through financial participation as will be discussed in the next section or through other routes outside the traditional scope of company law. To limit participation only to the board representation is a blind disregard of variety of the current governance practices and may only do a disservice.

(b) Financial Participation

The main methods of financial participation are Employee Stock Ownership Plans (ESOPs) and pension funds.[12] In ESOPs, employees hold shares of the company they work for and may thus enjoy the rights granted to shareholders in company law. In that sense, the governance function of ESOPs is to attach a shareholder status to employees.

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[8] Hammer, T., *et al*., *Worker Representation on Boards of Directors: A Study of Competing Roles*, (1991), *Industrial and Labor Relation Review*, 44(4): 661-680.
[9] See the Report of the Committee of Inquiry on Industrial Democracy, (1975), Cmnd. 6706, *i.e.* the 'Bullock' Report. The failed proposal advocated a parity representation of employees on the board.
[10] Davies, (2002b), at 274.
[11] *ibid*., at 275.
[12] In addition, financial participation by employees can also be achieved by profit sharing. Since tax free awards are no longer permitted after the end of 2002 under the current finance act, profit sharing will gradually be replaced by ESOPs and thus will not be discussed here.

Alternatively, employees' long-term interests in the company are not only revealed in their dependence on the long-term job for their living but also reflected in their limited pension requirement long after they leave the company. Employee pension schemes can be divided into two separate categories, *i.e.*, personal pension schemes and occupational pension schemes.[13] Personal pension schemes are usually in the form of insurance policies purchased by individual employees, with or without the contribution from the employer and they are usually managed by fund managers in insurance companies.[14] In comparison, occupational pension schemes are in the legal form of trust funds, which are subject to the regulation of trust law, and are managed by trust fund managers. As pensions for employees are either a mandatory requirement from law or a norm among employees, both company's contributions and employees' self-contribution to pension funds may thus make difference to the company's remuneration policy and the corporate strategic decision making process.

However, employees' financial participation suffers from inherent deficiencies. Traditionally, employee shareholders do not enjoy the voting right conferred on shareholders. Nor can employees freely transfer their shares in ESOPs. Moreover, even if they have voting rights, employee shareholding is too small in most cases to make a difference in corporate decision-making processes. While it is true that ESOPs are statutorily promoted in the structure of trust,[15] such structures are still not the norm of ESOPs in practice.[16]

In addition, employers may fiddle the scheme by changing the payout formula or simply by redefining "profits" in order to downsize the award.[17] Besides, employee

[13] Pensions Act 2004 s259.
[14] The establishment and running of the personal pension scheme is subject to the approval and authorization provisions under the Financial Services and Markets Act 2000. The result is that the providers of such pension schemes are required to observe the relevant authorization and conduct of business rules. See also, MacNeil, I., *An Introduction to the Law on Financial Investment*, (2005), Hart Publishing Oxford and Portland, Oregon, at 132-5
[15] Employee Share Schemes Act 2002, Schedule 8 of the Finance Act 2000; Schedule 13 of the Finance Act 2001.
[16] For an optimistic review of ESOPs in the UK, see Pendleton, A., *Employee Ownership, Participation and Governance: A Study of ESOPs in the UK*, (2000), Routledge. But for a criticism, see Turberville, S., *Book Review on Employee Ownership, Participation and Governance: A Study of ESOP's in the UK*, (2002), *Journal of Industrial Relations*, 44:151-3. Turberville comment that ESOPs described in the commented book is "*exceptionalism of employee share ownership*," at 152.
[17] Reilly, P., *et al*., *A Share of the Spoils: Employee Financial Participation*, (2001), the Institute for

investors with heavy investment in the company stock may also suffer disproportionately in finance for the reason of misleading communication between the management and the employee shareholders.[18] Thus, even though ESOPs may be commended for locking in employees by inducing employees' continuous efforts and work improvements, and continuous commitment to the company,[19] the effect of such plans in enhancing employees' governance rights and safeguarding employees' interests is doubtful.

Alternatively, employees' participation through pension funds can only be indirect. Both insurance companies in personal pension schemes and trust funds in occupational pension schemes are institutional investors, who are quasi-index-investors caring more about the general performance of the whole market than governance practices of any individual company. For instance, pension funds are often invested in companies that employees do not work for. Indeed, a fund which refused to invest in a competitor of a company those pension fund holders work for was judged to be in breach of its duty to its trustees.[20] Thus, if there is any effect, it is likely to be indirect.

Admittedly, employees may have their voice heard or even followed by taking part in the policy decision-making process of the investment of funds. For example, unions in the US have already advocated good labour standards to pension fund managers as one of the criteria to select target companies.[21] However, these cases are few in number and with little consequence. Moreover, participation by influencing pension fund investment policy changes the status of employees into that of investors. In practice, employees' support of their own interests can only be achieved indirectly through the general improvement of labour standards across industries.

In sum, employees may influence the board decision-making process through

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Employment Studies Report 373, available at <u>*http://www.employment-studies.co.uk/summary.php?id=373*</u>, at page XI and 27-8.

[18] O'Hare, J., *Misleading Employer Communications and the Securities Fraud Implications of the Employee as Investor*, (2003), *Villanova. L. Rev*., 48(4):1217-1245.

[19] Hyde, A., *In Defense of Employee Ownership*, (1991), *Chi.-Kent L. Rev.* 67:159-211, at 209.

[20] *Cowan v Scargill*, [1984] 2 All E.R. 750.

[21] Gospel, H., and Pendleton, A., *Finance, Corporate Governance and the Management of Labor: A Conceptual and Comparative Analysis*, (2003), 41(3):557-82, at 574.

their financial participation but the effect is very limited. However, such creative arrangements are vivid examples that the inherent flexibility of the corporate governance institution can help to soothe the intensive conflicts between labour and capital.

2. Workplace Democracy and the Hierarchical Structure of a Company

The promotion of workplace democracy, however, may conflict with the hierarchical structure of a company. Within a company, the hierarchical structure and authority substitute for the free exchanges between subjects with equal status on the market.[22] The hierarchy system can reduce role conflicts and ambiguity through a formalization process—the creation of written rules, procedures and instructions.[23] Additionally, compared with democracy, hierarchy can help to achieve an effective monitoring scheme and efficient information transmission channels in the company.[24] Thus, the hierarchical structure not only saves cost but also leads to predictability and order within the company.[25] The hierarchical structure is accordingly a requirement of economic efficiency.

However, with characteristics of coercion, bureaucracy, and domination,[26] the hierarchical structure seems to be in conflict with employee control and may encroach on employees' rights as citizens. Nevertheless, since employee democracy depends on the existence or the healthiness of the company, economic efficiency is complementary with workplace democracy at least to the extent that the financial existence of the company is not an impending headache.

The above discussion shows that the widely promoted workplace democracy is still seriously constrained by the current finance dominated social context. However,

[22] Coase, R., *The Nature of the Firm*, in Coase, R., *The Firm, The Market, and the Law*, (1988), Chicago Univ. of Chicago Press, at 33.
[23] Bainbridge, (1998a), at 767.
[24] *ibid.*, at 805.
[25] Cheffins, (1997), at 83.
[26] Collins, H., *Market Power, Bureaucratic Power, and the Contract of Employment*, (1986), *Indust. L. J.*, 15:1.

whatever the result of such a discussion, it must be noticed that empirical evidence does not support a consistent relationship between employee participation and productivity improvement.[27] Indeed, in some cases employee participation is found to be less effective than non-participation.[28] Such findings, however, may be attributable to the facts that employees have heterogeneous preferences for participation[29] and that personalities of workers and managers can largely decide the success of the participation program.[30] Thus, it is worth noting that the promotion of workplace democracy or employees' participation in the decision making process may not achieve what is intended.

B. ECONOMIC EFFICIENCY AND SOCIAL JUSTICE

The employment relationship in the UK must be viewed within the wider background of the European Union, in which "*the employment relationship is heavily regulated, through legislation that is influenced and shaped in turn by the European Social Policy.*"[31] In fact, 40% of employment regulations in the UK are imposed from the European Union.[32] Under the joint influence of both the traditional collective laissez-faire and the EU-initiated principle of procedural justice for individuals, employment law in the UK has undergone huge development, the end result of which has already differentiated employment law in the UK from that in the US.[33]

The overwhelming influence from the EU can be traced back to the social policy promoted within the EU. A communication paper in 1993 pointed out that

[27] Bainbridge, S., *Privately Ordered Participatory Management: An Organizational Failures Analysis*, (1998b), *Del. J. Corp. L.*, 23:979-1076.
[28] Locke, E., *et al*., *Participation in Decisionmaking: When Should it Be Used?*, (1986), *Org. Dynamics*, 14:3:65, at 69.
[29] Glew, D., *et al*., *Participation in Organizations: A Preview of the Issues and Proposed Framework for Future Analysis*, (1995), *J. MGMT*., 21:395, at 404-05.
[30] Bainbridge, (1998a), at 767.
[31] Lynch-Fannon, I., *Employees as Corporate Stakeholders: Theory and Reality in a Transatlantic Context*, (2004), *Journal of Corporate Law Studies*, 4 (1):155-186, at 160. And, generally, Lynch-Fannon, I., *Working within Two Kinds of Capitalism: Corporate Governance and Employment Stakeholding: US and EC Perspectives*, (2003), Oxford, Hart Publishing.
[32] Better Regulation Task Force, *Employment Regulation: Striking a Balance*, (2002), available at *http://www.brtf.gov.uk/docs/pdf/employmentregulation.pdf*, at para.2.5.
[33] Hutchison, H., *Evolution, Consistency, and Community: The Political, Social, and Economic Assumptions that Govern the Incorporation of Terms in British Employment Contracts*, (2000), *N.C. J. Int'l L. & Comm. Reg.*, 335-358 and Lynch-Fannon, (2003).

"*much of Europe's influence and power has come precisely from its capacity to combine wealth enhanced benefits and freedoms for its people.*"[34] Recently, the Social Policy Agenda document (post-Lisbon) clarifies the new strategic goal for Europe is to become the "*most competitive and dynamic knowledge-based economy capable of sustainable economic growth with more and better jobs and greater social cohesion*."[35] Moreover, the "*essential linkage between Europe's economic strength and its social model*" has also been reiterated.[36]

Within this background and given the persistent efforts of the current labour government to align the domestic policy with the policy of the EU, the juxtaposition of economic efficiency and social justice will guide the future development of the employment relationship in the UK. This again shows that the dynamic development of the social context dictates a dynamic view of the employment relationship and employees' role in corporate governance.

C. FINANCE CORPORATE GOVERNANCE AND THE MANAGEMENT OF LABOUR

1. The Company Level

The liquid stock market and the active labour market in the UK not only facilitate corporate restructuring activities but also drive innovations by providing for entrepreneurs readily accessible financial resources through flotations.[37] This in turn leads to an economy with both a high birth rate and a high death rate of enterprises. Such a high rotating rate not only presses companies for good short-term financial performance so that they can keep their heads above the rapid water but also helps to mould short-termism in employment patterns, training and the work force development, as evidenced in the increasing uses of contingent employment in practice and also in the introduction of incentive schemes for employees based on

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[34] Commission of the European Communities COM (1993) 551 final 17.11.1993, at 7, para. 4.
[35] Commission of the European Communities COM (2000) 379 final 28.6.2000, at 5, para. 1.1.
[36] *ibid.*, para. 1.2.
[37] Teece, D., *Managing Intellectual Capital: Organizational, Strategic and Policy Dimensions*, (2000), OUP.

short-term financial performance.[38] Accordingly, workers in the UK are prone to '*hold-up*' activities, which emphasize job control and restrictive practices due to their perception that the current governance system does not offer long-term benefits for co-operation.[39]

Nevertheless, the short-term implication on employment practices can be mitigated by the observed stickiness in employment at the company level.[40] This is because the flexibility of substitution is limited within the term of the capital. Additional flexibility is only possible when new capital is coming in. Besides, certain costs relevant to labour, such as those of recruiting and training, are fixed. As adjustments will also bring in new costs, companies prefer a kind of stability in their labor force.[41] In fact, companies neither casually decrease the employees in bad times nor increase their employees as the increasing productivity demands. The inflexibility or stickiness of employment practice, "*in effect, …, [implies] a stream of relatively fixed payments, not easily adjusted to accommodate variation in revenues, for firms which are going concerns.*"[42] In turn, the "*intangible liabilities*" of a company to its employees can engender an effect of the so-called labor leverage, like that of financial leverage, on corporate finance policies such as the equity investment policy, the dividend distribution policy and the capital structure.[43]

Alternatively, while it is costly or unrealistic to make income redistribution in the wide economy, such adjustments are surely possible within a given company.[44] Moreover, disadvantaged employees may politically unite, to some extent, with a subgroup of the finance suppliers of the company to safeguard their interests.[45] For example, compared with risk-favouring shareholders, banks, which hold rather fixed claims on corporate returns, stand closer to the labour. By politically influencing

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[38] Gospel and Pendleton, (2003), at 566.

[39] Gospel, H., *Markets, Firms, and the Management of Labor in Modern Britain*, (1992), CUP, at 149-58.

[40] Hamermesh, D., *Labor Demand and the Structure of Adjustment Costs*, (1989), *American Economic Review*, 79(4): 674-89.

[41] Brummet, L., *Accounting for Human Resources*, (1970), *Journal of Accountancy*, 130(6):62-66.

[42] Rosett, J., *Labor Leverage, Equity Risk and Corporate Policy Choice*, (2003), *European Accounting Review*, 12(4):699-732, at 703.

[43] *ibid*.

[44] Perotti, E., and von Thadden, E., *The Political Economy of Bank and Equity Dominance*, (2003), Center for Economic Policy Research, (CEPR), Discussion Paper No.993914, available at http://ssrn.com/abstract=427140.

[45] *ibid*.

company's risk taking, labour may thus unite with banks to secure their interests.

2. The Social Political Context

Within the wider social context, the industrial relationship is merely a knot of the whole institutional network. Thus, even though a supportive culture for employee governance role will encourage employees to make firm specific investment, "*the effectiveness of worker governance devices may depend on a highly reticulated set of supportive background institutions including intermediate institutions such as unions and financial monitors and public institutions for social welfare entitlements.*"[46]

Such an institutional view of corporate governance also necessitates a reconsideration of the current changes in employment relationship. The current promotion of workplace democracy can further entrench the acquired interests of employees because "*the higher these labor rents, the stronger is the political interest to protect them from corporate risk.*"[47] This may, in turn, engender backlashes from financial providers. For instance, shareholders, especially institutional shareholders, will strengthen their inherited role as residual claimants within the scope of company law. Creditors, similarly, will take advantage of their negotiating power to reinforce their contractual rights. The end result may not be easily predicted.

Indeed, both the relationship between employees and the financial aspects of corporate governance at the company level and that between labour and capital within the wider society are interactive ones. These concerns implicate that financial concerns and employment issues are juxtaposed in the decision making agenda of the company. Often, if not always, there is no predetermined priority order between financial and employment issues.

[46] Charny, D., *Workers and Corporate Governance: The Role of Political Culture,* in Blair, M., and Roe, M., (1999), at 118.
[47] Perotti, and von Thadden, (2003), at 4.

PART II. EMPLOYEES IN THE NORMAL LIFE

A. THE ROLE OF CONTRACTS

Employment contracts have long been recognized as the cornerstone of the modern employment relationship.[48] On the one hand, only persons engaged under an employment contract can be subjects of the instrumental labour law. On the other hand, "*it was only through the contract of employment that the terms of the great bulk of external regulation were enforceable legally.*"[49] Thus, the discussion of employees in corporate governance will be limited to those who have signed employment contracts with the company.

Generally, employment contracts can be understood on two levels, *i.e.*, the level of personal scope and that of collective bargaining. The former emphasizes the contractual rights of individual employees while the latter focuses on the collective negotiating power of employees as a class. Since they are mutually complementary, an appropriate understanding of the role of employment contracts in safeguarding the interests of employees entails consideration of factors on both levels.

1. Personal Scope

(a) The Dynamics of Employees' Negotiating Power

The current debate on employee protection can be attributed to the asynchrony between wage payment and employees' firm specific investment. Employees are commonly said to be exploited by the employer as employees usually do not receive due payment for their firm specific investment during their employment term. Such argument has its merits for some employees but it may go too far to extend it as a generalization to all employees.

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48 Deakin, S., *The Contract of Employment: A Study in Legal Evolution*, (2001a), *Historical Studies Journal of Industrial Relations*, 11:1-36, also available at *http://www.cbr.cam.ac.uk/pdf/WP203.pdf*, at 32.

49 Johnstone, R., and Mitchell, R., *Regulating Work*, in Parker, C., *et al*., (eds), *Regulating Law*, (2004), OUP, 101-121, at 109.

Employees' firm specific investment is a dynamic issue which is case-sensitive to individual employees. For any individual employee, there are four phases regarding the development of the relationship between his firm specific investment and the payment of wages.[50] In phase one, both the employer company and the employee make firm specific investments. Thus, it is justifiable to observe that the employee is paid with a value over or equal to that of his marginal product but less than his opportunity wage in the general external labour market. In phase two, employees' firm specific investment increases though the payment they receive is less than both the value of their marginal product and the opportunity wage on the external labor market. Employees accept such terms because they defer their compensation for the sake of their job security. Thus, employers are benefiting from the contribution of employees' firm specific investment in this phase.

In phase three, employees' firm specific investment makes them more valuable to the employer than other potential employers on the market. However, employees in this phase are paid higher than the value of her opportunity wage on the external labour market but less than the value of her marginal product. In phase four, employees are paid with an amount higher than the value of their marginal product and that of the opportunity wage on the external market. It is in this phase that employees recoup their former firm specific investment and deferred compensation.[51]

The realization of four phases in employees' firm specific investment tells us that employees in different phases enjoy different negotiating powers. For employees in phase one, due to the ever-changing individual psychological and physical conditions,[52] the incompleteness of the employment contracts may in fact permit the strong discretion for the employee *ex post* the contract. This is because it is difficult to translate into contractual terms efforts from employees, whose investment is not once-for-all, as what shareholders do, but continuous.[53] An inference can be drawn that

[50] Stone, K., *Policing Employment Contracts within the Nexus-of-Contracts Firm,* (1993), *University of Toronto Law Journal,* 43:353-378.
[51] *ibid.*, at 366.
[52] O'Connor, M., *The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation*, (1993), *Cornell Law Rev.*, 78: 899, at 916.
[53] Accordingly, Gordon claims that shareholders are in need of governance institutions to protect their interests. Gordon, J., *Employee Stock Ownership in Economic Transitions: The Case of United and the*

rational employees in phase one will make long-term firm specific investment only when they are reasonably sure about the existence of the intended long-term contracts. In fact, in the current uncertain and complex context, a better alternative for employees in this phase may be to strike a trade-off between short-term commitment and transferable skills with a certain employer.[54] In other words, firm specific investment is more likely to be an exception for rational employees in phase one. Thus, for employees in phase one, a bilateral monopoly, rather than the usually claimed monopoly position of employers alone, is the right description of the employment relationship in employment contracting.[55]

In comparison, employees in phase two may well take advantage of their negotiating power to ask for more governance rights or simply leave the employer with a newly furnished resumé to a new post with better compensation. In other words, such employees may effectively insert contractual terms *ex ante* to guard against the *ex post* opportunism of the employer. For employees in this category, contractual negotiation may well settle the concern of employee participation in corporate governance.

For employees in phases three and four, their foregoing firm specific investment provides a sound argument for their unexpressed but implied requirement for job security. Employees in these two phases suffer from their lessened negotiating power as their firm specific investment makes them less attractive to other potential employers on the external labour market. Legal intervention in safeguarding the interests of employees in these two phases is accordingly necessary as unfair dismissals by employers can deprive such employees of opportunities to recoup their foregoing firm specific investment. Thus, the often claimed relational contract nature[56] of employment contracts on the basis of employees' firm specific investment

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Airline Industry, in Blair, M., and Roe, M., (eds), *Employees and Corporate Governance*, (1999), Brookings Institution Press, 317-354, at 323.

[54] Rajan, A., *Employability in the Finance Sector: Rhetoric vs. Reality*, (1997), *Human Resource Management Journal*, 7(1):67-78.

[55] Bainbridge, (1998a).

[56] A relational contract has largely been defined as "*a contract that involves not merely an exchange, but also a relationship, between the contracting parties*." See Goetz, C., and Scott, R., *Principles of Relational Contracts*, (1981), *Va. L. Rev*., 67:1089, at 1091. But for a comparison, see Eisenberg, M., *Why There is No Law of Relational Contracts*, (2000), *Nw. U. L. Rev*., 94:805-821, who argues at 816 that the implication of such a concept is that almost all the contracts are relational rather than discrete.

is of sense only for employees in these last two phases.

The four-phase argument shows that employees' firm specific investment is a case-sensitive, dynamic issue. In turn, the argument for employee control based on employees' firm specific investment must be understood with reference to the specific phases each individual employee is in. A general linkage between employees' firm specific investment and the promotion of employees' governance rights can only vitiate the persuasiveness of the argument.

(b) Relational Contracts and the Implied Duty of Mutual Trust and Confidence

Following the above line of reasoning, employees in phases three and four contract for both fair wage and job security when they negotiate their employment contracts. Employment contracts for such employees accordingly can only be rightly understood as relational contracts.[57] With this recognition, courts when interpreting the employment contract often imply in the contract a term of mutual duty of trust and confidence. For example, in the widely cited case, *Malik v. Bank of Credit and Commercial International [BCCI]*,[58] the court accepted the employee's argument that the fraud conduct of the management destroyed the trust and confidence implied in his long-term employment contracts with the employer and thus the employer breached its implied duty of trust and confidence to the employee.

The implied mutual duty of trust and confidence has been deemed as "*the core common law duty which dictates how employees should be treated during the course of the employment relationship.*"[59] Though the legal effect of implied terms is uncertain,[60] the potential expansion of employers' liabilities under the traditional employment contracts may in effect build up a cooperative culture in employment

[57] Lord Steyn said, "*[i]t is no longer right to equate a contract of employment with commercial contracts. One possible way of describing a contract of employment in modern terms is as a relational contract.*" in *Johnson v Unisys Ltd* [2001] IRLR 279, at para. 20.
[58] [1997] ICR 606
[59] Brodie, D., *The Heart of the Matter: Mutual Trust and Confidence*, (1996), *Indus. L. J.* 25:121 at 125
[60] As it is the court who will decide the applicability of the implied terms or whether such terms will be implied into the contract or not. Lord Steyn said in *Malik v BCCI* [1997] ICR 606, "*implied terms operate as default rules. The parties are free to exclude or to modify them.*" at 621, para. A.

contracting.[61] This is because the underlying assumption of the implied duty is the "*judicial vision of the work place as a community*," a recognition that personal factors should be implied and the dignity of the workers should be promoted in the employment relationship set up by employment contracts.[62]

(c) Job Security

Legally speaking, job security is a concept limited by the relevant employment contracts. An employee acquires the job through a legal contract with the company. His rights are thus off-limits to the employer's intentional unjustified breaches of the employment contract. However, such contractual rights must be differentiated from the ownership of the job, as implied by the argument that employees own the job.[63] Rather, the job is owned by the employer company. Thus, job security cannot be identified with a job with an infinite term. Viewed from this perspective, employees' firm specific investment should also, like other financial investment, bear the risk of zero returns.

A related but often overstated issue is the rate of employee turnover. Even though employers are said to be prone to grant a group of core workers permanent jobs and leave jobs of the other employees at the discretion of the market, statistical data show that the permanent employees are still the mainstream.[64] Thus, even if the promotion of job security can be regarded as a worthwhile effort, it should not be overextended.

[61] Brodie, D., *Commentary: Mutual Trust and the Values of the Employment Contract*, (2001), *Indus. L. J.*, 30:84-100, at 86 and Deakin, S., and Morris, G., *Labour Law*, (4th edn), (2005), Hart Publishing, at 242-7.
[62] Brodie, D., *Commentary: Specific Performance and Employment Contracts*, (1998), *Indus. L. J.*, 27:37.
[63] Job ownership by employees is rejected in all economic systems. Collins attributes this to the idea of general welfare, which is mainly expressed in the efficiency in both the product and the labour markets. Collins, H., *Justice in Dismissal: the Law of Termination of Employment*, (1992), Clarendon Press Oxford, at 9-12.
[64] Cheffins, (1997), at 577.

2. Collective Dimension

The heterogeneous interests and the free rider concern of employees, which have long been blocking effective employee governance, can more or less be settled by employee representation in the collective dimension. Intricate issues not suitable to individual bargainers, such as physical working conditions, redeployment within the organization, and redundancy, may be suitable for collective bargainers. In this regard, Kahn-Freund argues that collective bargaining can help to rectify the unequal bargaining power between the employer and individual employees "*by raising the latter to a level of equality of bargaining power*."[65] Thus, collective bargaining can be deemed as a mechanism to fill the gap of incomplete individual contracts.[66]

(a) Representation of Employees in Collective Bargaining

Traditionally, representation of employees in the UK was mainly achieved through a single channel of union recognition by employers.[67] The importance of independent unions in worker representation can mainly be attributed to their financial independence from the employer.[68] Nor are they chosen or endorsed by the employer. In addition, unions in the UK traditionally cover different work places, making them aware of the different treatments and have more opportunities to accumulate skills and build up expertise in contractual negotiations.

In general, unions are said to have at least three roles, which include acquiring substantial bargaining power, providing protection to its members and enhancing the voice of the employees.[69] Ever since 1970s when Directives on transfers of undertakings and collective economic dismissal[70] were introduced, an additional

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[65] Kahn-Freund, O., *Collective Agreements under War Legislation*, (1943), *M. L. R.*, 6:112, at 117.
[66] Cheffins, (1997), at 94.
[67] Davies, P., and Kilpatrick, C., *UK Worker Representation after Single Channel*, (2004), *Industrial Law Journal*, 33(2):121.
[68] Section 5 of the Trade Union and Labour Relations (Consolidation) Act 1992 (TULR 1992). Also, Deakin and Morris, (2005), para. 7.23.
[69] Brown, W., *et al.*, *The Individualisation of Employment Contracts in Britain*, (1998), Research Paper for the Department of Trade and Industry, Center for Business Research Department of Applied Economics, University of Cambridge, at 10-11.
[70] For the former Council Directive 77/187/EEC, implemented in the Transfer of Undertakings (Protection of Employment) Regulations 1981 (SI 1981/1794) and now Transfer of Undertakings

function of information and consultation has been added to that of the collective bargaining. Failure of employers to supply the required information may lead to an application of the case by unions to the Advisory Conciliation and Arbitration Service and further to the Central Arbitration Committee (CAC).

However, the current effect of collective bargaining through unions may have to be discounted. First, unions in the UK have largely been marginalized, a situation which is reflected not only in the decreasing membership or the coverage of members under the collective agreements but also in the level of collective negotiations.[71]

Second, the collective bargaining role of unions is also limited by the inherent deficiency of its representativity among employees.[72] Since there is no representativity requirement of membership for a recognized union and the recognized union will be the only body with which the employer can enter into consultation in cases of redundancy and transfer of undertakings, the monopoly of a recognized union can block the recognition of another union which represents more employees.[73] Besides, non-union-members may also be treated differently.

Third, employers may refuse to provide information by relying on defences such as potential substantial injury to the company or disproportionate amount of work in compiling information needed.[74] Moreover, once the employer fails to provide required information to the recognized union, a compulsory award on information disclosure is not available. The CAC may ask for certain information to be disclosed but again, if the employer does not, the only remedy is to make improvements in terms and conditions of relevant employees, rather than to compel the employer to supply relevant information. So, the enforcement mechanism is too weak to play a serious role.[75]

(Protection of Employment) Regulations 2006 (SI 2006/264) (TUPE 2006) and for the latter, Council Directive 75/129/EEC, implemented in the Employment Protection Act 1975.

[71] Brown, W., *et al*., *The Employment Contract: From Collective Procedures to Individual Rights*, (2000), *British Journal of Industrial Relations*, 38(4):611-629, also available at *http://www.cbr.cam.ac.uk/pdf/wp171.pdf*, at 4-9.

[72] See the NUJ case, as discussed in Davies and Kilpatrick, (2004), at 131.

[73] *ibid*.

[74] Gospel, H., and Willman, P., *The CAC Decisions on Disclosure of Information*, (1981), *Industrial Law Journal*, 10-22.

[75] Gospel, H., and Willman, P., *Comparatively Open: Statutory Information Disclosure for Consultation*

Admittedly, efforts to rejuvenate unions have been made as evidenced in the widely adopted labour-management partnership agreements ever since the mid-1990s.[76] Unions earn their independent representation and the exercise of employee voice in the workplace by agreeing to encourage employees' investments in human capital and streamlining the information flow between management and workers, and other functions such as to resolve grievances and disputes. However, as no legal or institutional guarantees are in place for continuous commitment from both sides, the efficacy of these partnership agreements is open to doubt though such arrangements do contribute to establishing a cooperative culture.

Alternatively, mainly due to the challenges from the EU, the traditional single channel through recognized unions in the UK has largely been changed in the past.[77] Now, in combination with the recognized union scheme is the elected representative scheme for those who are not members of the recognized union.[78] Considering the current marginalization of unions, we may project that the elected representative scheme will be more widely adopted than that of the recognized union scheme.[79] Still, as the employer has no duty to inform and consult the non-recognized unions and there are no corresponding steps to equip those elected representatives with necessary negotiating skills and expertise on the issue, elected representatives may not represent the interests of workers or may not negotiate for a well-considered result. In consequence, resources from the non-recognized unions may be wasted.

(b) Collective Agreements

While collective bargaining can enhance the negotiating power of the employees, contractual terms reached in collective agreements must be incorporated into individual employment contracts to be effective. In general, except for those

and Bargaining in Germany, France, and the UK, (2004), London School of Economics and Political Science Center for Economic Performance Discussion Paper 0615, available at *http://cep.lse.ac.uk/pubs/download/dp0615*, at 13.

[76] Brown, W., *Putting Partnership into Practice in Britain*, (2000), *Brit. J. Indus. Rel.*, 38:299 and Davies and Kilpatrick, (2004), at 122.

[78] TULR 1992 ss188-188A and TUPE 2006 regs.10-11A

[79] Davies and Kilpatrick, (2004), at 143.

terms that cannot be incorporated,[80] incorporation can readily be materialized if there are express terms to that effect. If not, to view these terms as business practices may be possible. However, even if terms in collective agreements are incorporated into individual contracts, the termination or major modifications of relevant terms in a collective agreement cannot be applied to individual contracts without the employee's express or implied consent.[81] Individual employees can thus have opportunities to screen any changes in collective agreements. Collins accordingly argued that collective agreements should be better viewed as kind of "*administrative rules which create expectations which deserve a measure of protection*."[82]

(c) The Relevance of Competition on the Product Market

Alternatively, labour's negotiating power is also constrained by the competition on the product market.[83] Fierce competition on the product market may lead to a rather disadvantaged negotiation position for unions. In a highly competitive market, union's movements which have the potential to lower the productivity may backfire and thus be counterproductive to the union's original objectives.[84] In fact, not only will employers resist such movements persistently, unions themselves may also block such movements in the first instance because any achievement in this respect may come at the expense of lower payments or losses of job security, which, in turn, will lower the number of members of the unions. Thus, the intensiveness of the competition on the product market may also constrain employees' collective negotiating power.

The discussion in this section tells us that the role of employment contracts in safeguarding the interests of individual employees is a case sensitive issue. While firm specific investment and relational contracts provide good arguments for some employees, they are definitely not applicable to all employees. Moreover, collective bargaining can strengthen the bargaining power of employees as a class but various factors can counteract the positive effects.

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[80] For example, terms regarding collective actions cannot be readily incorporated.
[81] *Robertson v. British Gas Corporation* [1983] I.C.R. 351 (C.A)
[82] Collins, (1986), at 8.
[83] Brown, *et al.*, (1998), at 9.
[84] *ibid.*, at 11.

B. THE ROLE OF LAWS AND REGULATIONS

Legal intervention in the employment relationship is usually outside the scope of company law. Indeed, employment law is the main area where protection for the interests of employees, either individually or collectively, can be found. Moreover, for directors making strategic decisions both employment law and company law should be considered with equal status. The implication for the purpose of this thesis is that corporate governance is not an issue limited within the boundary of company law. At least, employment law should be included.

1. Employment Law

(a) The Status Approach and the Public Law Element in the Regulation of Employment Contracts

An appropriate understanding of the employment relationship induced by employment contracts entails analyses of both the contractual relationship and the social relations involved.[85] With the objective to elicit extra-functional contributions based on high trust relationships, this view, in turn, requires a promotion in employment relationship of a status relationship, which involves "*the replacement of specific contractual obligations as the main mechanisms of controlling the exchange between workers and employing organizations, by general, unspecific and long term commitments on both sides to cooperation.*"[86]

The status approach to employment relationship has already been recognized in the UK law. Deakin, in his study on the evolution of employment contracts in the UK, has noticed that general precepts of private law on contracts have never enjoyed primacy in the legal history. "*On the contrary, conception of status drawn in part from*

[85] Collins, (1986), at 3.
[86] Streeck, W., *The Uncertainties of Management in the Management of uncertainty: Employers, Labor Relations and Industrial Adjustments in the 1980s*, (1987), *Work, Employment and Society*, 1(3):281-308, at 293.

legislation and in part from judge-made rules which were specific to employment underpinned the rise of the modern employment relationship at every stage."[87] This status approach thus extends, at least in law, the interests of employees to those non-commercial considerations.

Alternatively, the status approach dictates that employment relationship must be governed by principles of public law, which require that parties with power should not misuse their power and that the exercise of the power must be fair and reasonable.[88] Indeed, the increased government intervention has already led the law regulating employment contracts into "*a process of transition from the dominance of traditional private law regulation to one where welfarist regulation increasingly provides the basic discourse of the legal regulation of contracts*."[89] Such a welfarist conception is in stark contrast to the carefully measured reciprocity implicit in the traditional commercial contracts.[90] For example, not only are mutual trust and confidence implied in individual employment contracts but specified clauses are also required by the Employment Rights Act 1996 in written employment contracts.[91] The relevance of this understanding is that the redistribution of wealth among stakeholders can appropriately be excluded from the coverage of private contracts while at the same time still be achieved by the public policy element of employment law.[92]

(b) Information and Consultation

Regulations on information disclosure can largely be categorized into process-driven and event-driven.[93] Process-driven information disclosures can be seen as steps in a set of general rules on consultation or bargaining process, which is usually

[87] Deakin, (2001a), at 8.
[88] In detail, "*[t]he concept of fairness includes not only conformity to the promulgated rules, but also questions about whether those rules are fair in themselves and whether in their application the employer has acted fairly*," whereas reasonableness requires rational exercises of the power for the interests of the company must be realized with due respect for the rights of those affected. See Collins, (1986), at 11.
[89] Collins, H., *Regulating Contracts*, (1999), OUP, at 8.
[90] Hutchison, (2000), at 339.
[91] Specified clauses of contracts are prescribed across the Act. In specific, see ERA1996 s203(1). Also, Trade Union and Labour Relations (Consolidated) Act 1992 s288.
[92] Daniels, R., *Stakeholders and Takeovers: Can Contractarianism Be Compassionate?*, (1993), *University of Toronto Law Journal*, 43:315, at 342.
[93] Gospel and Willman, (2004), at 1.

connected with employee representatives with an objective to ensure the continuity of the governance scheme. Examples in this category include the European Work Council Directive (EWC)[94] and the newly introduced Information and Consultation (IC) Directive.[95] In comparison, event-driven disclosure is initiated by certain events, without consideration of the general consultation or negotiation, such as those triggered by ownership changes or redundancy. The Acquired Rights Directive,[96] and the TUPE in the UK, can be categorized into this group.

In addition to information disclosure, mandatory consultation has also been an "established feature" of employment law in the UK regarding health and safety issues, redundancies, transfers of undertakings and pension schemes.[97] While further clarification of the definition of these rights is still needed and the specific performance of these rights in practice is still in their incubation,[98] information disclosure, in combination with the mandatory consultation, by employers either as a continuing obligation or as a duty at crucial junctures in the life of a company can however redress the information asymmetry existing between the employees and the employer and, in turn, employees can have their voice more seriously considered than before.

(c) Unfair Dismissal Law

By prescribing fairness in both substantive and procedural senses,[99] unfair

[94] Council Directive 94/45/EC, [1994] OJ L:254/64 (EWC)and Council Directive 97/74/EC [1997] OJ L010/22 extending EWC to the UK, implemented in the UK through the Transnational Information and Consultation of Employees Regulations 1999, SI 1999/3323

[95] Directive 2002/14 EC OJ L080/29 (IC), implemented in the UK through the Information and Consultation of Employees Regulations 2004, (ICE), SI 2004/3426

[96] Directive 75/129 EC [1975] OJ L48/29 and Directive 98/59 EC [1998] OJ L 225/16.

[97] Respectively, Health and Safety at Work Act 1974, s2; Employment Protection Act 1975, ss99-107, implementing the EC Directive on the Approximation of the Laws of the Member States Relating to Collective Redundancies (OJ 1975, L48/29) (CRD); and TUPE 1981, implementing the Directive on Safeguarding Employees' Rights in the Event of Transfers of Undertakings (OJ 1977, L61/26); and Pension Act 1995.

[98] Lorber, P., *Reviewing the European Works Council Directive: European Progress and United Kingdom Perspective*, (2004), *Indus. L. J.*, 33(2):191-199 and Gospel and Willman, (2004), at 2.

[99] In *Polkey v A. E. Dayton Service* [1988] AC 344, the court decided that, except for extreme cases, the use of proper procedure to effect dismissal is necessary. However, the consideration of proper procedures is subject to economic efficiency in *St John of God Care Services v Brooks*[1992] IRLR 546 where even though a majority of employees accepted in a prior consultation on all employees a proposal of an across-board payment reduction for job security, a minority of employees, who opposed

dismissal law grants employees a form, in kind, of property rights in their jobs.[100] Employees unfairly dismissed by their employer can be awarded with legal compensations. Employees with such legal supports are thus expected to contribute more firm specific investments than if otherwise.

The relevant law in this area can be cited as evidence of how the concept of fairness has penetrated into the freedom of contract. However, in deciding whether a dismissal is unjust or not, courts and tribunals interpret the law by imposing a range of reasonable response tests, whereby a decision is fair "*provided that it is not so unreasonable that no reasonable employer could have reached such a decision.*"[101] In other words, "fair" is identified with "not unreasonable" in legal practices. The nuance between the legal practice and statutory clauses in effect broadens the managerial prerogative. In a similar vein, constructive dismissal[102] can only be supported if there is a fundamental breach of the contract.[103]

While unfair dismissal law provides legal protections for employees with firm specific investment, it must be noted that a reference of a case to a tribunal is "*an atypical minority response*."[104] In addition, remedies available to unfairly dismissed employees are still short of satisfactory. Indeed, if employees are granted with a kind of property ownership in their jobs, remedies for unfairly dismissed employees should not be limited only to financial compensation, as the court has already done in *William Hill Organization Ltd. v Tucker*.[105] However, reinstatement, though preferred by the dismissed employees, is hard to achieve in a tribunal.[106] This is because the tribunal when giving the reward still puts in the first place whether or not the reinstated employee will cause problems to the employer.[107] Moreover, even though financial compensation has long been established in unfair dismissal cases, such

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the proposal, lost their case.

[100] Per Lord Denning in *Lloyd v Brassey* [1969] 2 Q.B. 98.

[101] Collins, (1992), at 38-9.

[102] An employee is constructively dismissed as dismissed within the meaning of s95(1)(c) of the ERA 1996.

[103] Hepple, B., *European Rules on Dismissal Law?*, (1997), *Comp. Lab. L. J.*, 18:204-228, at 213.

[104] Dickens, L., *et al*., *Dismissed: A Study of Unfair Dismissal and the Industrial Tribunal System*, (1985), Oxford England Blackwell, at 31.

[105] [1998] IRLR 313.

[106] *Johnson v Unisys Ltd* [2001] IRLR 279.

[107] Hepple, B., and Fredman, S., *Labor Law and Industrial Relations in Great Britain*, (2nd edn), (1992), Kluwer Law and Taxation Publishers, at 150.

compensation does not include compensation for employees' psychological sufferings.[108] In sum, although unfair dismissal law improves interests of employees both procedurally and substantively, compensation for employees unfairly dismissed is still far from satisfactory.

2. Company Law Related

First of all, it must be realized that the concept of "company" in the UK company law "*refers to the essentially financial relationship between managers and investors; there is no equivalent to those concepts which recognize the enterprise's organizational dimension*," a concept which necessitates contribution from a number of stakeholder groups.[109] Thus, it is not a surprise to observe that employee governance rights are not the main issue for company law in the UK.

Also, even though company law in the UK does not preclude the possibility of employees' board presentation, such representation is a rarity in practice. Indeed, given the predominant financial consideration in the current governance practices, employees' participation in strategic decision making is hard to achieve without a mandatory requirement from law.[110] However, as discussed, such a mandatory stipulation is incongruent with the current social political situation in the UK.[111]

In addition to the employees' board representation, company law has other stipulations relevant to the interests of employees. We will discuss them in sequence.

(a) S309 of the Companies Act 1985[112]

The main clause relevant to employees in company law is s309 of the CA

[108] *Johnson v Unisys Ltd* [2003] 1 A.C. 518; *Eastwood v Magnox Electric plc* [2004] I.R.L.R. 733 and *McCabe v Cornwall City Council* [2004] UKHL 35, HL

[109] Deakin, S., *Renewing Labor Market Institutions*, (2001b), International Labor Organization International Institute for Labor Studies ILO Social Policy Lectures in 2001, available at http://www.ilo.org/public/english/bureau/inst/download/deakin2.pdf, at 25.

[110] Bainbridge, (1998b).

[111] See the discussion in Part I.

[112] To be replaced by CA 2006 s172(1).

1985, under which directors are required to take into consideration the interests of employees. Section 309(2) points out that the enforceability of such consideration is "*in the same way as any other fiduciary duty owed to a company by its directors*". With no express fiduciary duty to employees and clear guidelines to balance conflicting interests within the company,[113] a mere mention of the consideration of the interests of employees can only be perfunctory. Indeed, the clause has already been described as "*a statutory provision without teeth*"[114] or as "*a piece of window-dressing.*"[115]

The above stance is largely maintained in the new Companies Act 2006. Although s172 of the new Act expressly states that interests of employees should be included in directors' decision making process, we still do not know how employees can enforce their proactive governance role. Moreover, employees, as such, do not have a *locus standi* in initiating actions against the company and directors. In other words, the Companies Act 2006 merely implements the '*enlightened shareholder value*' model of corporate governance. There is still a long way to go to satisfy the advocates of employees' strategic participation in the UK.

(b) Information Disclosure

From the perspective of corporate governance, provisions in company law relevant to information disclosure may also be beneficial to employees. *Employee Involvement* is one main part of the Directors Report.[116] Moreover, the Companies Act 2006 also requires directors of all quoted companies to opine on "*the main trends and factors likely to affect the future development, performance or position of the*

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[113] Paragraph 11(3) of the Part V of Schedule 7 to the CA 1985 does provide some practical guidelines on how directors should take into consideration employees' interests. Nevertheless, the schedule itself is permissive rather than mandatory. Moreover, consultation under the schedule is not an ongoing obligation but only of an indiscrete and contingent nature.

[114] Farrar, J., and Hannigan, B., *Farrar's Company Law*, (4th edn), (1998), London Butterworth, at 386

[115] Birds, J., *Making Directors Do Their Duties*, (1980), *Company Lawyer,* 1:67 at 73. However, successful reference to s309, though rare, is still in existence. In *Re Welfab Engineers Ltd*, [1990] BCLC 833, the liquidator's claim that directors were in breach of their duty as the company had been sold at a gross undervalue was defeated by the court by referring to s309. It was held that preservation of employees' jobs was a worthwhile consideration.

[116] CA 1985 Schedule 7 s234(3) and (4) which are largely maintained by CA 2006 s416.

companies business" in their Business Review.[117]Information thus required includes not only financial information on company performance but also major strategy movements relevant to employees. Such information may well be taken advantage of by employees and their representatives especially in wage bargaining. Still, the dichotomy between private and public companies exempts directors of private companies, whatever the size, from such a duty. Thus, employees in numerous private companies, especially those as a result of going private transactions, may still face a lack of information in this aspect under company law.

Furthermore, information so disclosed is too financial oriented and often out of date. Compliance with the requirement is also unsatisfactory. For instance, one research finds that substantive non-compliance with the mandatory information disclosure on employee involvement and consultation is up to 44% among 400 required disclosures.[118] Besides, the lack of information on employee human capital investment is still apparent even if we admit that the employee contribution to the company is indispensable.[119] Thus, for employees, information disclosed according to company law can only be described as being symbolic.

3. Conflicts between Shareholders and Employees?

It is often argued that the supremacy of shareholders in the current governance structure may lead shareholders and management to seek profits at the cost of employees. However, as Rock and Wachter argued, such argument has "*misperceived the similarities between shareholders and employees.*"[120] Both employees and shareholders perform as capital investors of the company. They have their own governance roles to play with rare overlap. This understanding even holds when we consider the property rights of employees in the company arising from their firm

[117] See CA 2006 s417(5).
[118] Day, R., and Woodward, T., *Disclosure of Information about Employees in the Directors' Report of UK Published Financial Statements: Substantive or Symbolic?*, (2004), *Accounting Forum*, 28:43-59, at 55.
[119] Kingsmill, D., *Accounting for People: Report of the Task Force on Human Capital Management*, (2003), London DTI.
[120] Rock, E., and Wachter, M., *Tailored Claims and Governance: The Fit Between Employees and Shareholders*, in Blair, M., and Roe, M., (eds), *Employees and Corporate Governance*, (1999), Brookings Institution Press Washington D.C., 121-159, at 156.

specific investment because there is no legal difficulty for different property owners to co-own the same property.

Indeed, by defining corporate governance with four parameters, *i.e.*, the degree of asset specificity, the extent of information asymmetry, the extent of risk aversion, and the costs of drafting and enforcing explicit contracts, Rock and Wachter find that employees can enjoy similar control rights to those of shareholders when shareholders and employees have similar composition of the four parameters.[121] In fact, governance roles of employees and shareholders are more complementary than conflicting in nature if we consider the interests of a company is a concept inclusive of interests of different stakeholders with different weights. Moreover, it must be emphasized that there is no legally prescribed order among the interests of different stakeholders. The priority, if there is one, is decided by the market and the social institution.[122]

On the whole, discussion in this Part shows that interests of employees are protected in both contracts and laws. Though individual negotiating power is a concern for employees, it should not be exaggerated due to the existence of the four phases of employees' firm specific investment and their collective bargaining power. In addition, the wide promotion of the status approach in employment relationship and the enhancement of employees' information and consultation rights in collective bargaining have already improved employees' situation both individually and collectively. Thus, employees' lack of control rights within company law does not provide sufficient evidence for the conclusion that their interests have been unduly prejudiced. Their interests as discussed are at least widely protected through their contractual arrangements and multifarious stipulations in employment law. The inefficiencies in and the ineffectiveness of the employment law, however, cannot be used as evidence to argue for more governance rights for employees in company law. Rather, it is better to improve employees' governance rights outside company law in employment law than otherwise.

[121] *ibid*.
[122] Faleye, O., and Trahan, E., *Is What is Best for Employees Best for Shareholders?*. (2006), Northeastern University Working Paper, available at *http://ssrn.com/abstract=888180*.

PART III. EMPLOYEES IN FLOTATIONS

The development of the employment relationship is a continuous process. In this part, the discussion will be extended to earlier phases of the development of the company. Such extension will help us understand how employee governance transforms around the specific juncture of a flotation.

A. THE ROLE OF CONTRACTS

1. Relative Bargaining Powers of Employees and Employers

In the entrepreneurship phase of the company, the mutual demand for the existence of the company and the fierce competition faced by such companies on the product market dictate mutual efforts from both the employer and employees. Accordingly, the general employment relationship in entrepreneurships should be more cooperative than conflicting in nature.

Within such a cooperative context, employment contracting also has its own characteristics. Employees in negotiating their employment contracts may well have the knowledge of the outside intensive competition whereas entrepreneurs may more often than not follow the market practice or even provide favourable terms for those employees they need for their project. Besides, monitoring of employees may not be effective and may have to be lax due to employers' unfamiliarity with the newly introduced products or production process. Employees thus enjoy great discretion *ex post* contracting. Indeed, compared with employees' job-hunting efforts and their suffering of being laid off, entrepreneurs may have to face additional pressures of capital, management, and reputation, *etc*. In other words, entrepreneur employers have relative higher costs of both entry and exit.[123] Thus, the bi-lateral monopoly model of employment contracting is more apparent in entrepreneurship than in other phases of the company life.

[123] Watt, B., *Regulating the Employment Relationship: From Rights to Relations*, in Collins, H., *et al.*, (eds), *Legal Regulation of the Employment Relation*, (2000), Kluwer Law International, 335-346, at 341.

While employment contracts are important in establishing rights and duties of both parties, it should be noticed that norms, strong interpersonal relationship and reputation play more important roles than formal contractual terms in shaping employment relationship in entrepreneurship. [124] Such informality can help to redress the deficiency of collective bargaining among employees in entrepreneurships[125] and strengthen the predominance of the bilateral monopoly model in employment contracting. The strong role of norms and reputation in shaping employment relationship indicate that the regulation of employment relationships in entrepreneurship must be flexible and permissive in essence. Accordingly, with a general policy to promote entrepreneurship, "*regulation [of employment relationships] is exercised to maintain the parties' integrity in their respective roles within the market.*"[126]

2. Contingent Employment Contracts

In order to meet the changing labor relationship with their limited resources, entrepreneurs may adopt contingent employment contracts.[127] This is especially the case for start-ups, where contingent employment contracts are necessary due to their lack of ability and legitimacy to attract or retain talents and skilled workers.[128]

Because employers enjoy great discretion to terminate the contingent contracts,

[124] Ram, M., *Managing to Survive: Working Lives in Small Firms*, (1994), Blackwell, Oxford, at 161-2.
[125] Scase, R., *Employment Relations in Small Firms*, in Edwards, P., (ed), *Industrial Relations Theory and Practice*, (2nd edn), (2003), Blackwell Publishing Ltd., at 471.
[126] Watt, (2000), at 342.
[127] Cardon, M., *Contingent Labor as an Enabler of Entrepreneurial Growth*, (2003), *Human Resource Management*, 42(4):357-373. The concept of contingent employment contracts is largely a term used in human resources management. Broadly, its corresponding legal term is the limited term employment contract, which covers all the non-standard full-time, salary-paid jobs. To employ *contingent employment contract* here is to emphasize the changing nature of the employment contracts in flotations. In comparison, an employment contract with an indefinite term can only be terminated by a reasonable period, which is either stipulated through an express term of notice in the contract or decided by the courts. See Gallagher, D., and Sverke, M., *Contingent Employment Contracts: Are Existing Employment Theories Still Relevant?*, (2005), *Economic and Industrial Democracy*, 26(2):181-203.
[128] Williamson, I., *et al.*, *Smaller but not Necessarily Weaker: How Small Businesses can Overcome Barriers to Recruitment*, in Katz, J., and Welbourne, T., (eds), *Managing People in Entrepreneurial Organizations: Learning from the Merger of Entrepreneurship and Huma Resource Management*, (2002), Amsterdam: JAI Press, 83-106.

it may be projected that contingent employment contracts may seriously compromise the interests of employees. However, this may not necessarily be the case in practice. In fact, many contingent employees may just prefer their contingent status and enjoy their freedom to move to other small companies.[129] For example, employees in high tech companies may just want to shift employers every certain period for higher payment or higher status.[130] Or, contingent workers may intentionally avoid those concerns troubling permanent staffs, like contrition due to the long-term interpersonal conflicts.[131] Alternatively, contingent jobs may benefit the company itself as new employees will bring new insights and information into the organization, a situation which may be beneficial to start-up companies.[132]

Beyond the start up phase, contingent employment seldom plays its dominant role. Rather, the co-existence of contingent employment and permanent employment is the norm.[133] This can be attributed partly to the increasing familiarity with the market and the stronger anti-risk ability of the company and partly to the mature internal labour market, which makes internal movement of employees a much preferred choice.[134] Within a mature internal labour market, a contingent employee may well be transferred to a permanent one during the expanding phase of the company. Also, the co-existence of contingent employees and permanent employees strengthens the commitment of the permanent staff to the company as the mobility of the contingent employees highlights the security of the permanent staff.[135] Thus, the normal practice of combining permanent employees with contingent employees beyond the start-up phase helps to soften the debilitating effect expected of a dominantly contingent employment model.[136] In other words, employment policies at individual companies may adjust in alignment with the development of the company.

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[129] Flynn, G., *Contingent Staffing Requires Serious Strategy*, (1995), *Personnel Journal* 50-8 reports that 38% of respondents declined their full time job offers and preferred a contingent one.
[130] Baron, J., *et al*., *Labour Pains: Change in Organizational Models and Employee Turnover in Young, High-Tech Firms*, (2001), *AJS*, 106(4): 960-1012, at 976.
[131] Foote, D., and Folta, T., *Temporary Workers as Real Options*, (2002), *Human Resource Management Review*, 12:579-97.
[132] Matusik, S., and Hill, C., *The Utilization of Contingent Work, Knowledge Creation, and Competitive Advantage*, (1998), *Academy of Management Review*, 23:680-97.
[133] Filatotchev, I., *The Firm's Life Cycle and the Dynamics of Corporate Governance: Overcoming Governance "Thresholds*", (2005), at 13, in DTI Economics Paper No.13, *Corporate Governance, Human Resource Management and Firm Performance.*
[134] Foote and Folta, (2002).
[135] Osterman, P., *Employment Futures: Reorganization, Dislocation, and Public Policy*, (1988), OUP.
[136] Lautsch, B. , *Uncovering and Explaining Variance in the Features and Outcomes of contingent Work*, (2002), *Industrial and Labor Relations Review*, 56:23-43.

3. Employee Turnover

For a company with a high turnover rate of employees, as in start ups where contingent employees are dominant, it has to consider both the short-term costs, such as the severance payments, unemployment benefits and other contractual compensation, and the long-term costs, such as the social costs arising from the high turnover rate. One example of the social costs is the reputation damage, which may not only produce bad feelings among existing employees but also create hurdles in attracting new talents to the company.[137]

While empirical evidence does support the view that flotations enhance the retention rates of employees,[138] the disruptive role of flotations on employment relationship will become perceptible as time passes by. If employees hold shares of the company going public, the original bond among employees is destroyed as shares become transferable. Moreover, as governance requirements of public companies are more stringent than those for private companies and are new to the original employees of the entrepreneurship, more staff with new skills adaptable to public companies will have to be recruited. This is especially true for administrative staffs and financial staff. Conflicts may accordingly arise due to the different conception of the enterprise culture between new and old staff.

Additionally, outside investors may play a more important role than an entrepreneur in employee turnover. For example, venture capitalists usually control the board and may insist that certain key employees be retained in or be dismissed from the company. Because venture capitalists normally seek ways to exit through takeovers or flotations, their short-term investment policy, compared with the life of the company, requires of a corresponding flexible employment relationship and human resources management. Such intervention may be more apparent in those

[137] Osterman, (1988); and Whetten, D., *et al*., *Implications of Organizational Downsizing for the Human Resource Management Function,* (1995), in Ferris, G., *et al*., (eds), *Handbook of Human Resource Management*, Cambridge, MA: Blackwell Publishers, 282-296.
[138] CGEY Center for Business Innovation, *How Intangibles Drive IPO Success,* (2001), *Perspectives on Performance,* 1(4): 16 Performance Measurement Association Cranfield University School of Management, at 17.

companies going public than in start-up companies. In such cases, employee turnover is better seen as a reflection of the disadvantaged role of labour in the finance dominated society than the unexpected result of employers' discretion.

4. Compensation for Employees in Flotations

Constrained by the limited cash availability, entrepreneurs may well issue stocks and/or options to retain highly wanted employees.[139] Payment to employees accordingly depends on the cash flow of the company. Several studies reveal that the flexibility inherent in such plans plays an important role in retaining and sorting employees due to the uncertainty of the development of a company in this stage.[140] Without these alternatives, the founding owner may well select to exit rather than to make the '*overhanging*' fixed payments to employees.[141]

Still, compensation with only equity or options to all employees is unrealistic.[142] Given the risk aversion and the negligible ability of employees at lower levels to make a difference to the share price, it seems that shareholding and option holding cannot provide an appropriate incentive scheme for those employees.[143] On the contrary, traditional compensation with fixed income may be preferred by risk-averse employees at lower levels. The introduction of the minimum payment is thus relevant here. The problem, however, is at what level such minimum payments may dampen the incentives of entrepreneurs to set up their start-ups in the first place.

Another usually prescribed payment is the severance payment in cases of

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[139] Inderst, R. and Müller, H., *Benefits of Broad-Based Option Pay*, (2004), London School of Economics and New York University Working Paper, available at *http://ssrn.com/abstract=728443*.
[140] Ittner, C., *et al.*, *The Structure and Performance Consequences of Equity Grants to Employees of New Economy Firms*, (2003), *Journal of Accounting and Economics* 34:89-127; Oyer, P. and Schaefer, S., *Why Do Some Firms Give Stock Options to All Employees? An Empirical Examination of Alternative Theories*, (2005), *Journal of Financial Economics*, 76(1):99-133.
[141] Inderst and Müller, (2004).
[142] Generally, equity grants are more stable than option grants. Thus, entrepreneurs can design different compositions of stocks and options for employees at different levels. See Pukthusnthong, K., *et al.*, *How Employee Stock Options and Executive Equity Ownership Enhance Long-term IPO Performance*, (2005), UCLA School of Management Working Paper, No. 05-19, accepted *Journal of Corporate Finance*, available at *http://www.anderson.ucla.edu/documents/areas/fac/finance/19-05.pdf*.
[143] Hall, B., and Murphy, K., *Stock Options for Undiversified Executives*, (2002), *Journal of Accounting & Economics*, 33:3-42 and same authors, *The Trouble with Stock Options*, (2003), *Journal of Economic Perspectives*, 17(3):49-72.

flotations. For example, entrepreneurs or key employees usually insert in their employment contracts a clause to the effect that they will leave the company with a bountiful severance payment in case of a flotation. In effect, such payments are used not only as compensation for their loss of private control but also as an anti-takeover device in flotations to safeguard their private control. Thus, for employees with a strong negotiating power, contractual arrangements of severance payments may be more of sense than legally prescribed minimum payment.

5. Employee Shareholders

It is usually the case that employees in companies intending to go public are also shareholders of the company they serve. The dual status may engender complications once the interests of the two statuses depart from each other. Say, once employees do not work for a company, they may still keep their shareholding in the company. If the remaining shareholders later change the corporate policy, such as the dividend policy, the interests of those employee shareholders who have already left the company may well be prejudiced.[144]

Carefully designed contractual terms may mitigate this concern. For instance, employee shareholders can insert in their contracts a clause to the effect that once they leave the company, their shares will be bought out by existing shareholders or the company on a prefixed valuation basis. But if there is no such contractual arrangement, relevant laws may prescribe a similar mandatory buyout of those shares on fair value or simply order a mandatory dissolution of the company if conflicts between shareholders arise.[145]

Still, the legitimacy of a mandatory dissolution is worth a second thought. While mandatory dissolution may help to settle the conflicts between minority employee shareholders and controlling employee shareholders, such an order is incongruent with the policy of promoting entrepreneurship. After all, one basic nature of entrepreneurship is the moderate risk taking. Moreover, it is usually the case that

[144] This is the situation of an American case *Re Kemp & Beatley, Inc*., 473 N.E. 2d 1173, discussed in Cohen, B., *Corporate Governance for the Entrepreneur*, (1997), *St John's L. Rev*. 71:125-152, at 144-6.
[145] Cohen, (1997), at 148

entrepreneurs are the controlling shareholders while other employees join either for a reward for their work, (pure employees), or for a financial return for their investment (pure investors), or for both (as employee shareholders). If controlling employee shareholders do represent the best interests of the company, their decisions, subject to the court rectification of unfairness, should be promoted or at least not depressed, as indicated by the solution of a mandatory dissolution.

B. THE ROLE OF LAWS AND REGULATIONS

1. Employment Law and Entrepreneurship

There is no employment law or regulation specifically targeting employees in companies going public. It is true that the current Labour government has introduced many employee-favoured laws and regulations, among which are the new national minimum wage; the working time regulations; family-friendly provisions on maternity, parental and emergency leave; equal treatment to part-time workers; new rights for trade union recognition and information and consultation.[146] However, we can see that exemptions for qualified small companies do exist across most recently introduced employment laws and regulations.[147]

This is not to say that employees in qualified small companies are left with no protection. Rather, a useful resort for employees in small companies is the unfair dismissal law, according to which employers cannot fire an employee without a due cause and without following a due procedure. In fact, field data show that an increased number of small companies have induced disciplinary and grievance procedures.[148] Moreover, empirical evidence also indicates that tribunals are more

[146] For a brief summary of these new laws, see Arrowsmith, J., *et al.*, *The Impact of the National Minimum Wage in Small Firms*, (2003), *British Journal of Industrial Relations*, 41(3):435-456, at 435.
[147] Small companies with fewer than 21 employees are exempted from the statutory trade union recognition and those with fewer than 20 employees are exempted from the consultation on collective redundancies, s188 of the TULR 1992; Exemptions for those with fewer than five employees are available in the Maternity and Parental Leave etc Regulations 1999, SI No.3312. s20(6); Welfare Reform and Pensions Act 1999; Employers' Policy Statements (Exceptions) Regulations 1975 SI No.1584.
[148] 68% of companies with fewer than 20 employees did not have such a procedure in place, in Evans, S., *et al.*, *Unfair Dismissal Law and Employment Practice in the 1980s*, (1985), Department of Employment Research Paper No. 53; 85% of the employers with between 25 and 99 employees

pro-employee in cases involving a small company employer than in cases involving big employers.[149] Thus, although exemptions in such laws and regulations are for the purpose of encouraging entrepreneurship, fair treatment to employees has been the bottom-line of the current employment laws and regulations.

Nonetheless, most companies intending to go public may not be qualified for those exemptions due to the rather low thresholds of those requirements. Employees in companies going public will accordingly be protected as those employees in the normal life of corporate governance. Still, it must be realized that legal protection for employees in such companies may have to be discounted by the constraints of intense competition on the product market. This is because fierce competition faced by entrepreneurs usually outweighs the constraint effects of laws and regulations.[150] Indeed, if competition is favourable to a company, the constraining effects of employment regulations can largely be absorbed by the company. If otherwise, such regulations will exacerbate the competitive pressures and threaten the survival of the company, a result that even employees may not want to face. Accordingly, enhanced individual employment rights in law do not necessarily result in the corresponding changes to the employment policy at the end of small and medium sized employers.[151]

2. Securities Market Regulations

Once a company decides to go public, employees in this context will be seen as the participants in the financial market. Their obligation is subject to the overall objective of the integrity of the securities market. For the purpose of this section, information disclosure to employees is relevant. UK Listing Rules do not restrict the company disclosing price-sensitive information to representatives of employees

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establish such a scheme in Millward, N., *et al.*, *Workplace Industrial Relations in Transition*, (1992), Dartmouth; and the median workforce size for companies with procedures is 60 while that for companies without such a procedure is less than 25, in Tremlett, N., and Banerji, N., *The 1992 Survey of Industrial Tribunal Applications*, (1994), Employment Department Research Series No. 22.

[149] Tremlett and Banerji, (1994) find that about half cases involving an establishment with less than 100 employees are held for employees while the corresponding figure for companies of bigger sizes is a little over 30%.

[150] Edwards, P., *et al.*, *Why Does Employment Legislation not Damage Small Firms?*, (2004), *Journal of Law and Society*, 31(2):245-65.

[151] Blackburn, R., and Hart, M., *Perception or Reality? The Effects of Employment Rights on Small Firms*, (2001), Paper presented at 3rd SBS-Kingston University Seminar Series Sheffield, available online at *http://business.kingston.ac.uk/research/kbssbs/percreal.pdf*.

before such information is disclosed to the public.[152] However, these people cannot deal with their shares before the relevant information is released to the public nor can they share the information with the wider workforce.[153] In such situations, compliance with the securities market regulations is superior to representatives' moral responsibility to other employees affected by the information. In addition, widely publicized advertisements stating the company is a pre-flotation company as an allurement for potential employees may court investigations by the LSE, as this may surely indicate that the company is arousing the public's interest in the company shares.[154]

Another issue is the disclosure of information on compensation to employees. While executives of public companies are required to disclose stocks or options in their compensation package, this is not the case for executives in private companies before flotations. In comparison, employees' holdings are not required to be disclosed in both cases unless they are substantial shareholders of the public company.[155] This is because, in comparison with the limited control of employees, directors may well take advantage of their *de facto* control of the company for their own benefits in their compensation package. Law makers may accordingly consider that stock or options play different roles as incentive schemes for employees and directors.

In sum, employees are relevant for the purpose of securities market regulation only when they are deemed as finance market participants. Employees' interests are not the main consideration of the securities markets regulations. Still, the main theme of information transparency on the public securities market may provide employees with additional information sources.

[152] DTR 2.5.7(c)
[153] See FSMA 2000 s118(2)(3).
[154] But notice the general market practice of voluntary "block-out" periods, during which promoting or marketing of securities is not similarly prohibited. Nonetheless, PR 3.3 requires the consistency of the contents of an advertisement and those of the prospectus. Moreover, market abuse sanctions may also be relevant, see FSMA 2000 s118(8).
[155] See relevant discussion in Chapter 3.

C. THE PERSISTENCE OF THE EMPLOYMENT RELATIONSHIP IN ENTREPRENEURSHIP

Research has shown that the employment relationship within companies before flotations has a '*blueprint*' function, which shapes organizational development routes[156] and influences the evolution of the human resources management policy.[157] To impose an abrupt change on the inherited competencies and routines already established in companies may engender a counterproductive effect since employees, who invest time and energy and usually hold reasonable expectations of the future, may have good reasons to think that their investments are made in vain and their expectations crushed in organizational changes. Indeed, this blueprint function can be identified as an institutionalization process, during which a set of corporate culture is set up. As some scholars have already argued: "*the longer the [initial] regime is in place, the more likely it is to have institutionalized a distinctive organizational blueprint and screened out employees who do not fit that blueprint.*"[158] This corporate culture, in turn, requires of the newly recruited to fit in this culture, reinforcing the existing culture.

While the blueprint function of the initial regime may produce a stable workforce, bureaucracy and stereotype administration may frustrate the company's adaptation to the outside changing environment as the company ages. Employees, who favour change over bureaucracy, may accordingly migrate to another employer for better chances.[159] In other words, the blueprint function of the employment relationship in companies going public may also act as an initiator of turnover for some individual employees. Thus, the institution here plays a background role whereas individual specific characters, *i.e.*, the negotiating power and psychological factors of a given employee, may change or negate the institutional effects. Moreover, the dual-effect of the blueprint function also indicates that employees are a heterogeneous group, unlike that of shareholders whose interests are single-mindedly

156 Baron, *et al*., (2001), at 963.
157 Baron, J., *et al*., *Building the Iron Cage: Determinants of Managerial Intensity in the Early Years of Organizations*, (1999), *American Sociological Review*, 64:527-47.
158 Baron, *et al*., (2001), at 974.
159 *ibid*., at 976.

settled on the pursuance of financial interests.

PART IV. EMPLOYEES IN TAKEOVERS

A. THE ROLE OF CONTRACTS

1. Information Asymmetry

It is argued that employees, due to the information asymmetry, are often disadvantaged in predicting the occurrence of takeover transactions. Accordingly, when negotiating employment contracts, employees may project that takeovers are only of a low probability in the distant future and in turn they may compromise their interests in takeovers in exchange for some other benefits.

The inability of employees to foresee the occurrence of takeovers, however, should not be exaggerated. Psychologists have shown us that even though individuals have difficulty in foreseeing any particular risk in the future, a group of individuals may be more adaptable to foresee, even with rough probabilities, the general category of risk which subsumes those particular risks.[160] In other words, even though individual employees may well underestimate the possibility of takeover activities, employee representatives, or unions, may well estimate the possibilities of merger and acquisition activities. In fact, due to the more and more unfavourable exposure of takeover activities in the past two decades, it is hard to presume that employees cannot foresee the occurrence of takeovers within employment terms, especially for those who are going to sign a long-term employment contract with the employer.

Nonetheless, to admit the possibility that employees can foresee the possible occurrence of takeovers in the future does not mean that they have the ability to insert corresponding terms to protect their interests. Thus, the disadvantaged negotiating position of employees still justifies government intervention, which can work either through legal support for unions or through safeguarding interests of individual

[160] Triantis, G., *Contractual Allocations of Unknown Risks: A Critique of the Doctrine of Commercial Impracticability*, (1992), *University of Toronto Law Journal*, 42:450.

employees. A strengthened role of unions can surely protect their member employees generally[161] while legally prescribed minimum treatment and compensation when these rights are breached can guarantee individual employees with some minimum protections.

2. The Implicit Contract

We have discussed in Part II that employees in phase III and IV may suffer from the observed asynchrony between their compensation and their firm specific investment. For those employees, an implicit contract of mutual trust and confidence exists between employees and the employer. Breaches of such implicit contracts may produce important implications in practice as employees' emotional reactions to the destruction of mutual trust can be translated into inefficient work behaviour.[162]

Takeovers, as the argument goes, deprive employees of the opportunity of acquiring their deferred payments and thus are breaches of the implicit contracts of mutual trusts between employees and the employer. The destructive effect of takeovers is especially apparent in hostile takeovers. One study has shown that even if hostile takeovers are unsuccessful, they may still engender a negative effect on employment.[163] Within the company, such breaches of trust may engender counterproductive effects across different levels of employees. For example, many downsizings are expected to increase productivity by separating employees who are less efficient than their peers. However, studies show that while the separation of low performers can be achieved by force, more efficient performers will leave the company voluntarily as the separation goes on.[164] Indeed, it is often the case that the most valued employees in the original companies are the first to leave the company being downsized.

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[161] But see constraints of unions in Part II.
[162] Citera, M., and Rentsch, J., *Is There Justice in Organizational Acquisitions? The Role of Distributive and Procedural Fairness in Corporate Acquisitions,* in Cropanzano R., (ed), *Justice in the Workplace: Approaching Fairness in Human Resources Management*, (1993), Lawrence Erlbaum Associates: Hillsdale, NJ, at 211-30.
[163] Bhagat, S., *et al.*, *Hostile Takeovers in the 1980s: The Return to Corporate Specialization*, (1990), *Brookings Papers on Economic Activity: Microeconomics* 1-72, at 22.
[164] Mone, M., *Relationships between Self-concepts, Aspirations, Emotional Responses, and Intent to leave a Downsizing Organization*, (1994), *Human Resource Management*, 33(2):281-298.

Nevertheless, implicit contracts are in terms of psychological perceptions, which are not traditionally protected from a legal perspective.[165] Indeed, the current implied terms of mutual trust and confidence in employment contracts have emerged only after a long time struggle and are a reflection in employment relationship of the democracy conception within the wider social context. Still, to imply such a term into the employment contracts predicates an employment term long enough to justify the bonding effect. If employees are newly employed just before takeovers, or if the contract itself is one-off, the argument will lack its lustre.

3. Employee Turnover

(a) Inconsistent Empirical Evidence

In general, empirical evidence on the effects of takeovers on employees almost always demonstrates job losses after takeovers. For example, according to two recent studies by Conyon, *et al* in 2001, employment declines substantially in post-acquisitions between 1983 and 1996.[166]

However, similar studies are narrowly limited by their coverage of the internal labour market of the companies being taken over, without considering the wider social effects. This lacuna thus leaves open the possibility that the immediate effect of job losses within a given employer may overshadow the wider long-term social effects of more justified resource distribution and more legitimate human capital flow and reinvestment. Indeed, contrary to the pessimistic view of takeovers on employees, positive empirical evidence also exists.[167] One research shows that most buyouts had

[165] Deakin, S., *et al.*, *Implicit Contracts, Takeovers, and Corporate Governance: In the Shadow of the City Code*, (2003), in Campbell, D., *et al.*, (eds), *Implicit Dimensions of Contracts*, Oxford: Hart, 289-332, also available at *http://www.cbr.cam.ac.uk/pdf/WP254.pdf*.
[166] Conyon, M., *et al.*, *Do Hostile Mergers Destroy Jobs*, (2001), *Journal of Economic Behavior and Organization*, 45:427-40 and the same authors, *The Impact of Mergers and Acquisitions on Company Employment in the UK*, (2002), *European Economic Review*, 46:31-49.
[167] Peacock, A., and Bannock, G., *Corporate Takeovers and the Public Interest*, (1991), Aberdeen University Press, at 68-70 and Garfield, A., *Helping the Casualties of Creative Destruction: Corporate Takeovers and the Politics of Worker Dislocation*, (1991), *J. of Corp. L.*, 16:249, at 252-6.

a record of increased employment.[168] Another study also demonstrates that, buy-outs may even produce positive effects on the employment relationship, which are reflected in the improved standard of human resource management practice and increased real earnings of almost all levels of employees.[169]

Alternatively, some studies indicate that continuity of the original relationship is what management normally cherish and try to maintain.[170] Indeed, offerors may well have an intention to revive the offeree company in order to strengthen its own competitive position.[171] Thus, a replacement of the original owner does not necessarily indicate a disruption of the morale of the employee of the offeree company.

In sum, empirical evidence on the general effect of takeovers on employees is confusing. Job losses, if they are the real cases in individual companies, may not necessarily be the case in the wide economy. Moreover, the debilitating effects of takeovers on employment relationship are only partly supported by empirical evidence. A possible explanation for such confusing empirical evidence is that in many, if not most, takeover transactions, both takeovers and job losses at individual companies can be attributed to a third factor such as the general economic depression or fiercer competition on the market.[172] In such situations, takeovers merely hasten the step of transformation the company has to experience anyway in the near future. Therefore, it is unjustified to argue that takeovers prejudice the interests of employees.

(b) Unevenly Distributed Job Losses

Among the empirical studies of the effect of takeovers on employees, two studies need further attention. Though large-scale employee layoffs in takeovers are observed in both studies, one study finds that it is common that such layoffs are made

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[168] Bacon, N., *et al*., *Management Buyouts and Human Resource Management*, (2004), *British Journal of Industrial Relations*, 42(2):325-347.
[169] Bruining, H., *et al*., *The Impact of Business Ownership Change on Employee Relations: Buyouts in the UK and the Netherlands*, (2005), *International Journal of Human Resource Management*, 16:345-365.
[170] Wright, M., *et al*., *Management Buyouts and Trade Unions: Dispelling the Myths*, (1984), *Indus. Rel. J*., 2(15): 45-52.
[171] Bacon, *et al*., (2004), at 342.
[172] Wright, M., *et al*., *Management Buy-outs, Trade Unions and Employee Ownership*, (1990), *Indus. Rel. J*., 2 (21):136-46.

at the managerial level, where duplication is most likely,[173] whereas another study reveals that job losses are disproportionately concentrated at the level of non-production workers.[174] Such a concentrated distribution of job losses at least indicates that takeovers have different effects on employees at different levels. It seems that employees over middle levels may suffer more than those at lower levels in takeovers. Such observation thus entails additional discussion.

i) The Relevance of the Hierarchical Structure

It is widely known that the hierarchical structure of a company requires employees to work at different levels. But the issue relevant here is that hierarchical levels bear relations with employees' firm specific investment and the possibility of their participation in the decision making process.

As we know, the lower the level an employee works at, the more likely the employee has interchangeable skills, and thus the more likely he may find suitable exits for their interchangeable skills. In other words, employees' firm specific investment may not provide a good argument for employees at lower levels. But if they do lose in these control transactions, they may lose their basic maintenance. This bleak concern thus provides a justification for government intervention by granting minimum compensation in cases of unfair dismissals and other minimum statutory protections.

In comparison, employees at the middle level, though they make more firm specific investments and accordingly suffer most in case of takeovers, are more easily adaptable to changeable commercial environment. *Ex ante*, they have more opportunities to predict the possibility of restructuring activities and thus negotiate corresponding contractual terms to safeguard their own interests. *Ex post*, they are more adaptable to new knowledge and have greater ability to adjust their acquired skills to new environments than their colleagues at lower levels. It can be argued that their interests can be appropriately protected in their employment contracts. Indeed, the higher the level an employee works at, the less important the statutory protection

[173] Becker, B., *Union Rents as a Source of Takeover Gains among Target Shareholders,* (1995), *Indus. Lab. Rel. Rev*., 49:3-19.
[174] Bhagat, *et al*., (1990).

means to him. In practice, the total sum of severance payments to employees at middle levels, both in statutes and in contracts, may well operate as a hindrance to takeover transactions.

Alternatively, employees at different levels in the hierarchical structure participate to different extents in the corporate decision making process. In fact, the lower the level an employee is in, the less the possibility that the employee can take part in the decision making process. In other words, the promotion of the employee participation in decision-making process is only of sense to employees over a certain hierarchical level within the administrative structure of a company.

So, if we may hold that employees at lower levels can be protected by minimum statutory protection (as this is the main objective of statutory protection) and their participation in decision making process is limited, the intriguing finding of concentrated distribution to employees in middle levels at least tells us that we should not simplify the effects of takeovers on employees by identifying the claims of employees at certain levels with those of employees in general. Indeed, it is fair to argue that the empirical evidence is "*more consistent with a final end game tactic in the continuing negotiation over the division of firm value than a breach of contract that threatens future relation-specific investments.*" [175]

ii) A Social-Political Understanding

Indeed, we may better understand this issue within the wider social and political context. Given the number of employees influenced by takeover transactions, it is more reasonable to assume that the concern of employee turnover is mainly a concern for employees in big established companies than for employees in small private companies. If we further accept that employees at middle levels in such companies are the main constituents of the middle class in the wider society, we may suspect that their claims for more protection and more rights in corporate decision making can be seen as the political voice of the middle class in the wider society. Therefore, the current zeal on issues of employment protection in takeovers are mere indicators that our society gives high esteem to people from middle classes and that

[175] Becker, (1995), at 18.

those people are reluctant to fall from their original class in society. The extent of the success of such claims can only be decided by the political force of those people in the society. This is just another example how people from different social classes take advantage of their political power to change the law for their own interests.

4. Employees and Shareholders

(a) Wealth Transfer

Considering the co-existence of the shareholders' premium, (especially offeree shareholders) and the loss of employees, some argue that takeovers transfer wealth from employees to shareholders.[176] However, this wealth transfer theory should be treated with caution. On the one hand, we have seen that empirical evidence on job losses can only be summarized as inconsistent. On the other hand, the direct evidence to support the wealth transfer theory is still unavailable. Empirical evidence up to date merely documents the co-existence of gains for offeree shareholders, and losses for offeree employees.[177] To support the wealth transfer theory, we need more direct evidence to establish a causal relationship between employees' loss and shareholders' gain.

Curiously, at least one empirical study shows the non-existence of a direct causal relationship between the loss of employees and the returns of shareholders.[178] A similar result is also supported in a more recent study where the authors find that there is no such profit transfer from employees to shareholders. Rather, it seems that both workers and shareholders "*experience a sort of 'equal misery' resulting from the poor performance of newly formed firms.*"[179] In a word, the inconsistent empirical evidence throws doubts on the legitimacy of the wealth transfer theory and, in turn, also negates the legitimacy of a mandatory redistribution from shareholders to

[176] Shleifer, A., and Summers, L., *Breach of Trust in Hostile Takeovers*, in Auerbach, A., (ed.), *Corporate Takeovers: Causes and Consequences*, (1988), University of Chicago Press, 33-67.
[177] Daniels, (1993), at 333-5.
[178] Rosett, J., *Do Union Wealth Concessions Explain Takeover Premiums? The Evidence on Contract Wages?*, (1990), *Journal of Financial Economics*, 27(1):263-282, also available at *http://ssrn.com/abstract=277296*.
[179] Beckmann, T., and Forbes, W., *An Examination of Takeovers, Job Loss and the Wage Decline within UK Industry*, (2004), *European Financial Management*, 10(1):141-165, at 163.

employees.

(b) Alliance between Employees and the Management

Because of the *qua* owner status of shareholders, management is often argued to work for shareholders' interests when a company is a going concern. However, this argument must be reconsidered due to the potential alliance between employees and management in takeover transactions.[180] Such alliance is possible because both employees and management have a desire of entrenchment, which is in intensive conflicts with shareholders' persistent pursuance of financial interests.

Examples of such alliance can be observed when the incumbent management defends a takeover offer by justifying the protection of the interests of employees in takeovers. Alternatively, incumbent management may simply pay a generous sum to seek alliance with employees.[181] The efficacy of generous payments by incumbent management is apparent for the general practice that "*generous wages [are] the managers' preferred policy even ex post, while wage-cutting is the raider's preferred course of action.*"[182] Workers may therefore prefer the incumbent management, at least with some acquaintance and certainty, to the raider, who may well adopt a hard-nosed strategy and only bring uncertainty to current employees. In turn, employees may well help to entrench the incumbent management through their statutory rights of industrial actions and/or rights of information and consultation to fight potential takeovers. As a result, shareholders may suffer a loss of potential takeover premium.

In practice, huge sums arising from terminating or maintaining pre-existing long-term employment contracts at a rather high payment level may well forestall any raider from initiating the takeover battle. Moreover, the generous payment to employees may in the end be paid out of the pockets of those dispersed non-

[180] Pagano, M., and Volpin, P., *Managers, Workers, and Corporate Control*, (2005), *J. Fin.*, 60(2):841-868 and Hellwig, M., *On the Economics and Politics of Corporate Finance and Corporate Control*, in Vives, X., (ed): *Corporate Governance: Theoretical and Empirical Perspectives*, (2000), CUP, 95-133.
[181] Cespa, G., and Giacinta, C., *Stakeholder Activism, Managerial Entrenchment and the Congruence of Interests Between Shareholders and Stakeholders*, (2002), Working Paper No.634, Universitat Pompeu Fabra, available at *http://ssrn.com/abstract=394300*.
[182] Pagano and Volpin, (2005), at 842.

controlling shareholders, who cannot make any difference to the strategic decision of the company but only suffer from such anti-takeover efforts. Thus, the existence of the alliance between employees and the management may indeed compromise the interests of non-controlling shareholders and enhance the interests of employees.

(c) Employee Shareholders

The above discussion distinguishes between the status of employees and that of shareholders. However, there are also cases where employees are shareholders. If employee shareholders with voting rights make up a majority in the shareholding, their attitude towards a takeover may well decide the fate of any takeover offer. Given the abovementioned alliance between employees and the management, employees holding stock of the employer may thwart any takeover initiative for the sake of their job security, indirectly entrenching the incumbent management. Such a projection has been evidenced in the US where more ESOPs are found in states with less legal protection for managers against takeovers.[183] Since employee shareholders are less interested in share premium than in job security,[184] such a situation indicates that employee shareholders' non-shareholder interests may in effect act as a strong defence for incumbent management in takeover battles.

Alternatively, employee shareholders in a company may more often be minority shareholders even if all the employees take part in the ESOP. If employee shareholders are minority shareholders, they may rely on those protections for minority shareholders.[185] Nevertheless, employees who initiate statutory litigation may have to face the administrative hierarchical structure, which may well legally and legitimately dismiss the employee. Thus, a pragmatic method for disgruntled employee shareholders is not to sue but to keep their interests *qua* employees

[183] Rauh, J., *Own Company Stock in Defined Contribution Pension Plans: A Takeover Defense?*, (2006), *J. Fin. Econ*., 81(2):379-410.
[184] Chaplinsky, S., *et al.*, *Employee Buyouts: Causes, Structure and Consequences*, (1998), *J. Fin. Econ*., 48:283-332; indeed, positive effects of ESOPs in the UK have been attributed to the lower turnover of employees, rather than the shareholding of employees. See SenGupta, S., *et al.*, *Employee Share Ownership and Performance: Golden Path or Golden Handcuffs?*, (2006), paper presented to the Annual Meeting of the Labour and Employment Relations Association, Boston, available at *http://www2.warwick.ac.uk/fac/soc/wbs/research/irru/publications/recentconf/ssg_boston.pdf*.
[185] See relevant discussion of minority shareholders in takeovers in Chapter 3.

separately. At least, acting in this way may not make any difference to their interests as employees.

Also, under Part 28 of the Companies Act 2006, takeover offers can be made to a specific class of shareholders.[186] The intriguing questions here, however, are whether employee shareholders can be legally recognized as a unique class of shareholders for the purpose of s974 (2) (b) and whether employee shareholders can claim their interests as employees *per se*. Since there is no specific definition of the concept of class interests in company law, it is hard to determine whether the class interests of employee shareholders include non-financial concerns. Still, even if such interests are countenanced by the court, valuation of such interests may still frustrate the court to make any decision in that direction.

The argument further substantiates that the introduction of employee shareholding does not settle the conflicts between employees and shareholders. As discussed, employee shareholding may either be taken advantage by the incumbent management when employee shareholders are majority shareholders or largely be ignored if employee shareholders are minority shareholders of the company. In essence, interests as employees cannot be mitigated by or commingled with their accompanying interests as shareholders. The beauty, if it does exist, of the employee shareholding is thus merely a psychological commitment to the company, a commitment which is expected to be transformed into productivity but cannot be measured. The efficacy of employee shareholding thus needs further evidential support.

B. THE ROLE OF LAWS AND REGULATIONS

1. Laws and Regulations on Securities Markets

(a) The Takeover Code

In alignment with the duties of directors in company law, the board of the

[186] CA 2006 s974(2)(b).

offeree company under the Takeover Code must act for the interests of the company as a whole, the concept of which surely overlaps the interests of employees.[187] Specifically, boards of the offeree and the offeror must make available to employees or their representatives of the offeree company a summary of terms of the offer.[188] The opinion of the offeree board on the potential effects of the offer on employees and employment relationship must also be disclosed to employees or their representatives.[189] Moreover, such opinions must be accompanied by a separate opinion of employee representatives on the effects of offers.[190] The intentional juxtaposition of these two opinions may provide employees with a better chance to evaluate the potential effects of the intended offer on employment issues. Besides, if changes to pension schemes of the employees of the offeree company are introduced, the Panel must be consulted for the frustrating effects.[191]

The essence of such stipulations is to provide employees with a right of information and consultation. Employees' right of information and consultation is, however, in stark contrast to the *ex ante* right of the offeree shareholders to decide the fate of the takeover offer.[192] The information and consultation right only refers employees back to the contractual protection, which, given the disadvantaged position of labour to capital, is hard to provide due protection for employees. Even though the Takeover Code expressly states that opinions of the offeree board to shareholders must also include the effects of the implementation of the offer on the company's interests, "*specifically, employment*" and the potential repercussions of the offeror's strategic plans,[193] it is the offeree shareholders who will decide the fate of employees.

More importantly, there is no supporting sanction clause for employees in case of any breach of the duty by directors. For instance, employees do not have standing for action within the framework of the Takeover Code. In practice, the regulation is usually met by routinely inserting a boilerplate formula into the offer documents without due consideration of employees' specific interests in specific conditions.

[187] Takeover Code General Principle 3.
[188] Takeover Code r.2.6 and r.30.1.
[189] Takeover Code r.30.2.
[190] Takeover Code r.30.2 (b) and r.32.6 (b) (on a revised offer).
[191] Takeover Code r.21.1 Note 8.
[192] Takeover Code General Principle 3.
[193] Takeover Code r.24.1 and r.25.1.

Moreover, the actual transaction is materialized by contracts between the offeror company and each individual shareholder of the offeree company, with no participation by other stakeholders. Thus, it is hard to deny that the interests of employee can only be taken perfunctorily under the Takeover Code.

The lack of due protection for employees under the Takeover Code has already been pointed out as a lacuna in the law.[194] Still, it is easy to exaggerate the extent of deficiency in safeguarding the interests of employees in takeover transactions. In fact, as discussed below, protection for employees is mainly provided in laws in other areas than the Takeover Code and company law. Furthermore, an efficient corporate control market is not without benefits for employees. At least, the reduction of capital raising cost is beneficial to all stakeholders including employees. Thus, a complete negation of the positive effects of takeover transactions on employees is unjustified.

(b) Other Laws and Regulations on Securities Markets

For employees, information on takeovers may also be accessed through other routes than from employers. For example, in order to reduce the possibility of information leakage during the interval, announcement of price-sensitive information is required to be made as soon as the proposals are finished.[195] It has become a business practice that the company makes the decision at the end of the day and informs the Exchange to disclose the information on the following working day. Accordingly, in case of large-scale redundancies after takeovers, the affected employees may first hear the news from sources other than their employer. Thus the government may in practice promote a good practice by letting the market and the employees have the information at the same time.

However, employees may also be subject to the control of the Criminal Justice Act 1993 if an employee falls into the category of insiders due to his access to the

[194] Slinger, G., and Deakin, S., *Company Law as an Instrument of Inclusion: Re-Regulating Stakeholder Relations in the Context of Takeover*, in Askonas, P., and Stewart, A., (eds), *Social Inclusion: Possibilities and Tensions*, (1999), London Macmillan, 262-277.
[195] See DTR 2.2.3G and 2.2.4G.

inside information by virtue of his employment, office or profession.[196] In such cases, employees are deemed as financial participants in the securities market under the law. Still, it must be realized that such concerns may be of sense more to employees on higher levels than to those on lower levels.

2. The Implication of TUPE

(a) The Relevance of TUPE in Takeovers

When there is a transfer of an economic entity which retains its identity in a takeover transaction, employees concerned can further be protected by the Transfer of Undertakings (Protection of Employment) Regulations 2006 (TUPE)[197] in addition to those as set out in the Employment Rights Act 1996.[198] However, as most takeover transactions are effected through share transfers with no transfer of the economic entity, the application of TUPE to takeover transactions is strictly constrained.[199] The legal justification for this stance is that a transfer through share acquisition does not bring injustice to the employees transferred.[200]

Employees in such transactions may have to resort to the general law on redundancy and unfair dismissals for potential protection.[201] Moreover, pension scheme protection is also available.[202] Alternatively, the European Works Council Directive and the Information and Consultation Directive statutorily provide employees channels to be informed and consulted on companies' potential strategic movements. Under the latter Directive, an employer must consult employees at an appropriate time and, considering the different natures of the issues, at different levels

[196] See Criminal Justice Act 1993 s57(a)(ii).
[197] SI 2006/246
[198] ERA 1996 Ch.18 s218
[199] TUPE 2006 reg. 3(1)(a) and *Brookes v Borough Care Services and CLS Care Services Ltd*, EAT [1998] IRLR 636, but once businesses are integrated to a certain extent after share acquisition, the TUPE will still be triggered, see *Millam v The Print Factory (London) 1991 Ltd.*, [2007] EWCA Civ 322; for a discussion of the criteria in judging a relevant transfer under the TUPE see Lindsay J in *Cheesman v R Brewer Contracts Ltd.* [2001] IRLR 144, paras. 9-12
[200] The line of reasoning was first expressed in a context of company reconstruction in *Nokes v Doncaster Amalgamated Collieries Ltd.* [1940] AC 1014, where the Lord Romer opined that: "*… no one could possibly say without gross exaggeration that the landlord, the contractors, or the servants of the first company had suffered an injustice*", at 1047.
[201] See discussion in Part V of this chapter.
[202] Deakin and Morris, (2005), paras. 4.115-4.127.

of the employees within the undertaking. "*Anticipatory measures*" which may threaten employment are within the information to be disclosed. Moreover, if management decisions may lead to substantial changes in work organizations or contractual relations, representatives' opinions must be considered with a reasoned response and consultation must be "*with a view to reaching an agreement*."[203] To achieve that objective, confidential information should also be disclosed but an accompanying contract of confidentiality may be signed with employee representatives and "*any experts who assist them*". Besides, since "*effective, proportionate, and dissuasive*" sanctions are also explicitly supported in the Directive,[204] employees' participation in the decision making process may be meaningful.[205]

Although takeover transactions effected through share transfers are not covered by the TUPE, a change of shareholders may well indicate a possible change of the strategy of the company, which may possibly include changes in the current employment relationship. Accordingly, employees in takeovers *via* share transfers may be less adequately protected than their counterparts in relevant transfers covered by TUPE.[206] Nonetheless, if the court finds that complex transactions are designed to avoid the liabilities under the TUPE, a takeover on a share-for-share basis may be considered a step within a series of steps, the whole of which will be deemed as a single transaction within the coverage of the concept of the transfer of undertaking under the TUPE.[207] Indeed, as summarized by Lindsay,[208]

> *The aim of the [TUPE] is to ensure continuity of employment relationships within the economic entity irrespective of any change of ownership and our domestic law illustrates how readily the courts will adopt a purposive construction to counter avoidance.*

Thus, even though the application of TUPE is circumscribed by the legal

[203] Article 4 of the IC Directive.
[204] Article 8 of the IC Directive
[205] However, since direct communication with employees rather than through the reliance on employee representatives is more preferred by companies in the UK, such arrangements may lead to further debilitated unions, a concern indicating uncertainty in the law and regulation in the future. See Gospel and Willman, (2004), at 18.
[206] Armour, J. and Deakin, S., *Insolvency, Employment Protection and Corporate Restructuring: the Mixed Effects of the Acquired Rights Directive*, (2003), *International Review of Law and Economics*, 22(4):443-463.
[207] *Re Maxwell Fleet and Facilities Management Ltd* (No.2), [2000], 2 ALL ER 860.
[208] Per Lindsay J in *Cheesman v R Brewer Contracts Ltd.* [2001] IRLR 144, para. 12.

definition of transfer of undertaking, TUPE may still be relevant in some takeover transactions through share transfers.

(b) The Application of TUPE

i) Unfair Dismissal

Once TUPE applies, the legal result of regulation 4, the core of TUPE, is the automatic novation of the original employment contracts. Indeed, if there is a substantial change of working conditions to the detriment of employees, employees who voluntarily terminate their employment contracts may still be deemed as being unfairly dismissed under regulation 7 of the TUPE.

TUPE, however, does not render a dismissal before the transfer automatically void[209] and the transferee does not assume an unconditional obligation to take on all the employees of the transferor. Rather, employers may resort to economic, technical or organizational reasons for a defence. But, it is their responsibility to show the transfer is the sole or a substantial reason for dismissal.[210] For instance, dismissals as an effort to meet the requirement of the transferee or to achieve a higher price have already been judged not covered by this exception.[211]

In addition, an employer must also show that he has acted reasonably in dismissing a relevant employee.[212] Case law has indicated that adherence to the proper procedure is important as a failure to consult with the employee concerned may primarily be deemed as an indicator of unfairness.[213] Such procedural protection for employees is important as it is possible that both sides can review the situation fairly in a properly designed complaint and grievance scheme. Moreover, even if a dismissal is by all means inevitable, employees dismissed by redundancy are still entitled to a redundancy payment.[214]

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[209] *British Fuels Ltd v Baxendale* [1999] 2 AC 52.
[210] TUPE 2006 reg. 4(5).
[211] *Litster v Forth Dry Dock & Engineering Co. Ltd* [1989] IRLR 161.
[212] ERA 1996 Ch.18 Sch 3 para. 1.
[213] *Polkey v A E Dayton Services Ltd* [1987] JCR 142 HL
[214] *Gorictree Ltd. v Fenkinson* [1985] ICR 51 EAT.

ii) Information and Consultation

Section 13 of the TUPE stipulates that the transferor and the transferee employers owe a duty to inform and consult the employees or employee representatives affected by the transfer. Information to be disclosed includes the timing of the transfer, implications of the transfer on employees, and measures to be adopted for affected employees.[215] And, the duty to consult must be performed "*with a view to seeking their agreement to the intended measures*."[216] In order to redress the potential deficiency in cases where employees do not in fact have enough time to digest the information disclosed and accordingly take part in a meaningful consultation, the TUPE requires that the employer inform employees "*long enough before a relevant transfer*."[217]

Employees' information and consultation rights do move forward the participation of employees affected by the transfer in the decision-making of the intended transfers. However, such rights cannot be identified with the veto right granted to shareholders in company law. It is highly possible that this liability will only be imposed when the management has almost made their decision. In such cases, employers may have already prepared most, if not all, arguments to defend their decisions while employees are left unprepared with only a scarce chance to negate the decision to transfer and a right to defend their compensation.

Moreover, even if employees are consulted, further restriction on the number of parties privy to the information before the announcement of the takeover may in effect compromise the intended effect of the consultation. According to the City Code (now the Takeover Code) Panel's Annual Report 2003, the number of such people privy to the information can be no more than six external persons or parties, among which include employee representatives. While the Panel will consider employee representatives as constituting one person for this purpose, it seems a large number of representatives may not be appropriate for the spirit of the Code.

On the whole, the disadvantaged negotiating position of employees in private

[215] TUPE 2006 reg. 13(2). This is an event-driven information disclosure, which is different from the process-driven one in IC and EWC Directives.
[216] TUPE 2006 reg. 13(6).
[217] TUPE 2006 reg. 13(2).

contracting in takeover transactions can partly be redressed by the statutory protection for employees. On the one hand, the statutory information and consultation rights for employees impose on management a parallel liability to that owed to shareholders as stipulated in the Takeover Code and company law. This is a strategically important counterbalance to the current primary status of shareholders in corporate governance. On the other hand, the prohibitive cost, including the failure of the transfer, accompanying the breach of the employers' liability under the TUPE may seriously constrain the discretion of employers. In fact, courts have been stringent in this regard. In *Hagen v ICI Chemicals*,[218] an ambivalent statement that "broadly equivalent" rights for employees will be available under the scheme of the transferee is interpreted to mean a maximum 2% worse off as a result of the transfer. The finding that some employees received a 5% off their benefits under the transferee benefit scheme resulted in the failure of the transfer under the TUPE.

iii) The Pension Rights

Another important function of TUPE is its protection of the pension rights of employees transferred. Generally, employee pension schemes can be divided into two main separate categories, *i.e.*, personal pension schemes and occupational pension schemes.[219] Employees' pension rights under former schemes are covered by the TUPE while those under the latter schemes are not.[220] The legitimacy and legality of such regulations in the UK has already been confirmed by the Court of Appeal in *Adams v Lancashire County Council and BET*,[221] even though continuing efforts have been made to include in the employment contracts transferred the pension rights under the occupational pension schemes.[222]

However, such exemption should not deprive the employees and their representatives of the right to be informed of and consulted with any change in the

[218] [2002] IRLR 31
[219] See Pensions Act 2004 s239 and s259.
[220] TUPE 2006 reg.10.
[221] [1997] IRLR 436
[222] The more recent release of news from DTI shows that pension issues in case of business transfer will be considered separately and with a longer timescale. See DTI press release on 14 Feb 2003. Later in June 2003, the Department of Work and Pensions made a more affirmative proposal to extend the protection of the TUPE to occupational pension schemes in the private sector.

pension rights.[223] In fact, the lack of protection in this respect under the TUPE has been mitigated by the Transfer of Employment (Pension Protection) Regulations 2005 and section 257 and 258 of the Pensions Act 2004, which have already extended the TUPE protection to employees of the transferor who have access to the occupational pension scheme immediately before the transfer.[224]

Nevertheless, since an employee cannot require the transferee company to accept a transfer in of his accrued benefits, it is the usual practice that such a transfer is declined by the transferee even though Article 119 of the EC Treaty[225] requires the transferee company to be liable for any inequality of benefit. However, if this is the case, the accrued rights of the employees will be preserved in the former employer's pension scheme but subject to a statutory revaluation so that the real value of such benefits is maintained at the employees' retirement date.

Therefore, pension benefits of employees transferred are generally protected through contracts but with a statutory guarantee of a no-worse-off treatment after the transfer. If such an agreement cannot be reached between the parties, the transferee will usually inform those affected employees that the existing scheme is being wound up and their accrued benefits will be secured by another contract with an insurance company.[226]

In practice, the liabilities on pension transfer may change the financial model for potential purchasers, who may have to consider not only the statutory contribution of up to 6% from the transferor employer if the transferee employees select the money purchase scheme[227] but also the further complicated due diligence phase of the transaction, where the transferee has to take time and personnel to investigate relevant pension issues. Even though private contracts between the affected employees and the

[223] See Pension Act 2004 s259-s261. The information and consultation rights on pension rights refer to employees under both schemes. Also see The Occupational and Personal Pension Schemes (Consultation by Employers and Miscellaneous Amendment) Regulations 2006 and The Occupational Pension Schemes (Consultation by Employers) (Modification for Multi-employer Schemes) Regulations 2006.

[224] See Pensions Act 2004 s257 and s258.

[225] O J C224 31 Aug 1992 (equal remuneration for men and women). This has now been replaced by the new Article 141 of the Consolidated version 2002 O J C325 24.12.2002.

[226] Hepple, B., and Mumgaard, K., *Pension Rights in Business Transfers,* (1998), *Industrial Law Journal*, 27(4):309-324, at 319.

[227] The Transfer of Employment (Pension Protection) Regulation 2005 (SI 2005/649), reg. 3(1)(b).

transferee can help the transferor to avoid the contribution obligation, the possibility of such contracting out in practice may be too low to be meaningful. Thus, as far as takeover transactions are concerned, the statutory pension consideration may effectively frustrate the takeover transaction in concern, counterbalancing the shareholder primacy in the corporate control market.

iv) The Effect of TUPE

In sum, the protection for employees under the TUPE includes both procedural (information and consultation) and substantive aspects (unfair dismissal and pension rights). The inclusive coverage of the employee protection under the TUPE may, however, be limited by the difference in the existing working schemes of the two employers. This may either be reflected in the different payment and performance evaluating schemes or in the difference between the new grievance channel and their familiar one.[228] Additionally, psychological conflicts between transferred employees and other employees in the transferee company may be far more profound than the above mentioned effects, thus debilitating the ultimately intended commitment to the company or the organization, an element "*at the heart of any analysis of HRM (Human Resources Management).*"[229]

Furthermore, it is still not clear whether TUPE is applicable to those employees who work for the part transferred but sign the employment contract with the undertaking to which the part is attached.[230] In *CPL Distribution Ltd v Todd*, the application of TUPE is decided by the duties and the status of the employee as stated in the contract, rather than by the actual work or the function of the work of the employee.[231] However, a reverse decision was made in *Sunley Turriff Holdings Ltd v Thomson*[232], where the contract of a secretary, who signed the employment contract with the company but worked for a company subsidiary which was later transferred, was decided to be transferred to the transferee.

[228] Rubery, J., *et al*., *Changing Organizational Forms and the Employment Relationship*, (2002), *Journal of Management Studies*, 39(5):645-672, at 652-3 and 662-3.
[229] Guest, D., *Beyond Human Resource Management: Commitment and the Contract Culture*, in Sparrow, P., and Marchington, M., (eds), *Human Resource Management: The New Agenda*, (1998), London Pitman, 37-51, at 42.
[230] Deakin and Morris, (2005), at 226-7.
[231] [2003] IRLR 28 (CA).
[232] [1995] IRLR 184.

This is just one situation where transferor and transferee may have different understanding of which employees are transferred. Under such a situation, employees may well be left "*in a state of limbo with both the transferor and the transferee denying that they were the employers.*"[233] However, if this is the case, it clearly contravenes the intention of the TUPE that "*an employee should not forfeit his job because of a change in the identity of his employer*."[234]

C. EMPLOYEES IN BUY-OUT TRANSACTIONS

1. Employee Buy-Outs

In employee buyouts, employees will become the shareholders of the company. Employee buyouts may bring several financial benefits to the company.[235] For example, accession of the excess assets in pension plans, which is achieved by converting pension capital into equity claims, helps to finance the transaction. Meanwhile, the potential substitution of equity claims for the cash compensation for labour may also make available to the company more financial credit, decreasing the risk accompanying the highly leveraged transactions. Moreover, authorities have long been using favourable tax treatments to promote employee shareholding.

In addition to these financial incentives, employee buyouts may also be initiated by some other considerations. For example, employees may initiate employee buyouts for the mere desire of job security. Some empirical evidence shows that employees may use their redundancy payments to purchase a workplace from a parent company for the purpose of saving their jobs.[236] Alternatively, employees might use employee buyouts as a bargaining chip for their expected payments.[237] For

[233] Sargeant, M., *New Transfer Regulations*, (2002), *Indus. L. J.*, 31:35.
[234] Per Morison J. in *Duncan Web Offset (Maidstone) Ltd v Cooper* [1995] IRLR 633, at 635.
[235] Chaplinsky, *et al.*, (1998), at 286.
[236] Bradley, K., and Gelb, A., *Employee Buyouts of Troubled Companies*, (1985), *Harvard Business Review*, 63:121-30, and Waddington, D., *et al.*, *Keeping the Red Flag Flying? A Comparative Study of Two Worker Takeovers in the British Deep Coalmining Industry, 1992-1997*, (1998), *Work, Employment and Society*, 12:317-49.
[237] Ben-Ner, A., and Jun, B., *Employee Buyouts in a Bargaining Game with Asymmetric Information*, (1996), *American Economic Review*, 86(3):502-23.

instance, employees in unprofitable businesses may ask for a payment at a certain level while at the same time offer a price to buy the company in concern. Valuable to employees in this scenario is the negotiating process, through which employees may acquire more information regarding the real situation of the company, even though they may still suffer the lack of expertise in interpreting and understanding possibly truncated and distorted information in such precarious situations. This mechanism thus plays, more or less, a function of signaling or monitoring.

Despite these benefits, the occurrence of successful employee buyouts is still very low.[238] It should be noticed that most benefits we covered are for the company not for the employees. The unpopularity of employee buyouts on the one hand shows the employees' perception of the discrepancy between their own interests with those of the company while on the other hand indirectly reflects the risk-averse nature of the employees, who may prefer a stable income to a fluctuating income from shareholding.

2. Other Buyout Transactions

Different types of buyout transactions may produce different effects on employees. Empirical evidence reveals the positive effects on level of employment and improved employment relationship in MBO transactions whereas negative effects are evident in MBI transactions, where management teams are different from the existing management team.[239] This may be attributed to that fact that MBOs exploit the growth opportunities in the offeree company while MBIs are more likely to be involved in the ensuing restructuring processes.

However, the potential default risk of highly leveraged debt contracts in the current private-equity or hedge fund supported buy-out transactions may counteract

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[238] Robbie, K., and Wright, M., *Local Authorities, Compulsory Competitive Tendering and Buy-outs,* (1996), *Local Government Studies*, 1(22):127-46; Pendleton, A., *et al.*, *The Perceptions and Effects of Share Ownership: Empirical Evidence from Employee Buy-outs*, (1998), *British Journal of Industrial Relations*, 1(36):99-124.

[239] Bruining, *et al.*, (2005); and Amess, K., *et al.*, *Management Buyouts, Supervision and Employee Discretion,* (2007), *Scottish Journal of Political Economy*, 54(4):447-474. MBOs are reported to increase employment by 13% over five years and MBIs to decrease employment by 18% over six years.

the above positive evidence.[240] Moreover, there is a tendency that the number of unions recognized declines after buyout transactions.[241] Also, asset stripping following some buyout transactions has already led to the insolvency of several pension funds.[242] Besides, employees in public companies going private may be deprived of public information disclosure as required by company law and regulations on the securities market.[243] Considering the size of the current going private transactions, employees' information rights are extremely weakened in those companies going private. In turn, the end result may well be that the pre-existing trust between employees and companies will be harmed.[244]

Additionally, even though the impotence of the TUPE for employees in buyout transactions has already been widely pointed out by some worker organizations,[245] the government still did not insert a corresponding regulation in the TUPE 2006. Nevertheless, employees' negotiating power in such transactions cannot be underestimated. As identified by the FSA, several transactions have been stalled because the pension fund trustees of the offeree company require the private equity purchaser to make a substantial contribution to the deficit of the pension fund.[246] More broadly, the staggering income for private equity fund and hedge fund industries has already courted advocates from employees for distributive justice in the society. Indeed, the government has already promised to review the tax issue on private equity funds.[247] In this case, employees successfully take advantage of their political power in the society to claim their governance rights and protect their interests. This is just another piece of evidence that corporate governance can only be understood as an institutional issue.

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[240] FSA, *Private Equity*, para. 4.22.
[241] Advisory Booklet: Appraisal Related Pay, (2005), quoted in Thornton, Phil, *Inside the Dark Box: Shedding Light on Private Equity*, (2007), The Work Foundation Research Paper, available at *http://www.theworkfoundation.com/Assets/PDFs/private_equity.pdf*, at 24.
[242] GMB CEC Special Report, *Private Equity's Broken Pension Promises*, (2007), available at *http://www.gmb.org.uk/Shared_asp_files/GFSR.asp?NodeID=95553*. The report identifies 96 cases of pension fund insolvency are related to private equity funds.
[243] CA 2006 s417.
[244] For example, Thornton, (2007).
[245] Trade Union Congress, *Private Equity – A TUC Perspective*, (2007), The TUC represents nearly 6.5 million workers in 3 unions, available at *http://www.tuc.org.uk/economy/tuc-13312-f0.cfm*, at para. 1.2.
[246] FSA, *Private Equity*, para. 4.34.
[247] Houlder, V., *Tax Loopholes Leave Private Equity Investors to Clean Up*, Financial Times, June 11 2007. Also, Treasury Committee Press Notice No.36 and No.61.

PART V. EMPLOYEES IN INSOLVENCY

First, it must be warned that since insolvency is legally evaluated in financial terms, employees' non-financial interests cannot be seriously considered.[248] This is because any discussion of employees as stakeholders of a company is set up on the presumption that the financial existence of the company is not an issue. Indeed, as we will see, employees are mainly deemed as creditors and are financially compensated in insolvency. Their non-financial interests are largely outside the coverage of insolvency law. Even though employees can resort to employment law for their non-financial interests, the solvency status which is judged only in financial terms can in fact suffocate such claims. Advocates for incremental employees' governance rights are accordingly suggested to propose alternative methods to evaluate the solvency of the company before their argument can be seriously be considered.

Within this background, the current promotion of corporate rescue culture may have a special meaning to rescue the company financially first. Still, as recommended by the Cork Committee, corporate rescue can help achieve the social objective to protect those affected by the insolvency. A corporate rescue culture not only enhances the ongoing value of the company, providing more for whatever parties in participation, but also promotes a stable society and labour force, a very important political objective to be achieved in a welfare state. However, as said, the tricky question here is that it is hard to project the result of the corporate rescue. While corporate rescue may be good efforts to save jobs and maintain stability, it may be achieved only for a short-term and at the cost of other stakeholders. As pointed out by Brown, "*government and the workforce will regard the preservation of jobs as a success, even though unsecured creditors are left begging.*"[249] It is within this context that our discussion of employees in insolvency is carried out.

[248] See IA 1986 s123 (1) (2) and relevant discussion in Chapter 2.
[249] Brown, D., *Corporate Rescue: Insolvency Law in Practice*, (1996), John Wiley & Sons Chichester, at 3, para.1.6.

A. THE ROLE OF CONTRACTS

In cases of insolvency, employment contracts with new employees are rare even for the purposes of corporate rescue. Rather, it is more likely than otherwise for insolvency practitioners to insert new terms in existing employment contracts or to sign new employment contracts with existing employees. Under such situations, employees may either select to quit or to stay put to help saving the life of the company in distress.

If employees select to exit they will get compensation according to the statutory protection and contractual protection. However, too many exits will also accelerate the demise of the company and thus minimize the pie left. In the latter situation, employees can still get the legal guaranteed minimum payment even though other parts of their compensation will be left as claims of unsecured creditors, who usually get nothing at the end.

Alternatively, employees may suspend their original contracts and sign new contracts with the company or the insolvency practitioner to contribute to the turnaround of the business of the target. In some cases, employees may compromise their own interests to tide the company over. Or they may adopt buyouts, as discussed in the former Part, to be the owner of the company. Thus, despite extensive legal penetration in this juncture, private contractual arrangements still provide employees with opportunities to play a proactive role in corporate rescue.

B. THE ROLE OF LAWS AND REGULATIONS

1. Employment Contracting in Statutory Corporate Rescue Procedures

(a) Adoption of Employee Contracts

In general, the inception of administration and administrative receivership should not automatically terminate existing employment contracts because the insolvency practitioners are normally acting as the agents of the company, the appointment of whom does not make any difference to the continuance of the company's existing contracts with employees.[250] In law, the continuance of the employment contracts can be maintained by administrators or receivers through adoption,[251] "*which presupposes their [employment contracts'] continuance at the date of the administration order or commencement of administrative receivership*."[252]

For employees whose employment contracts are adopted in administration after the 14 days grace period, their claims for their services after the adoption date may enjoy a super-priority status to those of the insolvency expenses.[253] With a guarantee of at least some compensation, employees may prefer to stay put rather than to leave. Moreover, morale among employees will also be enhanced. Such a statutory protection thus grants a better protection to employees in administration than to their counterparts in administrative receivership, under which employees may only be protected by the receivers' personal liabilities if the receiver has not contracted out their personal liabilities with relevant employees.[254]

However, the super-priority status of "wage and salary" to employees in administration does not extend to their redundancy or unfair dismissal payments, which are neither strictly "[liabilities] arising under a contract of employment" nor can fall under the rubric of "necessary disbursement" under the r.2.67 of the Insolvency Rules 1986.[255] Such decisions indicate that courts still hold the rescue of the company as a going concern an objective superior to the protection for employees.[256] In this sense, interests of employees are not identified with the interests

[250] *Astor v Synthetic Technology* [1990] BCC 97. When insolvency practitioners act as agents of creditors, the argument is still valid.
[251] *Re Paramount Airways Ltd (No. 3)*, Reported as *Powdrill v Watson* [1995] 2 WLR 312, [1995] BCC 319; [1995] 2 All ER 65. Goode thus summarizes that adoption of employment contracts comes into being if the insolvency practitioner does not within 14 days of his appointment either terminate or repudiate a contract. See Goode, (2005), at 294.
[252] Brown, (1996), at 391.
[253] See IA 1986 Sch B1 paras.99 (4)-(6).
[254] See s44 (1)(b) and s44 (2A), where qualifying liabilities are defined to include pay wages or salary or pension contribution incurred when the receiver is in office.
[255] *Re Hudderafield Fine Worsteds Ltd*, [2005] EWCA Cov 1072; [2005] B.C.C. 915 (CA Div), *Re Allders Department Stores Ltd (In Administration)*, [2005] EWHC 172, [2005] 2 All E.R. 122 (Ch D)
[256] Walters, A., *The Impact of Employee Liabilities on the Administrator's Decision to Continue Trading*, (2005), *Comp. Law*., 26(11):321.

of the company or are only one component of the interests of company at most.

(b) The Implication of the Grace Period on the Consultation of Employees

The statutory interval of the 14-day grace period in corporate rescue is in effect to postpone the legal effective date of the adoption of employment contracts.[257] While the 14-days grace period for an insolvency practitioner is too short to make a comprehensive and well-considered decision, the short time appears even more limited for employees to realize their information and consultation rights. [258]

In fact, it seems that there is a conflict between the insolvency law and the law on employees' information and consultation rights. In contrast to the 14-days grace period, employees are given longer time to be consulted and informed under s.188 of the Trade Union and Labour Relations (Consolidation) Act 1992. [259] Under s188, the period of consultation is relevant to the size of the dismissal. The bigger the number of employees dismissed, the longer the consultation period. If insolvency practitioners have to make a balanced decision to sell the company as a going concern by considering the cost accompanying any lay off within the 14-day period, it is apparent that corporate rescue under the current insolvency legal regime cannot meet the legal requirements on consultation under the Trade Union and Labour Relations (Consolidation) Act 1992. Still, to employ employees in administration for additional 90 days period simply for the purpose of consultation is definitely not cost-justified.[260] Thus, the statutory 14-day interval may be a little arbitrary but any change of it necessitates further delicate cost-efficiency analyses.

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[257] Williams, I., *Administrative Receivers, Employees and the Impact of Winding Up*, (1995), *Insolvency Intelligence*, 8(8):59-62, at 60.
[258] Finch, V., *Corporate Insolvency Law Perspectives and Principles*, (2002), CUP, at 244.
[259] Roughly speaking, if over 100 employees at one establishment are proposed to be dismissed, a period of 90 days is granted; whereas if 20 to 99 employees are going to be dismissed, the consultation period is adjusted to 30 days. Also, Deakin and Morris, (2005), para.9.40.
[260] Armour, J., and Deakin, S., *Insolvency, Employment Protection and Corporate Restructuring: the Effects of TUPE*, (2001a) ESRC Working Paper No. 204, available at http://chass.utoronto.ca/clea/confpapers/JArmour.pdf, at 24.

2. Sales of the Company or Parts of the Company

For the purpose of corporate rescue, it is highly possible that a part or the whole of the company is sold or that the assets are realized. Employees under such situations may either be laid off or face a new employer, who may also consider possible changes to the original employment contracts. Legal protection for employees is mainly achieved through their rights to information and consultation, and the transfer of the employment contracts in concern. We will discuss these issues below.

(a) The Implication of TUPE

i) The Application of TUPE

The Collective Redundancies Directive ('CRD'), the Acquired Rights Directive ('ARD') and the Insolvency Directive within the EU have already made a difference to the corporate rescue process.[261] The essence of these Directives is to grant employees a property-like claim on the enterprise.[262] The effect, however, is two-sided. For the negative aspect, the cost consideration of the employees' interests may hinder potential efforts from the outside to buy the company as a going concern. For the positive, the integration of the interests of employees into the rescue negotiation process may produce a healthy productive unit.

Implementation of these directives in the UK is achieved through TUPE. If a transfer in insolvency meets the requirement of "a relevant transfer",[263] TUPE will apply and the employment contracts will be automatically transferred to the transferee. In turn, the transferee will be liable to compensate the employees for their unfair dismissal. Thus, if the transferor is in financial difficulties, TUPE will be especially important for the employees of the transferor since employees under this situation can hardly get any compensation from the transferor. Indeed, even when the identity of the transferee is still uncertain, TUPE may still apply as long as the dismissal is made

[261] Collective Redundancies Directive, 98/59/EC 1998 OJ L 225/16; Acquired Rights Directive, 77/187/EEC OJ L61/27 2001/23/EC OJ L 82 22.3.2001; the Insolvency Directive, 2001/C 221/19 OJ C 22 1/110 7.8.2001 and Directive 2002/74/EC OJ L 270/10 8.10.2002.
[262] Armour and Deakin, (2003), at 445.
[263] TUPE 2006 reg. 3.

with an objective to facilitate an intended transfer.[264] If this is the situation, the transferor will bear the responsibility for any loss incurred by employees.

Nevertheless, once the company is in any proceeding with a view to liquidating its assets or is under the supervision of an insolvency practitioner, regulations of 4 and 7 of the TUPE do not apply.[265] Moreover, employers may rely on the "*economic, technical or organizational*" exception to exempt their liabilities in business transfer transactions. However, it is worth mentioning that the efficacy of such exemptions for employers may strictly be limited by the courts. For example, one court has already decided that keeping a good price of the insolvent company by a sale as a going concern does not fall within the coverage of the "*economic, technical or organizational*" exception.[266]

The transfer of the acquired rights of employees to the transferee, however, is only one side of the coin. On the other side of the coin, the transferee also inherits rights against the transferor for the failure of the latter to observe any statutory liabilities. However, if insolvency of the transferor is impending, the possibility of success in such actions will be very low. Thus, if a sale is ensuing, the transferee may be especially careful about the fate of the insolvent company.[267]

ii) The Deterrent Effect of TUPE

According to TUPE, employees have a continuous right to access these assets and this continuity should not be interrupted merely by the transfer of the enterprise. Indeed, TUPE "*is another way of recognizing that the employee's human capital is firm-specific in the sense of being bound up with complementary physical assets and organizational routines.*"[268] Thus, TUPE is a strong indicator in law that employees'

[264] *Harrison Bowden Ltd. v Bowden* [1994] ICR 186 at 191 and *Morris v John Grose Group Ltd* [1998] IRLR 499. But see a rebuttal in *Ibex Trading Ltd v Walton* [1994] ICR 907, where the intended transfer is perceived by the court to be "*a mere twinkle in the eye and might well never have occurred*."
[265] This includes either bankruptcy proceedings or any analogous insolvency proceedings. See TUPE 2006 reg. 8(7).
[266] *Whitehouse v Charles A. Blatchford & Sons Ltd* [2000] ICR 542 (CA); *Wheeler v Patel and J. Goulding Group of Companies* [1987] ICR 631 (EAT); *Gateway Hotels Ltd v Stewart* [1988] IRLR 281 (EAT).
[267] Armour and Deakin, (2001a), at 19.
[268] Armour and Deakin, (2001a), at 13.

firm specific human capital investment should be protected from undue prejudice.[269]

In specific, the TUPE is a mechanism to realize the novation of employees' current employment contracts with the transferee. However, as far as dismissal in connection with a transfer is concerned, TUPE has already amplified the rights granted to employees transferred by referring to the exemption of "*economic, technical and organizational*" (ETO) reasons, which is much narrower than the coverage of the concept of "*some other substantial reason*" used as exception in non-TUPE restructurings.[270] It is thus clear that the transfer transaction serves as the trigger in law of a "stronger-than-normal level" protection for employees.

Due to the strong legal protection provided to employees, it seems doubtful that TUPE can facilitate corporate rescue efforts through the sales of the insolvent company as a going concern. This is because an immediate break-up of the transferee within reasonable expectation may substantially decrease the price a purchaser would pay. Indeed, case law shows that the transferor may have to take into consideration those employees dismissed by insolvency practitioners. In *Litster*,[271] actions of insolvency practitioners to lay off employees one hour before the transfer were seen as one of a series of steps "*in contemplation of the transfer*". Employees so displaced were accordingly deemed as being employed immediately before the transfer. Cases like these are clear indicators that TUPE can increase the expense of the corporate rescue. Therefore, it is highly possible that the price a transferee promised to pay has already made a corresponding reduction for their potential liabilities to employees transferred. Such reduction in effect is a reduction of the pool value for creditors. In other words, "*TUPE operates ex post to shift resources from the creditors as a group, to the employees*."[272]

Still, the deterrent effect of TUPE on corporate rescue should not be overrated. First, since the fate of the rescue is an accumulative result of a set of different factors, such as the number of employees to be displaced, the length of their service and the

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[269] Surprisingly, until now, there is no clear empirical evidence to prove the employees' loyalty in corporate rescue, see Finch, (2002), at 571.
[270] See ERA 1996 s.98(1)(b).
[271] *Litster v Forth Dry Dock & Engineering Co. Ltd* [1989] IRLR 161
[272] Armour and Deakin, (2001a), at 12.

negotiating power of the potential buyers, the amount and quality of information available to both parties, it is unfair to attribute the low success rate of corporate rescue solely to the deterrent effect of TUPE.[273] Second, the government has been making efforts to redress the potential debilitating effects of TUPE on corporate rescue. Indeed, two regulations of the TUPE purposefully refer to the specific context of insolvency and thus are of special importance to corporate rescue. One is regulation 8, according to which the liability of the Secretary of State under the Employment Rights Act 1996 applies to any relevant employees in such transactions and cannot be transferred to the transferee.[274] Thus, relevant employees affected by TUPE can get guaranteed protection under the Employment Rights Act 1996, facilitating their proactive involvement in the corporate rescue. The other is the newly inserted regulation 9, corresponding to article 4a of the Acquired Rights Directive, which expressly permits the variation of the employment contracts to be transferred but on the condition that such variation must be designed with a view to safeguarding employment opportunities through the survival of the part transferred.[275] Correspondingly, employee representatives and employees are granted with rights to be consulted if a permitted variation of the contracts is intended. The regulation thus provides some flexibility in rescuing the company in distress, clearing the former obstacle established in case law that the TUPE cannot be contracted out,[276] while at the same time duly promoting the employee interests in such precarious junctures.

(b) Information and Consultation

If large scale redundancies are in consideration or if a transaction within the meaning of TUPE is about to be concluded, the law requires that representatives of the employees be consulted with a view to reaching agreement on ways of protecting the employees' interests.[277] Employers may have to pay an exorbitant penalty with a punitive nature if they fail to meet these requirements.[278] In addition to his or her

[273] Frisby, S., *TUPE or not TUPE? Employee Protection, Corporate Rescue and "One Unholy Mess",* (2000), *Company Financial and Insolvency Law Review*, 3:249-71.
[274] TUPE 2006 reg. 8 (2)-(5).
[275] TUPE 2006 reg. 9(7)(b).
[276] *Tellerup v Daddy's Dance Hall* (C-324/86) [1989] IRLR 315 TUPE cannot be contracted out.
[277] For the former see TULR 1992, ss.188 *et seq*.; for the latter see TUPE 2006 regs. 13-15.
[278] TUPE 2006 reg. 15.

contractual entitlements, an employee affected by such breaches may also be awarded "appropriate compensation."[279]

It is true that employers who fail to inform and consult the employees in the proposed redundancy dismissal[280] may cite "*special circumstances*" as a defence.[281] However, mere insolvency or the fact that the company is in administration cannot be referred to as a "*special circumstance*."[282] There must be something uncommon or unordinary that has made it practicably unreasonable to comply (at least fully comply) with the requirements.[283]

Nevertheless, case law in the UK tells us that employers' breaches of this consultation duty still cannot avoid the transaction.[284] In fact, with a penalty of compensation which the tribunal considers appropriate, the failure to observe the consultation obligation may make no difference to the existing employment relationship. Still, the effect of the potential penalty may be intimidating. As two scholars observed:

> "*By doubling the salaries and wages of the workforce for a period of weeks or perhaps months, the sum owed by the employer soon mounts up, eating into the income and assets which would otherwise be available to shareholders or, in some cases, creditors. The viability of a particular managerial strategy for restructuring may thereby be undermined.*"[285]

Accordingly, even though the failure of the employer to observe this liability only leads to the dismissal being considered unfair, and does not make the transaction void, the ultimate effect of the penalty may still be frustrating *ex ante.* The difference in the end result is thus "*one of degree, not one of kind*."

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[279] TUPE 2006 regs. 15 (7), 16 (3) & (4).
[280] Here, "propose" has a meaning more than "merely thinking about". See *Re Hartlebury Printers Ltd. (In Liquidation)* [1993] BCLC 902.
[281] See TULR 1992 s188(7).
[282] For the former see *Clarks of Hove Ltd. V Bakers' Union* [1978] 1 WLR1207 for the later see *Re Hartlebury Printers Ltd. (In Liquidation)* [1993] BCLC 902
[283] *Re Hartlebury Printers Ltd. (In Liquidation*) [1993] BCLC 902, at 912d.
[284] *Wilson v St. Helens BC/Baxendale v British Fuels* [1998] IRLR 706.
[285] Armour and Deakin, (2001a), at 12.

(c) Unfair Dismissal under Non-TUPE Transfers

While TUPE provides employees with a powerful weapon to safeguard their interests, a lot of sales or business transfers are not covered by TUPE. If there is no application of TUPE to the business transfer, employees may have recourse to general protection provided by the Employment Rights Act 1996.[286]

Still, employers, by showing the reasons for dismissal are potentially valid and reasonable under the specific condition, can have recourse to "*some other substantial reasons*" to defend the fairness of their decision to dismiss the employees.[287] In effect, the statutory defence of "*some other substantial reasons*" has generally enhanced the prerogative of the management since "*Judicial and tribunal interpretations have read into reasonableness an overly generous view of managerial prerogative*."[288]

Nonetheless, justifications for such exceptions may still exist in some cases where employment contractual terms may have to be changed for the sole purpose of saving the company. It should be noticed that in some cases employees themselves may even ask for similar changes in order to tide the company over.[289] In such cases, individual employee's interests may have to be subjugated to the overall corporate rescue objective.

Such understanding has been testified in *Ellis v Brighton Co-operative Society Ltd*[290], where the dismissal of the employee, who refused to accept the changed contractual terms, was decided fair for the reason that he could not be an exception to the whole rescue program. However, two points are worth mentioning about that case. The first is that reorganization is identified as a business necessity in *Ellis,* without which the whole business would come to a standstill. The second is that the employer observed a set of proper procedures, such as timely consultation with the aim to reach agreements. Such understandings may produce important implications on employees.

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[286] Especially Part X on unfair dismissal, Part XI on dismissal on redundancy, and Part XII on insolvency of employers in ERA 1996.
[287] ERA 1996 s98(1)(b).
[288] Anderman, S., *The Law of Unfair Dismissal*, (3rd edn), (2001), Butterworths LexisNexis, at 277.
[289] *Hollister v National Farmers' Union* [1979] ICR 542, [1979] IRLR 238 CA
[290] [1976] IRLR 419 EAT. It should be noted the case was decided before the enactment of TUPE but still the reason can be grouped under the Economic, Technological and Organizational exceptions.

On the one hand, it can be seen that the interests of the company are different from those of employees and that the latter must be subjugated to the former if a reorganization is really needed for the survival of the company. On the other hand, regulations on unfair dismissal and those regarding information and consultation, still play their due role by providing employees with a chance to get involved in the corporate strategic decision making process, though such a right cannot be identified with the *ex ante* decision right.

3. Distribution to Employees in Liquidation

On liquidation, with the exception of members' voluntary liquidation, employment contracts terminate automatically. The publication of the winding up order or a compulsory liquidation can be seen as the notice of discharge of the employment contracts.[291] The ensuing issue is thus the distribution to employees. While employees are generally deemed as creditors and the general distribution principle of *pari passu* still works, statutory qualifications can also be located. For example, some claims are regarded as insolvency expenses and are thus paid in the first echelon and some of the claims are regarded as having a super-priority even to the insolvency expenses.[292] Claims in the latter category are mainly for services rendered by employees during the corporate rescue period, during which the contributions from employees are indispensable parts of the rehabilitation process or their services rendered in the liquidation phase.[293] In addition, part of their claims, *i.e.*, wages and holiday pay accruing in the four months before "the relevant date"[294] of proceedings have a preferential status, ranking ahead of unsecured creditors and floating charges, but subject to a limit of £800.[295] Other claims from employees will generally be regarded as claims from unsecured creditors, who usually end up with almost nothing.

[291] *Re General Rolling Stock Co* (1866) 1 Eq 346 and *Commercial Financial Co Ltd v Ramsingh-Mahabir* [1994 1 WLR 1297
[292] IA 1986 Sch B1 paras. 99(4)-(6).
[293] Per Lightman J. in *Re Leyland DAF Ltd* [1995] 2 W.L.R. 312, at 323.
[294] See IA 1986 s387. It should be noted that this relevant date varies with different insolvency procedure involved.
[295] See IA 1986 s175 and Sch. 6.

In liquidation, employees may have no third party to claim their entitlements except through the National Insurance Fund.[296] The end result of this process is that the employees will be substituted by the NIF as the creditor of the company. Employees' claims against NIF are guaranteed to be paid in full, subject to a statutory limit, and there is no concern of priority for their claims as would happen if they claim as creditors. Indeed, the creation of NIF indicates that the compensation for employees in such categories is not an issue specific to any particular employer but rather a general concern to all employers. Viewed from this perspective, the mandatory requirement of insurance may operate as a potential constraint on the management's opportunism arising from the limited liability.[297]

Given the embarrassing financial conditions of companies going into liquidation and the superior status of claims from secured creditors, compensation for employees may in practice be limited to statutory minimum protection. The minimum statutory protection thus guarantees employees a superior protection compared with that for other creditors. The seemingly inconsistent treatment of employees, either in comparison with that of creditors or across different groups of employees, however, reflects the importance of an ethical concern, which is wider than the mere concern of distributive justice.[298] For example, for some employees a job is identified with the only source of their living maintenance. A mere legal status as unsecured creditors thus cannot meet this moral requirement.

In contrast, a resolution of voluntary winding up does not terminate existing employment contracts automatically.[299] Employees in such situations can be protected by unfair dismissal law. In one case, an express instant dismissal of an employee whose employment contract does not expire has been decided unfair and employees concerned can claim damages.[300] Indeed, even if the employer has ceased to do business, a dismissal following a resolution of voluntary winding up has been decided to be a wrongful dismissal.[301] Furthermore, since it is more often the case that the

[296] See ERA 1996 ss166-70 and ss.182-90.
[297] Davies, (2002b), at 81.
[298] Villiers, C., *Employees as Creditors: A Challenge for Justice in Insolvency Law*, (1999), *Company Lawyer*, 20 (7):222-232, at 228-9.
[299] Gaymer, J., *The Employment Relationship*, (2001), London Sweet & Maxwell, at 395.
[300] *Fox Brothers (Clothes) v Bryant* [1979] 2 All E.R. 905
[301] *Reigate v Union Manufacturing Co (Ramsbottom) Ltd*, [1918] 1 K.B. 592. But a managing

company has enough to distribute among different claimants, financial interests of employees may not be a big issue. Still, employees' non-financial interests can be compromised in such situations.

4. Statutory Arrangements

(a) S425 of the Companies Act 1985[302]

Arrangements under s425 of the Companies Act 1985 involve a wide range of re-structuring transactions. An approval of a statutory majority representing three-fourths in value of creditors or class of creditors or members or class of members is required.[303] Thus, if an employee shareholding scheme has already been in place, employee shareholders, if they are in the majority of the shareholding of the company, can protect their interests through their shareholding of the company concerned. However, in this case, it is highly possible the compromise or the arrangement is to some extent a sacrifice of the interests of the employees. Moreover, it must realized that case law has largely excluded employees' service contracts from the coverage of the 'property' or 'liability' transferred to the transferee under the s427(6) of the Companies Act 1985,[304] indicating that some employees' rights cannot be protected under an arrangement of s425 of the Companies Act 1985.

Employees may, however, rely on employment law to protect their interests. If there is a relevant transfer under TUPE, employees can seek relevant protection under that regulation. Alternatively, if such transfers are achieved through share-transfers, we may notice that such a change may well modify the contractual terms. Breaches of implicit contracts, especially in terms of trust and confidence, may be more common than apparent breaches of employment contracts. Nonetheless, it should be borne in

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director's employment contract is decided to be terminated automatically the time of the pass of the resolution of voluntary winding up. See *Fowler v Commercial Timber Co.* [1930] 2 K.B. 1 CA. Nevertheless in rare cases, where voluntary liquidation is announced during an administrative receivership, employment contracts can be terminated in fact because the liquidator cannot continue the employment contracts adopted by administrative receiver. See Williams, (1995), at 60.

[302] To be replaced by Parts 26 and 27 of the CA2006.

[303] See CA 1985 s425(2), to be replaced by CA 2006 s899 (1) (3), s907(1) and s922 (1).

[304] Section 427(6) of the CA 1985, to be replaced by s900 (5) and s 941 of the CA 2006. It seems from this section, employees' claims are different from those of the creditors. *Nokes v Doncaster Amalgamated Collieries* [1940] AC 1014 (HL)

mind that trust and confidence have already been implied in those long-term employment contracts.[305]

(b) S110 of the Insolvency Act 1986

In a process under s110, insolvency of the old company is impending. The set-up of the new company is merely a vehicle for the purpose of rearranging the debt and/or the capital structure of the old company. Even though such a change of the company's legal personality is important as the company with original shareholders and/or creditors but in a different, and perhaps healthier, capital structure, will open a new page of its own life, employees may well be dismissed in such a situation as the company is expecting a new start. However, it should be noticed that dismissals of employees at this time may well be considered unfair as common law has already established that a resolution of voluntary winding-up does not terminate the employment contracts at least if the company does not cease its entire business.[306] Since an arrangement under s110 usually does not change the business of the original company, it is highly possible that employees dismissed in an arrangement may succeed in claiming their compensation in court. In addition to their rights in employment contracts, employees may also rely on unfair dismissal law and the law of redundancy for corresponding protection. Moreover, as an arrangement under S110 of the IA 1986 is mainly employed as a rescue effort with a view not to liquidate the assets of the company, regulation 8 of the TUPE will apply if there is a relevant transfer.[307] Employees may accordingly enjoy the protection under the TUPE.

CONCLUSION

In this chapter, we begin our discussion with the social political issues relevant to employees. Even though the promotion of workplace democracy has made a difference to employees' governance rights, the current finance dominated commercial culture and the historically established confrontation between capital and

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[305] See discussion in Part IV of this Chapter.
[306] *Fowler v Commercial Timber Company* [1930] 2 K.B. 3.
[307] TUPE 2006 reg. 8(6) and (7).

labour seriously constrain the effectiveness of such efforts. In fact, labour controlled companies are rare. Nor can workplace democracy, which emphasizes the decision making rights of employees, improve productivity as expected within other organization forms. Moreover, the single-tier board practice in the UK can only be understood as an end-result of the political struggle between capital and labour during the post-war period, indicating that the specific business practice in the UK is not compatible with the two-tier board structure as in Germany or some other forms of employee codetermination. However, creative contractual solutions such as ESOPs and pension fund arrangements can help to achieve employees' financial participation, partly mitigates the long-established conflict between capital and labour. Still, as we have seen, several factors constrain the effectiveness of these arrangements in safeguarding the interests and governance rights of employees.

Indeed, workplace democracy can only be promoted when companies are financially viable. But on the other hand, the short-termism of financial pursuance co-exists with the stickiness of employment policy at the level of individual companies. Also, the current pursuance of both economic efficiency and social justice within the EU has greatly improved the situation of employees' participation within the UK. We thus observe that labour and capital are interactive knots in the governance institution network.

We then discuss employees in the normal life phase of corporate governance. As discussed, the implicit contractual right to job security is a case sensitive issue for individual employees. Accordingly, the general linkage between firm specific investment and job security may do a disservice as employees' firm specific investment is a dynamic issue. Moreover, collective bargaining through union representatives and selected representative schemes strengthens the negotiating power of employees though some concerns still constrain the representativity of such systems. Even though the marginalization of unions may discount the above effects, the newly introduced selected representative scheme and the strengthened information and consultation rights may more or less enhance the collective bargaining power of employees.

Next, we discuss the role of laws and regulations in safeguarding employees' interests. What is apparent in the regulations on employment contracting is the recognizance of the status approach to employment relationships and the existence of public law elements to redress the redistributive concern. Such a stance informs the whole legal institution on employment relationships. Also, as we have seen, through mandatory standards, contractual interpretation, interventions of industrial tribunals or courts, and such governance rights as recognition of trade unions, collective bargaining, information and consultation with worker representatives, labour law plays an important role in reshaping the governance role of employees under the governance structure established merely by the company law.

We then examine employees in the three thresholds in the life cycle of corporate governance. We intentionally extend the discussion of employees in flotations to earlier stages when companies are in their incubation. Such an approach reveals that the employment relationship before the flotation stage has a strong blue print effect on its latter development. Moreover, the predominance of the bilateral monopoly model in employment contracting and the strong role of norms and reputation in shaping employment relationship are two features of employment relationship for companies in this stage. In addition, the intensive competition on the product market may also constrain the legal protection for employees. Strong legal intervention, especially those affecting medium sized companies, may in fact impose costs on companies intending to go public.

For employees in companies going through takeovers, the traditional argument for disadvantaged employee negotiating power must be viewed with reservation. For one thing, it is hard to argue that employees cannot project the possibility of takeover activities and claim corresponding contractual rights. For another, we see strong legal intervention through unfair dismissal law and TUPE in protecting the interests of employees. Admittedly, the prior approval rights granted by the Takeover Code to offeree shareholders may substantively vitiate employees' participation in the decision making process. However, the counterbalancing effects of employment regulations, such as the ICE and the TUPE, are also very strong even if directors may prioritize the interests of shareholders in practice. In fact, the cost of breaches of legal stipulations may well lead to the abortion of the intended takeover transactions. Furthermore, as revealed in the quick response of labour to the recent private equity and hedge fund supported buyout transactions, employees may seek a general protection through their political strength in the wider society.

When companies face financial embarrassment, we observe strong legal intervention in the employment contracting process. Detailed laws and regulations strongly constrain the discretion of employers to dismiss employees. Employees may participate in the rescue process voluntarily either through employee buyout transactions or by accepting lower payments to tide the company over. Also, employees are granted with important information and consultation rights to rescue strategic movements such as sales or transfer part or whole of the company. Even if rescue efforts fail at last, employees are protected by minimum legal compensation with support from the national insurance fund. However, it must be realized that the solvency status only judged by financial performance may preclude any serious consideration of non-financial interests of employees. In fact, to deem employees as financial creditors is the main principle for distribution to employees in insolvency, although we observe different priority is prescribed for different categories of compensations. However, it is fair to argue that strong legal intervention at this stage grants employees a stronger negotiating power in distressed companies than in companies in normal life.

In sum, our discussion shows that employees' relative lack of decision-making power in company law has been somewhat counterbalanced by rather strong employees' rights in employment law, through which a range of institutional arrangements have arisen to constrain the discretion of the employer. Importantly, by providing substantive protection for individual employees in redundancy and unfair dismissal cases, voice rights in mandatory information and consultation regulations, and retention of their rights in cases of specific events like business transactions in TUPE and insolvency of the employer, UK employment law "*acknowledges the existence of a contingent control right for employees.*"[308] Indeed, for boards making decisions, company law and employment law are parallel.[309] In other words, boards may have to consider the potential liabilities imposed by employment law when they

[308] Armour and Deakin, (2001a), at 16.
[309] The parallel argument also indicates that shareholders and employees have different governance roles. See Davies, (2002b), at 274 and Rock and Wachter, (1999).

consider the interests of shareholders or when they present the argument to shareholders. Considering the strong threatening effects of liabilities when employees' statutory rights are breached, it may be too simple to say that shareholders will leave aside the interests of employees.

Moreover, even though the past history paves the way to a governance institution with *shareholder supremacy* and weak labour unions, the current development in employment law, mainly derived from the wider Europe, has already changed the landscape. In fact, if we consider the overwhelming influence of the dual pursuance of both economic efficiency and social justice within the EU, there is a strong argument that more *intrusive* employee rights will be imposed in the near future in the UK. The governance role of employees is thus a dynamic issue which must be considered within the ever-changing social political context.

In a word, protection for employees in the UK largely corresponds to their social political status and is instituted with flexibility according to the specific situations of the company.

CHAPTER 6. CONCLUSION

PART I. A REVIEW OF THE THESIS

A. A REVIEW OF THE THESIS

In this thesis, I begin by viewing corporate governance as a control system, which includes both the internal and the external control scheme. I argue that only by integrating these two schemes can we have a holistic picture of corporate governance. With the help of institutional economics, I reorganize factors included in those two schemes and set up a three-dimensional structure to integrate both the internal and external control schemes.

The discussion in this thesis shows that the corporate governance institution in the UK is largely appropriate for the purpose of providing due protections for stakeholders given their status in the wider society. We observe that stakeholders have different combinations of laws and contracts to safeguard their interests in different phases of the life cycle of corporate governance. In the normal life of a company, we see that protection for shareholders' interests has mainly been standardized as a set of default and mandatory rules in company law and securities markets regulations. In this phase, the interests of creditors are protected mainly through contractual arrangements. For employees, their interests are protected mainly through employment law, which provides not only minimum protection in their financial interests but also their rights arising from their status as citizens with dignity in welfare states. Moreover, some employees, depending on their strong negotiating power, may also enjoy protection from their own contractual arrangements with the company.

Once a company goes through a flotation, we observe that public companies are also subject to the laws and regulations on the securities markets. We also observe that institutional shareholders can enhance their established interests by taking advantage of their business relationships with financial intermediaries on the public capital market. As a flotation more often than not indicates a good prospect of the company in concern, contractual arrangements are still the main method for creditors and employees to protect their interests. What is worth emphasizing is that corporate governance practices at the company level present a path-dependent nature. In fact, we observe not only the '*lock-in*' effect of institutional shareholders and venture capitalists but also the '*blue print*' effect of the employment relationship in companies going through the process of flotation. While such observances do show that corporate governance develops continuously, a more important implication may be that finance dominated governance practices may well be maintained years after companies go public.

In takeovers, we observe that different stakeholders have different rights and different sets of constraints to safeguard their interests in this conjuncture. One important issue in the UK is that shareholders are the only group of stakeholders entitled with a decision making right. Still, the decision making process is not that clear cut as a single-minded target at financial interests for shareholders only may not be feasible considering the strong legal intervention for the interests of employees and the strong negotiating power of creditors. Since the strong negotiating power of creditors may justify the legal protection they receive, the disruptive effects on employees are especially apparent. However, it must be realized that disruptive effects of takeover transactions on employees more often than not refer to those of the ensuing sales of companies or insolvencies of companies. But on the other hand, we also see that strong legal intervention through TUPE and other employment laws which have greatly improved their legal protection. Moreover, the enhanced information and consultation rights in cases of important strategic movements can also improve the collective negotiating power of employees. It is true that such legal intervention still cannot meet the requirements of advocates for stakeholder-oriented corporate governance. However, it must be realized that such improvements can only be achieved through persistent political efforts.

In insolvency, shareholders are marginalized to the extent that they may only get involved proactively as participants in the corporate rescue process. Interests of creditors are expressly prioritized in insolvency law though their main protection is achieved through contractual arrangements in earlier phases of the life cycle of corporate governance. Employees, again, are protected in insolvency law as creditors and in employment law as both firm-specific human capital investors and citizens with dignity in welfare states. However, one intriguing point of insolvency in the life cycle of corporate governance is that the criteria judging the solvency status of a company have always been made in financial terms. Even though this lacuna can be explained by the strong role of finance in the current social political context, it is still curious to find that no advocate for stakeholder-oriented corporate governance has ever suggested the introduction of the non-financial interests of employees into the criteria evaluating the solvency status of a company.

B. THE INTERESTS OF A COMPANY

The above review thus sheds some light on the understanding of the concept of the interests of a company. Up till now, there is no clear definition of the interests of a company. Still, at first blush, it is easy to link the financial interests of a company with the interests of the company. The financial interests of a company are not only prescribed by the relatively strong position of capital to that of labour in society but also dictated directly and forcefully by insolvency law as whatever the interests of the company are, it must be sure that one primary objective of corporate governance is to ensure the survival or the solvency of the company. As we said, the criteria for a company to be insolvent are stipulated in purely financial terms. In other words, there are good reasons to argue that the financial solvency of a company is one basic component of the interests of a company. Accordingly, the objective of directors' fiduciary duty to achieve the long-term success of the company under the new Companies Act 2006 must first be understood as to achieve the financial sustenance and then the long-term development of a company. In combination with the understanding in this thesis, the long-term success of a company requires the company to be flexible and strong enough to suit the ever-changing internal and external environment.

However, this understanding may in practice be easily transformed to pursue financial profit to the extreme and in turn the identification of the interests of shareholders with those of the company. Our analysis show that only the interests of shareholders fluctuate in tune with the rise and fall of the company. In comparison, creditors may only care for their already established financial interests in their contracts with the company. They may insert covenants to safeguard their interests long before the statutory insolvency criteria are met. Protections provided in insolvency law are thus in most cases a last resort. Alternatively, interests of employees, with minimum protection either from law or from social political concerns, are not so tightly knitted with the fluctuation of the development of the company. Indeed, employees are separately protected to some extent without due consideration of the phase of the development of the company. As shown in this thesis, the interests of employees can at least be distinguished into a fixed part and a fluctuating part. Though the fluctuating part is closely connected with the development of the company, the existence of the fixed part in the interests of employees at least provides some argument for the residual status for shareholders. Thus, compared with the other two stakeholders, shareholders' interests can be easily measured and also fluctuate in tune with the life cycle of the company. In turn, it is not a surprise that the interests of shareholders are more often linked with those of the company in practice.

Nevertheless, there is still a big step between such a link and the identification of the interests of shareholders with those of the company. On the one hand, the involvement of creditors and the firm-specific investment of employees are all relevant. Financial performance, or specifically the performance of the share price, is influenced by several factors in both the internal and the external governance systems. It is hard to separate the financial interests from the other influencing factors. On the other hand, if we agree that distributive justice is a worthwhile pursuit in any democratic welfare state, we may prefer a modest pursuit of financial health to a pursuit of the financial profit to the extreme. Moreover, a relentless pursuance of financial interests will attract violent opposition from labour either at the company level or in the wider society and thus is infeasible in modern society.

To put things together, it is arguable to say that the interests of a company should at least include both an element of financial healthiness and a due consideration of the distributive justice among different stakeholders within a company. In other words, given the coverage of this thesis, the interests of the company must overlap interests of all three stakeholders though different weight will be attached to different stakeholders in different phases of the life cycle of corporate governance.

We then need to put into perspective the decision making process by directors in public companies. One implication of this study is that directors' decision making must be a multiple-objective decision making process. It is naive to claim that directors only consider interests of their own or those of a certain group of stakeholders. Indeed, the enlightened shareholder governance model implied in Companies Act 2006 expressly prescribes that directors must take into consideration interests of the other stakeholders. Moreover, the decision making process must be a dynamic process subject to the constraints and incentives from both the internal and external control systems, in which the weight attached to different interests within a company can only be decided by the specific condition each individual company is in.

In sum, the above review shows that a holistic approach integrating both the institutional perspective and the dynamic life cycle of corporate governance is the only appropriate way to study corporate governance. Through this approach, corporate governance can only be understood as an embedded and multiply connected system in which the interests of participants are balanced and orchestrated to pursue the purpose of the company. Such a *control balancing* understanding thus is in stark contrast with the traditional *control or power pursuance* perspective of the concept of corporate governance. In other words, corporate governance should not be about who control whom but be about how control should be shared and balanced between and among the different stakeholders. This thesis thus provides support to the view of Teubner, who deems corporate governance as a dynamic process in which no stakeholder '*has a natural claim to "sovereignty within the group"* and through which inside and outside are aligned for the "*the interests of the "corporate actor", which do not coincide with the interests of any participants.*"[1]

[1] Teubner, G., *Law as an Autopoietic System,* (1993), Oxford: Basil Blackwell, at 140.

PART II. IMPLICATIONS FOR REFORM OF CORPORATE GOVERNANCE

A. STAKEHOLDER-ORIENTED OR SHAREHOLDER-ORIENTED

Discussion in this thesis reveals that stakeholders employ different sets of constraints to establish, reinforce and protect their interests. In the meantime, their interests are also interdependent and thus counterbalanced among themselves. In other words, corporate governance can only be understood as an institutional network. A touch of the knot may produce important implications for the whole network. In turn, to review and propose for improvement on the current governance practice we must see whether the whole net is stable or not, rather than only consider whether any specific knot is tight or not.

Viewed from this perspective, the enlightened shareholder model and the stakeholder-oriented model are only two methodologies to address the discretion of directors in their decision making process. Which is better? It is hard to say. But at least our discussion in social political issues may provide us with a hint. Indeed, the specific approach to corporate governance adopted in any certain jurisdiction is first a choice of the special social political context in concern. In other words, the path-dependent nature of the development of corporate governance indicates that an abrupt and violent transition from one model to the other is inadvisable.

Nevertheless, the stakeholder oriented governance model has its merits and is worth pursuing. But the pursuance of that model cannot be made from a blank sheet of paper. An arrogant disregard of the merits of the existing shareholder-oriented governance model can only be misleading and be unfeasible in practice. In fact,

> *"It is easier to find particular legal obligations or legislation that may be socially sub-optimum. But it seems almost impossible to specify any institutional mix that is more efficient or just than any other."*[2]

Advocates for the stakeholder oriented governance model must realize that a

[2] Hyde, A., *Ownership, Contract, and Politics in the Protection of Employees against Risk,* (1993), *University of Toronto Law Journal*, 43:721-750, at 724-5.

mere change, or even a profound change, in company law is not enough. Indeed, company law is not the only legal source for corporate governance. Insolvency law, employment law, even the capital market law also play important roles. Accordingly, even if we limit our discussion to law only, such a change can only be possible when we consider the legal institution as a whole.

Moreover, it seems that advocates for stakeholder-oriented corporate governance must provide a feasible plan to achieve their objective. The complexity of the decision making process for directors and the feasibility of integrating non-financial interests of employees into the legal rules in each different phases of the life cycle of corporate governance are two examples of potential concerns. Even if such alternatives are available, caution should still be paid to the potential costs of such changes. For this, Dooley warns that "*in a complex and interdependent system, inefficiencies in one part of the system should be tolerated if 'fixing' them would create even greater inefficiencies elsewhere in the system as a whole.*"[3]

Indeed, to promote stakeholder-oriented corporate governance practices, a change of business culture is advisable.[4] For instance, a supportive culture for the employee governance role apparently facilitates the introduction of employee-favourable improvements. Still, it cannot be an easy job to change the current finance-dominated commercial culture, which has deep-rooted and wide-ranging implications on governance practices. Just as observed by Teubner, within a capitalist world, "*the logic of the market is central and profit necessarily assumes primacy as an objective. The board of the enterprise must then work within the logic of and the priorities of capitalism.*"[5] All these understandings thus point out that the transition from one model to the other, even if it is preferred, can only be carried out as a work of an institutional scope.

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[3] Dooley, M., *Two Models of Corporate Governance*, (1992), *Bus. Law.*, 47:525.

[4] For example, Charny points out *culture*, a concept defined as shared beliefs and social norms, is an important factor that makes difference to the corporate governance practice. See Charny, D., *Workers and Corporate Governance: The Role of Political Culture*, in Blair, M., and Roe, M., (eds), *Employees and Corporate Governance* (1999), Washington DC Brookings Institution Press, at 117.

[5] Teubner, G., *Industrial Democracy through Law? Social Function of Law in Institutional Innovations*, in Daintith, T., and Teubner, G., (eds), *Contract and Organization: Legal Analysis in the Light of Economic and Social Theory*, (1986), Berlin, 261-273, at 268-9.

B. PIECEMEAL REFORMATION RATHER THAN VIOLENT CHANGES

The above discussion thus points out that governance reform must be carried out with caution. However, the realization that corporate governance is a dynamically developing institutional network is not enough by itself. We must also realize that institutions need not be optimal for a buoyant economic performance. Rather, institutions are only required to be "*just good enough to survive*."[6] That is, even though the current legal institution relevant to corporate governance in the UK cannot be deemed as optimal, it may still be the "*best fitted for adaptation in a given environment.*"[7]

Alternatively, the flexibility of institutions should not be underestimated. David Kershaw argues that "*…organizational efficiency is much more flexible than currently believed and that the pursuit of shareholder value can accommodate considerable institutional variation, even an employee role in strategic participation.*"[8] In turn, over-intervention through mandatory stipulation into the regulation of corporate governance is inadvisable since the law making process *per se* can be seen as a rent seeking process by interest groups, whose view of participation in decision making process in the company is at best no better than the market selection process.

In light of this understanding, corporate governance reform, if it is desirable, can only be a delicate balancing process, in which gradual, piecemeal modifications rather than violent and abrupt changes should be preferred.[9]

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[6] Roe, M., *Chaos and Evolution in Law and Economics*, (1996), *Harvard L. Rev.*, 109:641, at 647.
[7] Deakin, S., *Evolution for Our Time: A Theory of Legal Memetics*, (2002), *Current Legal Problems*, 55:1.
[8] Kershaw, D., *No End in Sight for the History of Corporate Law: The Case of Employee Participation in Corporate Governance*, (2002), *Journal of Corporate Law Studies*, 34-81, at 37.
[9] But notice that such a gradual change cannot be identified with a mixture or a simple and legalistic transplant of foreign elements to domestic schemes. See Bratton, W. and McCahery, J., *Comparative Corporate Governance and the Theory of the Firm: The Case against Global Cross Reference*, (1999), *Colum. J. Transnat'l L.* 38:213; Schmidt, R., and Spindler, G., *Path Dependence and Complementary in Corporate Governance*, in Gordon, J. and Roe, M., (eds), *Convergence and Persistence in Corporate Governance*, (2004), CUP, 114-126 at 121 et seq; and Deakin, S., and Ahlering, B., *Labour Regulation, Corporate Governance and Legal Origin: A Case of Institutional Complementarity?*, (2005), CBR Working Paper No.312, available at *http://ssrn.com/abstract=898184*.

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