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### Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom

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# Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom

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## INTRODUCTION

The corporate world today subdivides into rival systems of dispersed and concentrated ownership, each characterized by different corporate governance structures.<sup>1</sup> The United States falls into the former category, whereas major industrial rivals such as Japan and Germany are members of the latter. The past decade has seen intense academic debate over possible explanations for the different systems of ownership and control in key developed economies. Anecdotal evidence suggesting that market forces may be serving to destabilize traditional business structures and foster some form of convergence in a U.S. direction has given the controversy powerful current relevance.

For those seeking to account for the existence of rival systems of dispersed and concentrated ownership, the United Kingdom has proved to be something of a "problem child." Britain is a companion to the United States in the dispersed ownership category since, as is the

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1. John C. Coffee, *Privatization and Corporate Governance: The Lessons from Securities Market Failure*, 25 J. CORP. L. 1, 2 (1999).

case in the U.S., publicly quoted companies are a pivotal feature of the corporate economy, and large business enterprises typically have diffuse ownership structures. Given the similarities between the two countries, a logical way to test the various theories offered to account for the configuration of America's system of ownership and control is to see whether they have explanatory power in a British context. When this sort of analysis has been done, however, events occurring in the U.K. have tended to cast doubt upon each hypothesis. This has been the outcome, for instance, with theories concerning financial services regulation, political ideology, and minority shareholder protection.

This Article's purpose is to refer again to the British experience to test and refine an additional hypothesis that has been offered to explain why the corporate economy is organized differently in the U.S. than in countries such as Germany and Japan. Corporate bankruptcy, it has been said, is the "crucial missing piece in understanding corporate governance."<sup>2</sup> According to this thesis—an "evolutionary" account of corporate governance—a country's system of bankruptcy law is either "manager-driven"<sup>3</sup> or "manager-displacing," with the former offering the executives of a financially troubled firm substantial scope to launch a rescue effort and the latter having a strong bias in favor of liquidation. The thinking, in very basic terms, is that a manager-driven bankruptcy regime complements dispersed share ownership, while its manager-displacing counterpart aligns with a governance regime where concentrated ownership prevails. Given the configuration of the U.K.'s system of ownership and control, this would imply that Britain should have a manager-driven bankruptcy system. As we will see, though, the country's bankruptcy laws strongly protect lenders, and few British companies that end up in formal bankruptcy proceedings escape liquidation.

How is it possible to reconcile Britain's diffuse share ownership structure with a bankruptcy regime that has strong manager-displacing features? Three possibilities come to mind. First, the U.K.'s system of ownership and control may function differently from what the received wisdom implies. Second, closer scrutiny may reveal that Britain's bankruptcy regime in fact operates in a manager-driven fashion, despite the apparent bias in favor of liquidation. Third, the relationship between bankruptcy and corporate governance posited by the evolutionary account might need to be rethought in light of the

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2. David A. Skeel, Jr., *An Evolutionary Theory of Corporate Law and Corporate Bankruptcy*, 51 VAND. L. REV. 1325, 1350 (1998).

3. We will use the terms "manager-driven" and "manager-friendly" as synonyms throughout the Article.

British experience. This Article examines each of these possibilities and ultimately argues that the third option is correct. Moreover, modifying the thesis that there is a strong link between a country's bankruptcy regime and the configuration of its corporate economy allows us to develop a more powerful explanation of corporate governance systems that merits further investigation.

The key addition this Article makes to our understanding of the relationship between corporate bankruptcy and corporate governance is a more complete analysis of the role played by debt structure. Like equity, debt finance can be either concentrated (as when firms borrow from one bank or a syndicate of banks) or dispersed (as when they issue bonds that are publicly traded). By comparing and contrasting the effects of diffuse and concentrated debt finance and assessing the implications for bankruptcy purposes, this Article develops a richer account of the corporate governance patterns we see in different nations.

The rest of this Article is organized as follows. Section I provides a brief overview of the world's rival systems of ownership and control. Section II then identifies and elaborates on the U.K.'s status as a theoretical "problem child" by analyzing efforts that have been made to explain corporate governance arrangements by way of financial services regulation, political ideology, and minority shareholder protection. Section III then offers a synopsis of the evolutionary thesis: that corporate bankruptcy is the "crucial missing piece in understanding corporate governance." Section IV provides an overview of Britain's corporate bankruptcy law. This account, which demonstrates that Britain's approach is manager-*displacing*, rather than manager-*driven* as the evolutionary theory would predict, suggests that the U.K. appears to live up to its "problem child" status in the bankruptcy context, as in all the others.

Sections V through VII consider the likely explanations for the U.K.'s puzzling combination of dispersed share ownership and manager-displacing bankruptcy. Section V scrutinizes the received wisdom concerning Britain's system of ownership and control to see if, in practice, managers and investors conduct themselves in the manner that would be expected where share ownership is widely dispersed. The section concludes that they do, and thus that U.K. corporate governance has not been mischaracterized by the existing literature. In Section VI, we return to the analysis of Britain's corporate bankruptcy regime, but widen the focus to include not just the "law on the books," but also an informal procedure known as the "London Approach," by which financially troubled large companies carry out debt restructurings. The treatment meted out to managers in such

restructurings does not appear to be as harsh as the consequences of formal bankruptcy proceedings. This insight, when coupled with the prominence in practice of the London Approach, suggests that the U.K. approach to corporate bankruptcy is less manager-displacing in practice than the formal rules considered in Section IV would suggest. Still, it will be shown that this concession does not go nearly far enough to avoid the conclusion that Britain poses a puzzle for the evolutionary thesis.

Providing a satisfactory account of the British situation requires us to reconfigure the hypothesis that there is a fundamental link between corporate governance and bankruptcy. Section VII undertakes this task, developing a richer theory that both is informed by, and explains, the U.K. experience. It is here that we draw attention to the role of debt finance in corporate governance and suggest how debt structures interact with stock ownership and the relevant insolvency framework. The purpose of the analysis is to draw attention to links between corporate governance, debt structure, and bankruptcy rules, and thereby to advance the current understanding of these topics. We argue in particular that corporate capital structures reflect a trade-off between the expenses associated with different modes of borrowing and the conflicts of interest that can arise between shareholders and creditors ("financial agency costs"). To be more precise, while the issuance of public debt can be advantageous as compared to bank lending, companies with concentrated ownership structures will tend to rely on the latter to address high financial agency costs implied by a dominant blockholder. We also argue that concentrated debt has an affinity with manager-displacing bankruptcy laws and that dispersed debt is complementary with a manager-friendly regime. We conclude Section VII by outlining our theory's empirical predictions and suggest a range of possible tests. Section VIII draws together the Article's key arguments and concludes.

## I. RIVAL CORPORATE GOVERNANCE SYSTEMS

Share ownership in the U.S. and the U.K. is generally characterized as widely dispersed. This proposition deserves further elaboration. Almost all of America's largest corporations are quoted on the stock market, as are most major British companies.<sup>4</sup> Moreover,

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4. Pieter W. Moerland, *Alternative Disciplinary Mechanisms in Different Corporate Systems*, 26 J. ECON. BEHAV. & ORG. 17, 19 (1995); Julian Franks & Colin Mayer, *Corporate Ownership and Control in the U.K., Germany, and France*, in *STUDIES IN INTERNATIONAL CORPORATE FINANCE AND GOVERNANCE SYSTEMS: A COMPARISON OF THE U.S., JAPAN, AND EUROPE* 281, 283 (Donald H. Chew ed., 1997).

with firms that are publicly quoted, voting control is typically not concentrated in the hands of families, banks, or other firms. In Britain, fewer than two out of five of the country's publicly quoted companies have a shareholder that owns more than one-fifth of the shares.<sup>5</sup> Likewise, in major U.S. companies, large shareholdings, and especially majority ownership, are the exception rather than the rule.<sup>6</sup>

The structure of ownership and control that exists in the U.K. and the U.S. has been characterized as an "outsider/arm's-length" system.<sup>7</sup> The "outsider" typology is used to describe the situation that exists when share ownership is dispersed among a large number of institutional and individual investors, rather than being concentrated in the hands of "core" shareholders who would be capable of exercising "inside" influence. The term "arm's-length" signifies the received wisdom that investors in the U.S. and Britain are rarely poised to intervene and take a hand in running a business. Instead, they tend to maintain their distance and give executives a free hand to manage.<sup>8</sup>

Matters are organized quite differently in continental Europe and in market-oriented economies in Asia. Publicly quoted companies do not play nearly as important a role in these economies as they do in the U.S. and the U.K.<sup>9</sup> Even for those firms that are publicly traded, "core" shareholders are prevalent and are usually well situated to exercise considerable influence over management. Corporate governance therefore is "insider/control-oriented."<sup>10</sup>

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5. Mario Faccio & Larry H.P. Lang, *The Ultimate Ownership of Western European Corporations*, 65 J. FIN. ECON. 365, 379 (2002).

6. Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471, 491-96 (1999); Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 754 (1997).

7. ERIK BERGLÖF, *A Note on the Typology of Financial Systems*, in *COMPARATIVE CORPORATE GOVERNANCE: ESSAYS AND MATERIALS* 151, 152, 157-64 (Klaus J. Hopt & Eddy Wymeersch eds., 1997); MARC GOERGEN, *CORPORATE GOVERNANCE AND FINANCIAL PERFORMANCE: A STUDY OF GERMAN AND UK INITIAL PUBLIC OFFERINGS 1-2* (1998); see also Colin Mayer, *Financial Systems and Corporate Governance: A Review of the International Evidence*, 154 J. INSTITUTIONAL & THEORETICAL ECON. 144, 146-47 (1998); MARKUS BERNDT, *GLOBAL DIFFERENCES IN CORPORATE GOVERNANCE SYSTEMS: THEORY AND IMPLICATIONS FOR REFORM 2*, 9-11 (Harv. John M. Olin Discussion Paper Series No. 303, 2000) (focusing solely on an "insider/outsider" dichotomy and reviewing the terminology used in the literature).

8. The position in the U.K. will be discussed *infra* Part V. On the U.S., see BERNARD S. BLACK, *Shareholder Activism and Corporate Governance in the United States*, in 3 *THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW* 459 (Peter Newman ed., 1998).

9. Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131, 1137-38 (1997).

10. BERGLÖF, *supra* note 7, at 157-64; TAKEO HOSHI, *Japanese Corporate Governance as a System*, in *COMPARATIVE CORPORATE GOVERNANCE: THE STATE OF THE ART AND EMERGING RESEARCH* 847, 851-66 (Klaus J. Hopt et al. eds., 1998) [hereinafter *COMPARATIVE CORPORATE GOVERNANCE*].

Commentators have frequently pointed to banks as an additional key distinction between countries in the outsider/arm's-length category and their insider/control-oriented counterparts.<sup>11</sup> The conventional wisdom is that in the U.S. and the U.K. there is little interdependence between banks and larger industrial or commercial firms.<sup>12</sup> The idea is logical enough since these are countries where the stock market is said to be the key allocator of capital.<sup>13</sup>

In insider/control-oriented jurisdictions, by contrast, stock markets constitute a relatively small percentage of GDP as compared with the U.S. and the U.K.<sup>14</sup> By default, banking institutions should be at the forefront with respect to corporate finance.<sup>15</sup> Similarly, banks stand as leading candidates to exercise "inside" influence with respect to individual companies.<sup>16</sup> Consistent with this view (we will draw attention to some discrepancies below), banks in Japan, Germany, and certain other continental European countries have developed and retained strong links with major industrial and commercial enterprises over time.<sup>17</sup> For instance, a German "universal bank" that lends money to a major corporate customer also will quite often act as a financial adviser to the borrower, own a block of shares in the company, and act as a proxy for other investors at shareholder meetings.<sup>18</sup> In Japan, it is common for an individual company to have an ongoing relationship with a "main bank" where the bank owns a

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11. See Colin Mayer, *Corporate Governance, Competition, and Performance*, 24 J.L. SOC'Y 152, 157 (1997); Lawrence A. Cunningham, *Commonalities and Prescriptions in the Vertical Dimension of Global Corporate Governance*, 84 CORNELL L. REV. 1133, 1139 (1999); Klaus J. Hopt, *Common Principles of Corporate Governance in Europe*, in THE CLIFFORD CHANCE MEMORIAL LECTURES: THE COMING TOGETHER OF THE COMMON LAW AND THE CIVIL LAW 105, 121-22 (Basil Markesinis ed., 2000).

12. See JONATHAN CHARKHAM, *KEEPING GOOD COMPANY: A STUDY OF CORPORATE GOVERNANCE IN FIVE COUNTRIES 196-97*, 297-300 (1994); JOHN SCOTT, *CORPORATE BUSINESS AND CAPITALIST CLASSES 130-34* (3d ed. 1997).

13. *Survey: The Rise and Fall of Global Equity Markets*, ECONOMIST, May 5, 2001, at 7; cf. Asli Demircug-Kunt & Ross Levine, *Bank-Based and Market-Based Financial Systems*, in FINANCIAL STRUCTURE AND ECONOMIC GROWTH: A CROSS-COUNTRY COMPARISON OF BANKS, MARKETS AND DEVELOPMENT 81, 81 (Asli Demircug-Kunt & Ross Levine eds., 2001).

14. Eddy Wymeersch, *A Status Report on Corporate Governance Rules and Practices in Some Continental European States*, in COMPARATIVE CORPORATE GOVERNANCE: ESSAYS AND MATERIALS, *supra* note 7, at 1057, 1061; John C. Coffee, *The Rise of Dispersed Ownership: The Roles of the Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 18 (2001); La Porta et al., *supra* note 9, at 1137-38.

15. This proposition assumes that the country in question has a fully industrialized economy. A country that is "underdeveloped" may lack strong securities markets and yet still have a small banking sector. See Demircug-Kunt & Levine, *supra* note 13, at 84-85, 95.

16. Cunningham, *supra* note 11, at 1140.

17. See, e.g., Moerland, *supra* note 4, at 20-22; SCOTT, *supra* note 12, at 142-52, 160, 164-65, 185, 188-89.

18. See, e.g., CHARKHAM, *supra* note 12, at 35-43; Hopt, *supra* note 11, at 121-24.



block of shares, supplies management resources, and provides various financial services.<sup>19</sup>

In both Germany and Japan, corporate managers are allowed ample latitude by banks during good times since monitoring tends to be relaxed and informal. For instance, it has been said that a large German bank will act as an "owner, adviser, financier, and benevolent uncle."<sup>20</sup> Things are said to change if a company is performing poorly. Under these circumstances, the received wisdom is that control rights are swiftly transferred to the bank acting as the primary lender, which then orchestrates an informal restructuring, an advantageous merger, or an orderly liquidation.<sup>21</sup>

In order to serve as an effective monitor, a main bank must have enough leverage over the debtor to implement change if the firm's managers misbehave or the firm performs poorly. Since German and Japanese banks often own shares in their major corporate customers, voting rights offer one source of influence. Nevertheless, control of credit has been the primary means by which banking institutions have exerted influence in both countries.<sup>22</sup> While larger business enterprises that have a close relationship with a bank can achieve considerable autonomy by financing operations through retained earnings,<sup>23</sup> a German or Japanese company operating under difficult financial conditions typically has had little choice but to respond to a bank's interventions in the event of a crisis. A lack of alternative sources of finance is the reason why. On one hand, equity markets in the two countries are comparatively underdeveloped. On the other hand—and in contrast to the situation in the United

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19. See, e.g., CHARKHAM, *supra* note 12, at 97-106; OECD ECONOMIC SURVEYS 1995-1996: JAPAN 160-67 (1996) [hereinafter OECD]. For a skeptical assessment of the literature on the Japanese system, which argues that the "main bank" concept is largely a myth, see Yoshiro Miwa & J. Mark Ramseyer, *The Myth of the Main Bank: Japan and Comparative Corporate Governance*, 27 LAW & SOC. INQUIRY 401 (2002).

20. Tony Barber, *Split Personality*, FIN. TIMES (London), Aug. 25, 1999, at 17. On Japan, see Masaharu Hanazaki & Akiyoshi Horiuchi, *Is Japan's Financial System Efficient?*, 16 OXFORD REV. ECON. POL. 61, 63 (2000).

21. CHARKHAM, *supra* note 12, at 42, 101; Hanazaki & Horiuchi, *supra* note 20, at 63; OECD, *supra* note 19, at 165-66.

22. Stephen Prowse, *Corporate Governance in an International Perspective: A Survey of Corporate Control Mechanisms Among Large Firms in the US, UK, Japan and Germany*, 4 FIN. MARKETS, INSTITUTIONS, AND INSTRUMENTS 1, 41-42 (1995); CHARKHAM, *supra* note 12, at 36-42, 53-54 (explaining, however, that major German companies can switch bankers if they so choose); Skeel, *supra* note 2, at 1344.

23. This situation, indeed, is particularly common in Germany. See Prowse, *supra* note 22, at 24, 42; Stefan Prigge, *A Survey of German Corporate Governance*, in COMPARATIVE CORPORATE GOVERNANCE, *supra* note 10, at 1016-17.

States—there has not been a tradition of larger corporations in these countries raising fresh capital through the public bond markets.<sup>24</sup>

There has been extensive debate on the relative merits of a “bank-based” financial system as compared with its “market-based” counterpart.<sup>25</sup> Nevertheless, it should not be taken for granted that banks are as pivotal as this intense dialogue implies.<sup>26</sup> Indeed, it appears that there are at least three reasons for thinking that attempting to classify financial systems on the basis of whether they are “bank-based” is an exercise fraught with difficulties.<sup>27</sup> First, the role of the stock market in the U.S. and the U.K. should not be exaggerated. According to aggregate financial data, even in these two “market-oriented” countries, debt is a more important source of corporate funding than the issuance of shares.<sup>28</sup>

A second reason it can be unhelpful to focus unduly on banks when categorizing financial systems is that there exists a substantial category of countries that have weak securities markets and concentrated share ownership, but no real interdependence between banks and larger industrial or commercial firms. For example, while Italy is an insider/control-oriented jurisdiction, the country’s banks are not closely involved in corporate governance.<sup>29</sup> Even in Germany, often cited as the prototypical example of a bank-oriented financial

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24. See Prigge, *supra* note 23, at 1016-17 (setting forth statistics); Jenny Corbett & Tim Jenkinson, *How is Investment Financed? A Study of Germany, Japan, the United Kingdom and the United States*, 65 MANCHESTER SCH. 69, 74-75, 80-81, 85 (Supp. 1997). On Japan, though, see CHARKAM, *supra* note 12, at 99. For more detail on the United States, see Marc R. Saidenberg & Philip E. Strahan, *Are Banks Still Important for Financing Large Businesses?*, CURRENT ISSUES IN ECON. & FIN., Aug. 1999, at 1 (noting that corporations that borrow via debt markets rely on bank lending in times of economic turmoil).

25. Ross Levine, *Bank Based or Market Based Financial Systems: Which is Better?* (unpublished manuscript, on file with authors).

26. Marco Becht & Colin Mayer, *The Control of Corporate Europe*, in THE CONTROL OF CORPORATE EUROPE 1, 3-4 (Fabrizio Barca & Marco Becht eds., 2001) (noting that while until a few years ago international comparisons of financial systems focused on banks, a bank-oriented distinction was a fragile one). Efforts to classify financial systems as “bank-based” and “market-based” do continue, however. See, e.g., Demircuc-Kunt & Levine, *supra* note 13, at 81.

27. Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3, 18 (2000).

28. See BERGLÖF, *supra* note 7, at 153-55; Prowse, *supra* note 22, at 24; *Is the Financial System to Blame for “Low” UK Investment?*, ECON. OUTLOOK (LONDON BUS. SCH.), Aug. 1996, at 12.

29. See Andrea Melis, *Corporate Governance in Italy*, 8 CORP. GOV. INT’L REV. 347, 351 (2000); La Porta et al., *supra* note 27, at 18; Robert E. Carpenter & Laura Rondi, *Italian Corporate Governance, Investment, and Finance*, 27 EMPIRICA 365, 368 (2000); PAOLO F. VOLPIN, OWNERSHIP STRUCTURE, BANKS, AND PRIVATE BENEFITS OF CONTROL 22 (London Bus. Sch. Inst. of Fin. & Acct., Working Paper No. 322, Oct. 2000), available at <http://facultyresearch.london.edu/showwp.asp>.

system,<sup>30</sup> there is evidence to suggest that the influence of the banks has been exaggerated.<sup>31</sup>

Third, no matter how powerful leading banks might have been in the past in individual insider-oriented countries, their influence is diminishing. For larger business enterprises, publicly traded debt is playing an increasingly important supplemental role to commercial bank lending, at least in Europe.<sup>32</sup> Also, banking institutions are reconfiguring in response to myriad financial pressures, with the result being that they are often content to abandon their "benevolent uncle" role.<sup>33</sup>

In short, it is important to recognize that "insider governance" does not necessarily mean "bank governance." Banks and other financial institutions can sometimes be key shareholders in an insider system. The pivotal blockholders are more likely, however, to be families and, to a lesser extent, the State.<sup>34</sup>

Even putting to one side the vexing issue of the role banks play, the entire insider/outsider dichotomy may soon require revision as a basis for characterizing governance systems. Anecdotal evidence accumulating prior to the decline in global equity prices in 2001 suggested that in continental Europe and in market-oriented economies in East Asia some form of convergence was occurring along Anglo-American lines. Frequent initial public offerings ("IPOs") meant the number of listed companies was growing rapidly in continental Europe,<sup>35</sup> and Japan's IPO market was similarly booming.<sup>36</sup> Firms

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30. See, e.g., CHARKHAM, *supra* note 12, at 35; Michael J. Rubach & Terrence C. Sebor, *Comparative Corporate Governance: Competitive Implications of an Emerging Convergence*, 33 J. WORLD BUS. 167, 175-76 (1998); SCOTT, *supra* note 12, at 150.

31. See, e.g., J.S.S. Edwards & K. Fischer, *An Overview of the German Financial System*, in CAPITAL MARKETS AND GOVERNANCE 257 (Nicholas Dimsdale & Martha Prevezer eds., 1994); Corbett & Jenkinson, *supra* note 24, at 74-75, 77-79, 85-86; Timothy W. Guianne, *Delegated Monitors, Large and Small: The Development of Germany's Banking System*, 40 J. ECON. LIT. 73, 119-20 (2002). Similar arguments have also been advanced from a historical perspective. See Caroline Fohlin, *Universal Banking in Pre-World War I Germany: Model or Myth?*, 36 EXPLORATIONS ECON. HIST. 306, 323-35 (1999).

32. Cathleen E. McLaughlin, *High-Yield Bond Financing Increases in Europe*, N.Y. L.J., May 1, 2000, at M9; Brian Hoffman et al., *Europe's High-Yield Bond Market Evolves*, N.Y. L.J., Nov. 13, 2001, at M6.

33. Harold James, *Goodbye and Hello to the Universal Bank*, FIN. GAZETTE, Nov. 22, 2001.

34. Becht & Mayer, *supra* note 26, at 30-32; Stijn Claessens et al., *The Separation of Ownership and Control in East Asian Corporations*, 58 J. FIN. ECON. 81, 82 (2000); La Porta et al., *supra* note 6, at 491-505, 511.

35. Coffee, *supra* note 14, at 16-17; CHRISTOPH VAN DER ELST, THE EQUITY MARKETS, OWNERSHIP STRUCTURES AND CONTROL: TOWARDS AN INTERNATIONAL HARMONISATION 5-6, 9-11 (Fin. Law Inst., Working Paper 2000-04, Sept. 2000).

36. Paul Abrahams, *A Sudden Increase in Demand Has Caught Everyone by Surprise*, FIN. TIMES (London), May 8, 2000, at 2.

that had already issued shares to the public were actively seeking out broader markets for their equity, quite often by obtaining listings on U.S. stock exchanges.<sup>37</sup> Furthermore, in insider/control-oriented countries, those owning large blocks of equity in publicly quoted companies appeared to be unwinding their holdings, at least to some extent.<sup>38</sup> At the same time, share ownership was becoming more widespread in society as the number of individuals owning equity directly or via collective investment vehicles (e.g., mutual funds) was growing significantly.<sup>39</sup> For instance, in Europe's eight largest countries, the number of people owning shares was forecast to rise from 35.6 million in 1999 to 53.1 million in 2003.<sup>40</sup>

The recent fall in global equity markets has led, at the very least, to a pause in the convergence trend. Global equity issuance has declined significantly,<sup>41</sup> and the pace at which concentrated shareholdings are being unwound might be slowing.<sup>42</sup> Moreover, the stock market drop has swiftly tested enthusiasm for shares in those countries where the first green shoots of an incipient "equity culture" were just emerging.<sup>43</sup> Still, it seems premature, on the strength of what might be nothing more than a cyclical downturn, to declare the end of "the age of equity."<sup>44</sup> As a result, convergence along Anglo-American lines could still be very much in the cards.

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37. Gerard Hertig, *Western Europe's Corporate Governance Dilemma*, in CORPORATIONS, CAPITAL MARKETS AND BUSINESS IN THE LAW 265, 271-72 (Theodor Baums et al. eds., 2000); Krishna Guha & Khozem Merchant, *India Makes a Clean Break*, FIN. TIMES (London), June 15, 2000, at 15; Marco Pagano et al., *The Geography of Equity Listing: Why Do European Companies List Abroad?*, 57 J. FIN. (forthcoming Dec. 2002) (manuscript at 16-18, on file with authors), available at <http://econpapers.hhs.se/paper/sefcsefw/28.htm>.

38. Coffee, *supra* note 14, at 15-16; Christopher Rhoads & Vanessa Fuhrmans, *Stakeholders Yield to Shareholders in New Germany*, WALL ST. J. EUR., June 21, 2001, at 1.

39. See, e.g., Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 452 (2001); George Melloan, *Europe's New Shareholder Culture Spurs Big Changes*, WALL ST. J., May 9, 2000, at A27; Edmund L. Andrews, *As Start-Ups Fall Flat, Europe's New Exchanges Scramble*, N.Y. TIMES (Web Edition), Jan. 28, 2001, at [http://www.nytimes.com/2001/01/28/technology/28\\_EURO.html?pagewanted=all](http://www.nytimes.com/2001/01/28/technology/28_EURO.html?pagewanted=all).

40. Simon Targett, *Europe Places its Bets on the Equity Culture*, FIN. TIMES (London), Jan. 26, 2001, at 12.

41. *Old Habits Die Hard*, ECONOMIST, Aug. 4, 2001, at 58; *Survey: The Rise and Fall of Global Equity Markets*, *supra* note 13, at 64.

42. *Old Habits Die Hard*, *supra* note 41, at 58 (discussing Japan).

43. *Survey: The Rise and Fall of Global Equity Markets*, *supra* note 13, at 4, 7, 34; Ellen Thalman, *Shareholder Value Loses Favor*, WALL ST. J. EUR., July 31, 2001, at 13.

44. See John Plender, *Falling from Grace*, FIN. TIMES (London), Mar. 27, 2001, at 20; see also *Survey: The Rise and Fall of Global Equity Markets*, *supra* note 13, at 7, 32-34, 38.

## II. THE FOUNDATIONS OF CORPORATE GOVERNANCE: THE U.K. AS A "PROBLEM CHILD"

### A. *Explaining Why Corporate Governance Arrangements Differ*

In "the single most influential book ever written about corporations,"<sup>45</sup> Adolf Berle and Gardiner Means drew attention to the outsider/arm's-length pattern of corporate governance that currently prevails in the U.S.<sup>46</sup> They said there was "a separation of ownership and control" in America's larger public companies since share ownership was too widely dispersed to permit investors to scrutinize properly managerial decisionmaking. The normative implications of this "separation of ownership and control" were keenly debated in the decades following the publication of Berle and Means's book.<sup>47</sup> Nevertheless, interested observers implicitly agreed on an important point: Fragmented share ownership was inevitable in major business enterprises.

According to the prevailing orthodoxy,<sup>48</sup> technology dictated that dominant firms be large. Dispersed ownership followed, because the capital needs of big companies were so great that a handful of wealthy individuals could not provide proper financial backing. Also, a separation of ownership and control was beneficial, since executives were hired on the basis of their managerial credentials, not their ability to finance the firm or their family connections with dominant shareholders. Therefore, the American version of the public corporation was the logical winner of a Darwinian struggle among competing forms of corporate structure.

So long as the U.S. public corporation was accepted as the evolutionary pinnacle, other systems with different institutional characteristics could be safely ignored: "[N]either laggards nor

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45. Robert Hessen, *A New Concept of Corporations: A Contractual and Private Property Model*, 30 HASTINGS L.J. 1327, 1329 (1979).

46. ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION & PRIVATE PROPERTY* (Harcourt, Brace & World, Inc. 1968) (1932).

47. See Ronald J. Gilson, *Corporate Governance and Economic Efficiency: When Do Institutions Matter?*, 74 WASH. U. L.Q. 327, 330-31 (1996); Gregory A. Mark, *Realms of Choice: Finance Capitalism and Corporate Governance*, 95 COLUM. L. REV. 969, 973, 975-76 (1995); Edward B. Rock, *America's Shifting Fascination with Comparative Corporate Governance*, 74 WASH. U. L.Q. 367, 370-75 (1996).

48. MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* 3 (1994); Mark, *supra* note 47, at 973-74; Skeel, *supra* note 2, at 1326, 1334.

neanderthals (compel) significant academic attention."<sup>49</sup> During the 1980s and early 1990s, however, Germany and Japan seemed to be enjoying greater economic success than the U.S.<sup>50</sup> This outcome implied, contrary to the received wisdom concerning the "Berle-Means corporation,"<sup>51</sup> that a different ownership and control framework was fully capable of delivering similar or even superior results.<sup>52</sup> The possibility that there might be several equally efficient ways to organize large-scale industry raised, in turn, a question: Why did the U.S. system of corporate governance evolve in a manner different from its counterparts in Germany and Japan?<sup>53</sup>

By the mid-1990s, the economic context was changing, but it was doing so in a way that ensured that the essential foundations of corporate governance systems remained topical. Throughout much of the decade, the United States enjoyed faster economic growth and lower unemployment than its chief economic rivals.<sup>54</sup> America's success in the capitalist "beauty contest" served, in turn, to cast doubt on the superiority of the German and Japanese approaches to corporate governance and suggested that the Berle-Means corporation was delivering the efficiencies that economic theory predicted.<sup>55</sup> The fact that countries with insider/control-oriented systems of ownership and control were experiencing some form of convergence along American lines did much the same, since the process could be characterized as an evolutionary drive toward efficient structures.<sup>56</sup>

Since economic trends seemed to be demonstrating the relative efficiency of the U.S. economic model, speculation grew as to why the

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49. Gilson, *supra* note 47, at 332; see also MICHEL ALBERT, CAPITALISM VS. CAPITALISM: HOW AMERICA'S OBSESSION WITH INDIVIDUAL ACHIEVEMENT AND SHORT-TERM PROFIT HAS LED IT TO THE BRINK OF COLLAPSE 128 (Paul Haviland trans., 1993).

50. See, e.g., ALBERT, *supra* note 49, at 128; Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 218-19 (1991).

51. The "Berle-Means corporation" shorthand is borrowed from Mark Roe. See, e.g., ROE, *supra* note 48, at 93.

52. Gilson, *supra* note 47, at 331-32.

53. Mark J. Roe, *Some Differences in Corporate Structure in Germany, Japan, and the United States*, 102 YALE L.J. 1927, 1934 (1993).

54. *Desperately Seeking a Perfect Model*, ECONOMIST, April 10, 1999, at 67 (offering a skeptical appraisal of the evidence); Stephen King, *How Japan and Germany Lost Their Glass Slippers*, INDEP. (London), Dec. 10, 2001, available at <http://www.independent.co.uk/story.jsp?story=109220> (last visited Nov. 10, 2002).

55. Cf. Hansmann & Kraakman, *supra* note 39, at 439, 444, 450-51 (arguing that the Berle-Means corporation itself functioned more effectively from the 1980s onward).

56. *Id.* at 450-51; Thomas Kamm, *Continental Drift: Europe Marks a Year of Serious Flirtation with the Free Market*, WALL ST. J., Dec. 30, 1999, at A1 (quoting the chairman of Credit Lyonnais SA, a privatized French bank); *Lean & European: Survey of European Business*, ECONOMIST, Apr. 29, 2000, at 5-7.

apparently inferior insider/control-oriented system of corporate governance had persisted in so many countries.<sup>57</sup> One reason the issue attracted attention was a growing belief that it might be beneficial to create conditions that would accelerate a switch towards the American version of capitalism.<sup>58</sup> In turn, this sentiment meant that it was necessary to understand the recipe for U.S. corporate success. Hence, while America's economic surge changed the context, it remained pertinent to contemplate why the U.S. system of corporate governance had evolved in a manner different from its counterparts in Germany and Japan.

In a wide range of published work, Mark Roe has sought to explain why the corporate governance arrangements that prevail in the United States are not universal. A key theme in his writing is that a deeply ingrained popular mistrust of concentrated financial power in the U.S. contributed significantly to the dominance of the Berle-Means corporation.<sup>59</sup> Roe has argued that at several points in the twentieth century, large financial institutions were poised to take substantial block positions in American business firms and adopt an activist approach to corporate governance. On these occasions, however, politicians intervened, forcing corporate ownership to remain fragmented and deterring big financial institutions from taking a close interest in the activities of corporate executives. The Berle-Means corporation, then, was not a necessity. It was an adaptation that arose to fit the kind of financial system produced by U.S. history.

Roe has also drawn attention to an additional political contingency that may have had an influence on corporate governance patterns. He identifies a statistical correlation between a country's position on the ideological spectrum and its corporate ownership structure. According to his findings, "left-wing" social democracies have fewer publicly quoted firms and significantly higher levels of ownership concentration than "right-wing" countries where there is little or no tradition of social democracy.<sup>60</sup>

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57. See, e.g., David Wessel, *The Legal DNA of Good Economies*, WALL ST. J., Sept. 6, 2001, at A1.

58. Discussion: Comments on Allen and Gale, "Corporate Governance and Competition," in CORPORATE GOVERNANCE: THEORETICAL AND EMPIRICAL PERSPECTIVES 84, 84-85 (Xavier Vives ed., 2000); Survey: *The Rise and Fall of Global Equity Markets*, supra note 13, at 32-34; Warwick Lightfoot, *Don't Stop Reforming Now*, WALL ST. J. EUR., Feb. 6, 2001, at 8.

59. See, e.g., ROE, supra note 48, at 93; Mark J. Roe, *Political and Legal Restraints on Ownership and Control of Public Companies*, 27 J. FIN. ECON. 7 (1990); Mark J. Roe, *The Political Roots of American Corporate Finance*, J. APPLIED CORP. FIN., Winter 1997, at 8.

60. Mark J. Roe, *Political Preconditions to Separating Ownership from Corporate Control*, 53 STAN. L. REV. 539, 561-66 (2000) [hereinafter *Political Preconditions*].

Roe's explanation for the correlation he has identified is that social democracies favor employees over investors and correspondingly use regulation to increase the leverage workers possess.<sup>61</sup> Under these conditions, he argues, corporate executives will tend to cater to employee preferences and give shareholders short shrift. This bias will exacerbate underlying conflicts of interest between managers and shareholders, thereby substantially increasing the disadvantages associated with investing in a widely held public company. The upshot is that the ownership format characteristic of the Berle-Means corporation is less likely to emerge in a social democracy than it is in a country without a strong socialist tradition, such as the United States.

Roe has not had a monopoly on discussion of the essential foundations of corporate governance arrangements in the United States and elsewhere. An alternate explanation for existing differences that has quickly gained adherents is that "law matters."<sup>62</sup> To elaborate, various economists and academic lawyers have hypothesized that corporate governance has not evolved along Anglo-American lines in other countries because appropriate rules of corporate law have not been in place.<sup>63</sup>

The version of the "law matters" thesis that has been developed in most detail has focused on the legal protection afforded to minority shareholders. The essential insight is that in an unregulated environment, there is a real danger that a public company's "insiders" (controlling shareholders and senior executives)<sup>64</sup> will cheat outside equity owners. According to the "law matters" thesis, minority shareholders feel "comfortable" in a "protective" environment where the legal system closely regulates opportunistic conduct by insiders.<sup>65</sup> Such confidence means that investors are willing to pay full value for shares made available for sale, which in turn lowers the cost of capital for firms that choose to sell equity in financial markets. Public offerings of shares can easily follow. Moreover, most controlling shareholders will be content to unwind their holdings since the law

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61. *Id.* at 553-60, 577-78.

62. On the popularity of this explanation, see Wessel, *supra* note 57, at A1. The "law matters" phrase is borrowed from John C. Coffee, *The Future as History: Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 644 (1999). For an overview of other factors that might have been relevant, see Brian R. Cheffins, *Corporate Governance Convergence: Lessons from Australia*, TRANSNAT'L LAW. (forthcoming 2003) (manuscript at 29-35, 56-62, on file with authors).

63. See, e.g., Coffee, *supra* note 62, at 644; Simon Johnson et al., *Tunnelling*, 90 AM. ECON. REV. 22 (2000); La Porta et al., *supra* note 27; KENNETH E. SCOTT, CORPORATE GOVERNANCE AND EAST ASIA (Stan. L. Sch. John M. Olin Working Paper Series No. 176, 1999).

64. La Porta et al., *supra* note 27, at 4.

65. The terminology is borrowed from *Political Preconditions*. *Supra* note 60, at 586.



will largely preclude them from exploiting their position. The conditions therefore are well suited for a widely dispersed pattern of share ownership.<sup>66</sup>

In a country where the law offers little protection against cheating by insiders, the outcome, at least in theory, must be different.<sup>67</sup> Potential investors, fearing exploitation, will steer clear of the stock market. Insiders, being aware of this adverse sentiment, will opt to retain the private benefits of control and rely on different sources of finance.

A series of empirical studies indicates that corporate law might matter in just the way that has been hypothesized.<sup>68</sup> The research suggests that the degree of protection a country's legal system provides for outside investors has a significant effect on its corporate governance regime. Stronger legal protection for minority shareholders is associated with a larger number of listed companies, more valuable stock markets, lower private benefits of control, and a lower concentration of ownership and control.<sup>69</sup> These results imply that the Berle-Means corporation is unlikely to become dominant in countries that do not offer significant legal protection to outside investors.

### B. Britain

Each of the various explanations that has been offered to account for the existence of divergent corporate governance regimes potentially accounts for developments occurring in the U.S. The first, Roe's financial services regulation thesis, was developed specifically to address the American situation.<sup>70</sup> Moreover, in presenting his analysis of social democracy, he has reminded readers that while he might

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66. Bernard Black, *The Core Institutions that Support Strong Securities Markets*, 55 BUS. LAW. 1565, 1565-66 (2000); Coffee, *supra* note 62, at 644, 647, 652, 683; La Porta et al., *supra* note 27, at 4-6.

67. Black, *supra* note 66, at 1565, 1572-73, 1584-86, 1606 (recognizing that stock market rules can be a partial substitute); Simon Johnson & Andrei Shleifer, *Coase v. the Coasians*, 116 Q.J. ECON. 853, 885-95 (2001); SCOTT, *supra* note 63, at 16-34 (discussing countries in East Asia).

68. Coffee, *supra* note 62, at 644.

69. For an overview of the literature, see Stephen J. Choi, *Law, Finance and Path Dependence: Developing Strong Securities Markets*, 80 TEX. L. REV. 1657, 1669-94 (2002); La Porta et al., *supra* note 27, at 14-16. The research methodology has, however, been subject to some criticism. See, e.g., Frank Partnoy, *Why Markets Crash and What Law Can Do About It*, 61 U. PITT. L. REV. 741, 765-67 (2000); Mark J. Roe, *Corporate Law's Limits*, 31 J. LEGAL STUD. 233, 251-53 (2002).

70. For instance, Roe says in the opening paragraph of the preface to STRONG MANAGERS, WEAK OWNERS: "I try here . . . to suggest new lines of research and thinking about the American public corporation . . ." ROE, *supra* note 48, at vii.

discuss other countries in some detail, he is in fact writing largely about the United States.<sup>71</sup> Furthermore, consistent with the "law matters" hypothesis, the U.S. has both dispersed share ownership and a legal system that regulates quite closely opportunistic conduct by insiders.<sup>72</sup>

As mentioned, the U.K., like the U.S., has an outsider/arm's-length system of ownership and control.<sup>73</sup> The two countries have other features in common. For instance, they have a shared legal heritage encompassing the common law and principles of equity.<sup>74</sup> Moreover, Britain and the U.S. both have a "shareholder economy," where private enterprise is about maximizing profits for those who invest, and where shareholders occupy the central position with respect to companies.<sup>75</sup> In contrast, continental European countries and Japan have a "stakeholder economy," where there is a desire to strike a balance between various constituencies linked with companies and where sustainable, stable, and continuous economic growth, not profit maximization, is the overriding priority.<sup>76</sup>

Admittedly, the corporate economy is not organized in precisely the same fashion in the U.S. and U.K. Indeed, we will focus later on two potentially significant distinctions, these being Britain's more concentrated share ownership structure and its comparatively underdeveloped market for corporate debt.<sup>77</sup> Still, since the U.S. and the U.K. have so much in common, ascertaining how matters developed in Britain is a good way to test the various theories that

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71. Roe admits in *Political Preconditions* that he discusses continental Europe, but says, "I need not remind the reader that this article is really about the United States." *Supra* note 60, at 600.

72. See, e.g., Coffee, *supra* note 62, at 644, 652, 683. Note, though, that Coffee now has doubts about the causation between strong investor protection and dispersed share ownership. Coffee, *supra* note 14, at 7, 22, 60, 65, 69, 80.

73. See *supra* notes 4-8 and accompanying text.

74. Deborah A. DeMott, *The Figure in the Landscape: A Comparative Sketch of Directors' Self-Interested Transactions*, 62 LAW & CONTEMP. PROBS. 243, 244 (1999).

75. Frits Bolkestein, *The High Road that Leads Out of the Low Countries*, ECONOMIST, May 22, 1999, at 75; Cunningham, *supra* note 11, at 1136-39. Others have used somewhat different terminology to make the same point. See, e.g., Erik Berglöf, *Reforming Corporate Governance: Redirecting the European Agenda*, 12 ECON. POL'Y 93, 105-06 (1997) (discussing a "company based system"); Michael Bradley et al., *The Purposes and Accountability of the Corporation in Contemporary Society: Corporate Governance at a Crossroads*, 62 LAW & CONTEMP. PROBS. 9, 37-38, 48 (1999) (describing a "contractarian" system).

76. FRANKLIN ALLEN & DOUGLAS GALE, COMPARING FINANCIAL SYSTEMS 111-14 (2000); Cunningham, *supra* note 11, at 1139-43; Bolkestein, *supra* note 75, at 75; Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063, 2072-73 (2001).

77. See *infra* notes 273-99 (concentrated stock); *infra* notes 309-14 (concentrated debt) and accompanying text.

have been advanced to explain why different corporate governance patterns emerge.<sup>78</sup> As we shall see, the British experience casts doubt on the explanatory power of each hypothesis we have considered so far. Hence, for those seeking to account for why an outsider/arm's-length system of ownership and control prevails in some countries and an insider/control-oriented regime exists in others, the U.K. is something of a "problem child."

Consider, for instance, Mark Roe's thesis that financial services regulation is important.<sup>79</sup> He has relied, in part, on developments in the American banking industry to support his argument that the Berle-Means corporation was simply an adaptation that arose to fit the American financial system—itsself a contingent product of U.S. history—rather than a product of market forces. He adopts the received wisdom regarding banks, stating that, while they developed and retained strong links with major industrial and commercial enterprises in Germany and Japan, they maintained their distance in the U.S.<sup>80</sup> Roe has argued that in the case of the United States, government regulations dictated the outcome since federal laws put a fault line between banking and other sectors of the economy.<sup>81</sup>

In Britain, as in the U.S., banking institutions typically adopted straightforward "arm's-length" lending arrangements with their customers and did not seek to cement relations by owning shares in their borrowers.<sup>82</sup> Given what Roe has written, one would expect that in the U.K. there would have been laws in place that discouraged banks from stepping forward. In fact, however, the U.K.'s commercial deposit-taking or "clearing" banks were never confronted with explicit restrictions on their ability to participate in the governance of

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78. Bernard S. Black & John C. Coffee, *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997, 1999-2007 (1994); Brian R. Cheffins, *Law, Economics and the UK's System of Corporate Governance: Lessons from History*, 1 J. CORP. L. STUD. 71, 79-80 (2001).

79. One of us has developed the arguments made here in more detail elsewhere. See Brian R. Cheffins, *Putting Britain on the Roe Map: The Emergence of the Berle-Means Corporation in the United Kingdom, Convergence and Diversity*, in CORPORATE GOVERNANCE REGIMES: CONVERGENCE AND DIVERSITY 147, 160-63 (Joseph A. McCahery et al. eds., 2002) [hereinafter CORPORATE GOVERNANCE REGIMES].

80. See ROE, *supra* note 48, chs. 5, 7, 11-12.

81. An important example was the Glass-Steagall Act of 1933, a federal law repealed in 1999 that prohibited bank affiliates from owning and dealing in corporate securities. Act of June 16, 1933, ch. 89, 48 Stat. 162 (repealed 1999).

82. FORREST CAPIE & MICHAEL COLLINS, *HAVE THE BANKS FAILED BRITISH INDUSTRY? AN HISTORICAL SURVEY OF BANK/INDUSTRY RELATIONS IN BRITAIN, 1870-1990* 37, 42, 50-51, 54-55, 58-59, 67, 76 (1992); Black & Coffee, *supra* note 78, at 2074-75; W.A. THOMAS, *THE FINANCE OF BRITISH INDUSTRY* 53, 189-90 (1978).

business enterprises.<sup>83</sup> Instead, influenced by a strong bias in favor of liquidity, top banking personnel chose to avoid offering long-term financial commitments to corporate borrowers and dismissed the ownership of shares as an option on grounds of poor marketability and high risk.<sup>84</sup> The experience with U.K. banks is therefore inconsistent with Roe's thesis that a country's approach to financial services regulation will help to dictate whether the Berle-Means corporation becomes dominant.<sup>85</sup>

Turning from Roe's analysis of financial services regulation to his social democracy thesis, the experience in the United Kingdom again casts doubt on his arguments.<sup>86</sup> Roe defines a social democracy as a nation with a government that is deeply concerned about distributional issues, favors employees over investors, and plays a large role in the economy.<sup>87</sup> According to such criteria, the U.K. likely qualified as a social democracy from the end of World War II until Margaret Thatcher's rise to power in 1979.<sup>88</sup> Still, despite this left-wing bias, there is evidence that the U.K.'s system of ownership and control was evolving toward the U.S. model during the decades prior to Thatcher's election.<sup>89</sup> Indeed, while the Berle-Means corporation was certainly not dominant in the U.K. before World War II, it may well have been by 1980.<sup>90</sup>

In order to account for the British experience and reconcile it with his social democracy thesis, Roe has sought to argue that "[s]ecurities development and separation were slow, or perhaps non-

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83. Franklin Allen & Douglas Gale, *Corporate Governance and Competition*, in CORPORATE GOVERNANCE: THEORETICAL AND EMPIRICAL PERSPECTIVES, *supra* note 58, at 23, 31, 35; HERBERT JACOBS, GRANT ON THE LAW RELATING TO BANKERS AND BANKING COMPANIES 579 (1923) (noting that British banks were permitted to own shares in their borrowers as long as they were authorized by their corporate constitution to do so); Mihir Bose, *From Lenders to Owners?*, DIRECTOR, Dec. 1993, at 45-46. Current Bank of England guidelines may, however, discourage the acquisition of large blocks of corporate equity. Allen & Gale, *supra*; Bose, *supra*.

84. On share ownership, see CAPIE & COLLINS, *supra* note 82, at 36, 49, 80-81; see also CAROLINE FOHLIN, THE BALANCING ACT OF GERMAN UNIVERSAL BANKS AND ENGLISH DEPOSIT BANKS, 1880-1913 24-25 (Cal. Inst. of Tech., Soc. Sci. Working Paper No. 1016, 1999). On lending practices, see, e.g., CAPIE & COLLINS, *supra* note 82, at 50-51, 54-55, 67.

85. The situation is the same with other U.K. financial institutions. See ALLEN & GALE, *supra* note 76, at 110-11; Brian R. Cheffins, *History and the Global Corporate Governance Revolution: The UK Perspective*, 43 BUS. HIST. 103-04 (2001).

86. For a more detailed analysis, see Cheffins, *supra* note 79, at 160-63. For additional criticism of Roe's social democracy thesis, see Coffee, *supra* note 14, at 71-75.

87. *Political Preconditions*, *supra* note 60, at 543.

88. Cheffins, *supra* note 79, at 161-63.

89. Cheffins, *supra* note 85, at 90, 105.

90. *Id.* at 90.

existent" between 1945 and 1979.<sup>91</sup> There is plenty of secondary evidence which casts doubt on this "deep freeze" account of events. According to a historical survey of British industrial entrepreneurship and management published in 1978, "[i]n the post-1945 period there has been considerable discussion of the democratization of company holdings [and] . . . this increasing democratization has clearly involved increasing separation of ownership and control."<sup>92</sup> A distinguished British business historian subsequently offered a similar verdict, saying that,

[I]n the postwar world the structure of British business changed radically. Family firms and family directors progressively disappeared off the corporate scene. By 1970 it would make little sense to talk of British personal capitalism.<sup>93</sup>

Still, regardless of precisely what happened in the U.K. between 1945 and 1979, Roe has conceded that "[t]he United Kingdom would seem the hardest case for the political theory."<sup>94</sup> He has therefore endorsed the notion that Britain is something of a "problem child" for his ideological account of corporate governance arrangements.

In addition to acknowledging that events in Britain cause some difficulties for his social democracy thesis, Roe has noted that "the U.K. also seems to fit badly with a law-driven theory."<sup>95</sup> Why is this the case? Again, the "law matters" thesis implies that a country has the potential to develop a vibrant stock market and a widely dispersed pattern of share ownership if its legal system closely regulates cheating and other opportunistic conduct by corporate "insiders."<sup>96</sup> If law in fact is a pivotal variable, then the U.K.'s legal regime should have favored minority shareholders over corporate "insiders" as the country's outsider/arm's-length system of ownership and control was taking shape. The historical evidence, however, suggests that matters did not progress in this fashion.

The publicly quoted company first became a well-established part of the British economy in the early years of the twentieth century. At this point, however, it was standard for the "core"

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91. Mark J. Roe, *Political Foundations for Separating Ownership from Control*, in CORPORATE GOVERNANCE REGIMES, *supra* note 79, at 113, 141.

92. Peter L. Payne, *Industrial Entrepreneurship and Management in Great Britain*, in THE CAMBRIDGE ECONOMIC HISTORY OF EUROPE, THE INDUSTRIAL ECONOMIES: CAPITAL, LABOUR AND ENTERPRISE pt. 1, 180, 221 (Peter Mathias & M.M. Postan eds., 1978).

93. Geoffrey Jones, *Big Business, Management, and Competitiveness in Twentieth-Century Britain*, in BIG BUSINESS AND THE WEALTH OF NATIONS 102, 118 (Alfred D. Chandler, Jr. et al. eds., 1997).

94. Roe, *supra* note 91, at 129.

95. *Id.*

96. See *supra* notes 64-66 and accompanying text.

shareholders of a business traded on the stock market to be the entrepreneurs who had founded the firm and their heirs.<sup>97</sup> This share ownership pattern ultimately unwound sufficiently for a separation of ownership and control to emerge, although the Berle-Means corporation did not become dominant in Britain until at least the 1950s and perhaps as late as the 1970s or early 1980s.<sup>98</sup> Throughout the relevant period, U.K. company law offered minority shareholders little protection against opportunism by insiders.<sup>99</sup> Admittedly, the regulation of U.K. financial markets was toughened considerably in the mid-1980s.<sup>100</sup> The country's current share ownership pattern was already in place, however.<sup>101</sup> The upshot is that the Berle-Means corporation became dominant when lawmakers were not doing much to ensure that those buying shares in publicly quoted companies would feel "comfortable."

While the legal system did not afford much explicit protection to minority shareholders as a separation of ownership and control was becoming entrenched in the U.K., this did not mean that investors were left completely at the mercy of market forces. For instance, particularly during the first half of the twentieth century, British companies sought to cultivate a loyal constituency of investors by offering regular and steady dividend payments.<sup>102</sup> Moreover, from at least the 1920s onward, the financial professionals who organized public offerings of shares in the U.K. were sufficiently motivated by reputational concerns to carry out significant "quality control."<sup>103</sup> Finally, the London Stock Exchange, functioning without direct support from the government, scrutinized offerings of shares before trading commenced and tailored its listing rules to deal with various matters of potential concern to outside investors (e.g., disclosure, preemptive rights, insider trading, and other forms of self-dealing by directors and controlling shareholders).<sup>104</sup>

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97. Brian R. Cheffins, *Does Law Matter? The Separation of Ownership and Control in the United Kingdom*, 30 *J. LEGAL STUD.* 459, 466-67 (2001); Cheffins, *supra* note 85, at 89.

98. Cheffins, *supra* note 85, at 89-90; Cheffins, *supra* note 97, at 467-68.

99. Cheffins, *supra* note 97, at 468-72, 476-81.

100. The most important change was the enactment of the Financial Services Act, 1986, c. 60 (Eng.).

101. Cheffins, *supra* note 97, at 482.

102. JONATHAN B. BASKIN & PAUL J. MIRANTI, *A HISTORY OF CORPORATE FINANCE* 192, 194-95 (1997); HORACE B. SAMUEL, *SHAREHOLDERS' MONEY: AN ANALYSIS OF CERTAIN DEFECTS IN COMPANY LEGISLATION WITH PROPOSALS FOR THEIR REFORM* 145-46 (1933). At times between 1948 and 1972, dividends were suppressed by a combination of tax policy and "voluntary restraint" urged by the government. THOMAS, *supra* note 82, at 237-42.

103. Cheffins, *supra* note 97, at 472-73.

104. *Id.* at 473-76, 480-81.

The upshot, as at least one leading advocate of the "law matters" thesis has explicitly acknowledged, is that events occurring in Britain illustrate that strong corporate laws may not have been necessary for widely dispersed share ownership to evolve.<sup>105</sup> Instead, the British experience indicates that a complete understanding of the way in which any aspect of corporate governance is regulated requires scholars to look beyond the "law on the books" and include institutional alternatives to corporate law, such as self-regulation and market norms, each of which can help to foster sufficient investor confidence to permit an outsider/arm's-length regime to take shape.<sup>106</sup> Hence, as is the case with Roe's explanations for the existence of divergent corporate governance regimes, events in Britain cast doubt on the hypothesis that a country's company law has a pivotal effect on the configuration of its corporate economy. They also make clear the need to include in comparative corporate governance analysis extralegal institutions which may constrain or determine the way in which market actors behave.

### III. THE COMPLEMENTARITY OF BANKRUPTCY REGULATION, CORPORATE LAW, AND CORPORATE GOVERNANCE: AN EVOLUTIONARY HYPOTHESIS

#### A. *Debt as the Missing Piece of the Corporate Governance Puzzle*

One feature that links the various theories we have considered thus far is an equity bias. Each seeks to address the same primary question: Why do share ownership patterns differ? To be sure, bank-oriented finance has attracted attention, but this popularity is the result of its treatment as the logical corollary of underdeveloped equity markets. The analytical bias in favor of shares means that in the comparative corporate governance literature, a potentially important piece of the puzzle is missing: a systematic appraisal of

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105. Coffee, *supra* note 14, at 39-44, 64-65, 78-79. On Coffee's status as a "law matters" advocate, see *supra* note 62, at 644, 647, 652, 683. Note, though, that Coffee argues that legal regulation may be required for securities markets to persist and attain their fullest development. Coffee, *supra* note 14, at 64-71.

106. Black, *supra* note 66, at 1568, 1571-72 (making the same point without referring specifically to the U.K. experience) For further background on institutional alternatives to corporate law, see Katharina Pistor et al., *The Evolution of Corporate Law*, in BACKGROUND PAPER COMMISSIONED FOR WORLD BANK DEVELOPMENT REPORT 2002: INSTITUTIONS FOR MARKETS 9 (2001); John C. Coffee, Jr., *Do Norms Matter? A Cross-Country Evaluation*, 149 U. PA. L. REV. 2151, 2152 (2001); ALEXANDER DYCK & LUIGI ZINGALES, PRIVATE BENEFITS OF CONTROL: AN INTERNATIONAL COMPARISON 3-5 (Center for Res. in Security Prices, Working Paper Series No. 535, 2001).

corporate borrowing.<sup>107</sup> This bias is not restricted to the cross-border analysis of financial systems. Instead, on a more general level, the typical model of corporate governance views issues through the lens of equity interests.<sup>108</sup>

The analytical bias in favor of share ownership patterns seems odd when aggregate patterns of corporate finance are taken into account. The available data indicates that in major industrialized nations debt is a more important source of corporate funding than is the issuance of shares.<sup>109</sup> As we have seen, this is even the case in the U.S. and the U.K., even though both have a "shareholder economy."<sup>110</sup>

Regardless of the precise balance between equity and debt as a source of finance, corporate governance is best seen as an "interactive" process involving shareholders and creditors.<sup>111</sup> Often, the interests of these two constituencies will be congruent. For instance, a lender's monitoring of a corporate borrower can benefit shareholders since the disciplinary aspect will help constrain managerial misconduct.<sup>112</sup> Moreover, a lender's strong reaction to changing circumstances can provide signals for those owning equity to intervene and vice versa.<sup>113</sup>

The relationship between debt and equity can, however, also have its frictions. These frictions, which we will refer to as the "agency costs of debt" or "financial agency costs,"<sup>114</sup> can take several forms. The first arises because managers may take actions that are calculated to benefit shareholders at the expense of creditors. An example is where a corporation takes on a substantial debt load, thereby increasing the risk of default, in order to finance high-risk ventures with a potentially lucrative "upside."<sup>115</sup>

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107. For a partial exception to this trend, see Shleifer & Vishny, *supra* note 6, at 757-58, 761-66.

108. George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CAL. L. REV. 1073, 1076 (1995). For criticism of this bias, see Gregory Jackson, *Comparative Corporate Governance: Sociological Perspectives*, in *THE POLITICAL ECONOMY OF THE COMPANY* 265 (John Parkinson et al. eds., 2000).

109. Corbett & Jenkinson, *supra* note 24, at 74-75; *Is the Financial System to Blame for "Low" UK Investment?*, *supra* note 28, at 12.

110. See *supra* note 28 and accompanying text.

111. Triantis & Daniels, *supra* note 108, at 1078-79.

112. See Frank H. Easterbrook, *High-Yield Debt as an Incentive Device*, 11 INT'L REV. L. & ECON. 183 (1991); Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers*, 76 AM. ECON. REV. 323, 324 (1986).

113. Triantis & Daniels, *supra* note 108, at 1082-88.

114. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 333-43 (1976); George G. Triantis, *A Free-Cash-Flow Theory of Secured Debt and Creditor Priorities*, 80 VA. L. REV. 2155, 2158 (1994).

115. WILLIAM KLEIN ET AL., *BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES* 355-58 (7th ed. 2000); Skeel, *supra* note 2, at 1333; BRIAN R. CHEFFINS, *COMPANY LAW: THEORY, STRUCTURE AND OPERATION* 79-80 (1997). For empirical evidence of the existence



Conflicts of interest between shareholders and creditors can also run in the opposite direction. Take the case of a corporation that obtains financing primarily from one lender. Management may, in response to an implicit threat of exit by the lender, implement decisions benefiting that party at the expense of shareholders.<sup>116</sup> Biasing the borrower's investment decisions in favor of projects with low risk would be one example of this type of "creditor rent extraction."<sup>117</sup> Others would include arranging fresh borrowing on terms highly favorable to the lender and charging excessive fees for the supply of additional services (e.g., management consulting or underwriting).<sup>118</sup>

There is an additional reason why debt finance deserves consideration from a corporate governance perspective. When a company defaults on its debts, its creditors become entitled—more or less—to take over the rights previously enjoyed by its shareholders. The transition essentially occurs when bankruptcy proceedings are commenced. At this point, it is the creditors, rather than the shareholders, who become the firm's residual claimants.<sup>119</sup>

It should now be evident that a fully developed account of the configuration of the corporate economy in major industrialized nations needs to account for the role of debt in corporate governance. One of us, in previous work, has made this point and has taken an initial step toward adding debt to the comparative corporate governance equation.<sup>120</sup> This work developed an "evolutionary theory" that posited a strong complementarity between a country's financial system and its bankruptcy law.<sup>121</sup> The analysis that follows revisits this theory and considers its implications for U.K. governance.

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of such costs, see Katherine H. Daigle & Michael T. Maloney, *Residual Claims in Bankruptcy: An Agency Theory Explanation*, 37 J.L. & ECON. 157, 182-87 (1994) (offering evidence of risk-shifting, excessive dividend payments, and even outright fraud in five-year period prior to bankruptcy in a sample of fifty-six U.S. firms which filed for Chapter 11 in the 1980s).

116. See Triantis & Daniels, *supra* note 108, at 1096-1103.

117. Frank H. Buckley, *The Termination Decision*, 61 UMKC L. REV. 243, 255 (1992); RANDALL MORCK & MASAO NAKAMURA, JAPANESE CORPORATE GOVERNANCE AND MACROECONOMIC PROBLEMS 11 (Harv. Inst. of Econ. Res., Discussion Paper No. 1893, 2000).

118. Gary Gorton & Frank A. Schmid, *Universal Banking and the Performance of German Firms*, 58 J. FIN. ECON. 29, 46-47 (2000) (discussing lending); Colin Mayer, *Financial Systems and Corporate Governance: A Review of the International Evidence*, 154 J. INSTITUTIONAL & THEORETICAL ECON. 144, 154 (1998); MORCK & NAKAMURA, *supra* note 117, at 11.

119. Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEG. STUD. 127, 129-31 (1986).

120. Skeel, *supra* note 2, at 1332.

121. *Id.*; see also David A. Skeel, Jr., *The Market Revolution in Bank and Insurance Firm Governance: Its Logic and Limits*, 77 WASH U. L.Q. 433, 434-45 (1999) (applying the theory to bank and insurance firm governance).

*B. The Evolutionary Theory of Corporate Governance and Corporate Bankruptcy: A Précis*

For the purposes of the evolutionary theory, national bankruptcy regimes can be divided into two categories. These are “manager-driven,” where those in charge of a financially troubled firm have substantial scope to launch a rescue effort, and “manager-displacing,” where there is a strong bias in favor of liquidation. The intuition underlying the evolutionary theory is that corporate executives are aware of the bankruptcy law they face and adjust their behavior accordingly. At the same time, though, the way managers conduct themselves may help to dictate how a country’s bankruptcy system is configured. By virtue of this sort of feedback loop, the result should be a complementary relationship between a country’s system of ownership and control on one hand and its regulation of corporate financial distress on the other.

To appreciate the connections, let us start with arrangements in the United States. As we have seen, the U.S. has an outsider/arm’s-length system of ownership and control, which means that investors engage in, at most, only intermittent oversight of the managers of a publicly quoted company.<sup>122</sup> Corporate executives do not, however, have unfettered discretion. Instead, various constraints make managers fearful of poor share price performance and give them incentives to boost earnings.<sup>123</sup>

One consideration is the managerial labor market. Executives, mindful that other jobs might be more challenging and lucrative, will want to perform well in their current positions in order to increase their marketability with possible future employers. At the same time, they will know that the board of directors might orchestrate a managerial shake-up in the event that earnings are stagnant or declining. Fears on the latter count have become more acute in recent years, since the job security of chief executives has apparently become more tenuous,<sup>124</sup> due partly to the growing influence and vigilance of independent directors on corporate boards.<sup>125</sup> As the director of a large U.S. publicly quoted company said shortly after the dismissal of the

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122. See *supra* notes 7-8 and accompanying text.

123. For an overview, see CHEFFINS, *supra* note 115.

124. Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871, 883 (2002). There is, however, evidence to the contrary. See David Leonhardt, *Cornering the Corner Office*, N.Y. TIMES, Aug. 16, 2000, at C1.

125. Kahan & Rock, *supra* note 124, at 883.

CEO in 2000, "[T]here is zero forgiveness. You screw up and you're dead."<sup>126</sup>

Also pertinent will be executive compensation. During the past two decades, managerial remuneration has become much more strongly "incentivized" in the U.S. Between 1980 and the late 1990s, the percentage of chief executives of publicly quoted corporations who were awarded stock options increased from 30% to more than 70%.<sup>127</sup> Indeed, by 1997, a typical CEO received more pay in the form of option grants than salary (42% of total remuneration as compared with 29%).<sup>128</sup>

A distinctive feature of stock options is that they operate somewhat like a "one-way" bet for management. To elaborate, while shareholders and an executive entitled to exercise options both benefit when a company's share price rises, if there is a decline the shareholders suffer genuine losses whereas the executive simply must forgo a potential profit opportunity.<sup>129</sup> Correspondingly, a management team that has a large number of options will tend to discount adverse outcomes when evaluating business opportunities to exploit. Hence, as the recent wave of U.S. corporate scandals seems to illustrate, when stock options are a pivotal part of CEO compensation, those running public companies have a financial incentive to proceed with projects that shareholders might like but creditors will fear: those that might yield spectacular returns but which encompass "downstream" risks that could cause default in the event of a mishap.<sup>130</sup>

The market for corporate control is an additional factor that can influence managerial decisionmaking and thereby motivate executives to pursue strategies that could leave their corporation vulnerable if things go wrong. The theory involved is well known.<sup>131</sup> If there is a substantial disparity between a corporation's actual and potential performance, a bidder may calculate that it is worthwhile to make a tender offer to the shareholders with a view to installing new

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126. Joann S. Lublin & Matt Murray, *CEOs Depart Faster Than Ever Before as Boards, Investors Lose Patience*, WALL ST. J., Oct. 27, 2000, at B1 (quoting the Acting Chairman of Mattel, Inc.).

127. Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 113 Q.J. ECON. 653, 663 (1998); Martin J. Conyon & Kevin J. Murphy, *The Prince and the Pauper? CEO Pay in the United States and United Kingdom*, 110 ECON. J. F. 640, F647 (2000).

128. Conyon & Murphy, *supra* note 127, at F646-47.

129. CHEFFINS, *supra* note 115, at 657.

130. John Plender, *Pitfalls of Bigger Incentives*, FIN. TIMES (U.S.), Aug. 26, 2000, at 26; Steven Pearlstein, *Executive Privilege?*, WASH. POST, Mar. 24, 2002, at H02.

131. See CHEFFINS, *supra* note 115, at 119; FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 171-74 (1991).

managers. The bidder will presume that with new direction the target company will generate enough additional profit to compensate for the costs and risks associated with making the offer.

Executives fear takeover bids since they usually lose their jobs after a successful offer. This anxiety, however, has a beneficial by-product: managers, with their jobs potentially on the line, have an incentive to deploy corporate assets to best advantage. On the other hand, apprehension about a possible bid can cause managers to respond in a way that wreaks havoc on the capital structures of their companies. For instance, target managers may engage in a leveraged recapitalization to consolidate control of the firm, thus adding a large layer of new debt to the firm's balance sheet. More generally, executives might seek to make their corporation less attractive as a takeover target by borrowing large sums since potential bidders will not be able to finance an acquisition of the corporation as easily if it is heavily leveraged.<sup>132</sup>

As Marcel Kahan and Ed Rock have argued, in the U.S. the relative potency of the disciplinary mechanisms just described has been reconfigured over the past two decades.<sup>133</sup> Partly due to the prevalence of poison pills, there has been a transition from tender offers opposed by those running the target company ("hostile" bids) to proposals supported by management ("friendly" bids). Though defining whether a takeover bid is hostile or friendly can be difficult,<sup>134</sup> this switch implies a shift from acquisition activity that is explicitly disciplinary in orientation to deals motivated by the desire to increase market share or generate synergies. This does not mean, however, that the disciplinary pressures faced by U.S. executives have abated. Instead, the markets for managerial talent and executive compensation have functioned as "adaptive devices."<sup>135</sup> As we have seen, the incentives they create for managers to focus on shareholder value have become stronger in recent years.<sup>136</sup>

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132. Managers' decisions to add leverage in the face of a potential or actual takeover threat can also be construed as a commitment to increase the company's value by "moving toward a more beneficial, though less comfortable, capital structure." See Philip G. Berger et al., *Managerial Entrenchment and Capital Structure Decisions*, 52 J. FIN. 1411, 1412 (1997) (providing an empirical analysis suggesting that decisions by executives to increase leverage can be explained not only as managerial entrenchment but also as reflecting a value maximizing adjustment); see also Jeffrey Zwiebel, *Dynamic Capital Structure under Managerial Entrenchment*, 86 AM. ECON. REV. 1197, 1197 (1996) (setting out a model in which managers increase debt both to fend off takeovers and to commit to forgoing bad investments).

133. See Kahan & Rock, *supra* note 124, at 875-84.

134. G. William Schwert, *Hostility in Takeovers: In the Eyes of the Beholder?*, 55 J. FIN. 2599, 2600 (2000).

135. The terminology is borrowed from Kahan and Rock, *supra* note 124, at 872, 889.

136. See *supra* notes 123-28 and accompanying text.

Now that we have a sense of the disciplinary mechanisms that can motivate the executives of America's publicly quoted corporations to focus closely on share prices, we can explore the ramifications with respect to bankruptcy. Consider a scenario that the literature on financially distressed companies suggests is highly plausible.<sup>137</sup> A publicly quoted firm has a positive operating income but also has a substantial debt load because those in charge have been pursuing costly but worthwhile ventures predicted to earn excellent returns for shareholders over time. Conditions outside the control of those in charge subsequently render the company unable to service its debts. This highly leveraged but otherwise sound and viable company will end up facing financial distress that could result in liquidation.

The evolutionary theory of corporate governance and corporate bankruptcy comes in at this point. It suggests that if a country has a system of ownership and control like America's, it will function more effectively if there is a framework in place designed to preclude the outcome just described. Matters fit together smoothly if the managers of a troubled but viable business have the option to continue running the firm, at least initially, rather than losing their jobs as soon as formal bankruptcy proceedings are commenced. Consider the advantages this arrangement offers from the managerial perspective. If bankruptcy means immediate ouster, executives would face, *ex ante*, an unpleasant combination of possible results. On the one hand, if they adopt a "safety first" mentality they will fail to reap the rewards available under their managerial services contracts, and they could face dismissal at the hands of outside directors or a takeover bidder. On the other hand, if they pursue promising but risky ventures that require substantial corporate borrowing, they will be displaced if factors beyond their control lead to the launch of bankruptcy proceedings.

One way that managers facing this sort of "lose-lose" situation could respond would be to orchestrate a reconfiguration of the pattern of ownership and control by seeking out large, stable, relational shareholders.<sup>138</sup> These shareholders, under the new arrangement, would take a "hands-on" role within the firm, thus muting the need for discipline via incentive-oriented executive pay, vigilant outside

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137. Gregor Andrade & Steven N. Kaplan, *How Costly is Financial (not Economic) Distress? Evidence from Highly Leveraged Transactions That Became Distressed*, 53 J. FIN. 1443, 1450-55 (1998); Naveen Khanna & Annette B. Poulsen, *Managers of Financially Distressed Firms: Villains or Scapegoats?*, 50 J. FIN. 919, 929 (1995).

138. Michael E. Porter, *Capital Disadvantage: America's Failing Capital Investment System*, HARV. BUS. REV., Sept.-Oct. 1992, at 65, 81.

directors, and hostile takeover bids.<sup>139</sup> A widely held view is that in the U.S., legal constraints deter the sort of "relationship investing" just described.<sup>140</sup> If the law imposes this sort of obstacle, a second move would be to attenuate the unforgiving nature of corporate bankruptcy law. The idea would be to pursue legislative changes or to use the existing regime creatively to ensure that managers of financially distressed companies remain at the controls at the outset of a restructuring.

The latter outcome, as the evolutionary theory predicts, is what prevails in the United States. Chapter 11 of the Bankruptcy Code essentially provides a distressed company's incumbent executives with a mechanism to orchestrate a turnaround while remaining at the helm.<sup>141</sup> With Chapter 11 proceedings, there is no requirement that a firm entering reorganization be insolvent. Correspondingly, the executives in charge have substantial discretion to direct the timing of entry into bankruptcy.<sup>142</sup> Moreover, matters subsequently function on a "debtor-in-possession" ("DIP") basis, which means the incumbent directors remain in control and continue to run the business.<sup>143</sup>

Chapter 11 offers other forms of assistance to the executives in charge of a financially troubled corporation. Crucially, management has extensive powers to arrange new financing, including the power in some circumstances to grant priority over all preexisting security interests.<sup>144</sup> Also, a corporate debtor acquires valuable breathing space because creditors, secured and unsecured alike, are stayed from enforcing their claims.<sup>145</sup> In due course, the creditors must vote on a plan of reorganization. Their ability to do so gives them some leverage

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139. On the monitoring role that blockholders can perform, see the discussion of family capitalism, *infra* Part III.C.

140. See, e.g., Robert S. Frenchman, *The Recent Revisions to Federal Proxy Regulations: Lifting the Ban on Shareholder Communications*, 68 TUL. L. REV. 161, 170-71 (1993); cf. JAMES P. HAWLEY & ANDREW T. WILLIAMS, *THE RISE OF FIDUCIARY CAPITALISM: HOW INSTITUTIONAL INVESTORS CAN MAKE CORPORATE AMERICA MORE DEMOCRATIC* 147-65 (2000) (noting that the law is being relaxed in important respects); see also *supra* note 59 and accompanying text.

141. DOUGLAS G. BAIRD, *THE ELEMENTS OF BANKRUPTCY* 182 (3d ed. 2001).

142. The vast majority of bankruptcy filings are voluntary. See CHARLES J. TABB, *THE LAW OF BANKRUPTCY* 92 (1997) (noting that "the overwhelming norm (in excess of 99% of all cases) is voluntary bankruptcy"); Susan Block-Lieb, *Why Creditors File So Few Involuntary Petitions and Why the Number is Not Too Small*, 57 BROOK. L. REV. 803, 804 (1991).

143. Creditors do retain the ability to petition for the removal of the managers and the appointment of a trustee in cases of fraud or gross mismanagement. 11 U.S.C. § 1104 (2000). However, this is a high hurdle to clear.

144. § 364 (postpetition financing). Empirical evidence confirms that the availability of such finance increases the chances of a successful reorganization. MARIA CARAPETO, *DOES DEBTOR-IN-POSSESSION FINANCING ADD VALUE?* (London Bus. Sch. Inst. of Fin. & Acct., Working Paper No. 294, 1999).

145. § 362.

against management, but no creditor may propose an alternative plan for at least the first 120 days after the case commences, which is routinely extended by courts to 180 days and beyond.<sup>146</sup> Correspondingly, if creditors do not approve management's proposed plan of reorganization, this may result in the proceedings being substantially prolonged. Creditors will also be induced to approve what the incumbent management team suggests, because doing so can serve to avoid a costly hearing during which the corporate debtor seeks to "cram down" nonconsenting classes of debt.<sup>147</sup>

In recent years, creditors have sought to counteract the influence of incumbent managers relying on Chapter 11. Perhaps most importantly, DIP lenders are increasingly imposing stringent requirements as a condition to their agreement to provide financing.<sup>148</sup> A condition that might be attached is that the corporate debtor must sell important assets if a positive cash flow is not being generated within a specified period of time. Also, creditors are now beginning to negotiate "pay-to-stay" deals with key executives in a Chapter 11 company that provide a substantial bonus if the assets are sold or the reorganization is completed quickly.<sup>149</sup> Such developments have put managers on a tighter leash in bankruptcy than in the past. Still, it remains fair to say that U.S. managers have much more influence over the corporate rescue process than their counterparts in most other bankruptcy regimes.

A related point should be made about executive tenure. Chapter 11 is not always as manager-friendly as the analysis thus far may suggest, because executives are frequently fired during, or immediately before, such proceedings.<sup>150</sup> Such an outcome is potentially devastating for those affected, since they are unlikely to return to top managerial posts for a number of years, if ever.<sup>151</sup> The

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146. § 1121; BAIRD, *supra* note 141, at 19.

147. § 1129(a)-(b) (setting forth requirements).

148. See, e.g., Douglas Baird & Robert Rasmussen, *The End of Bankruptcy* 39-40 (May 2002) (unpublished manuscript, on file with authors).

149. See, e.g., Lorene Yue, *Kmart Lines Up Cash for New Boss*, DETROIT FREE PRESS, Apr. 5, 2002, at 1A (reporting a request to approve two-year contract that would include a \$2.5 million signing bonus, a \$1 million in salary per year, and a \$4 million bonus if reorganization completed by July 2003, where the bonus would decrease by \$7299 per day thereafter and would disappear if Kmart failed to emerge by April 30, 2004); see also Frank Ahrens, *Enron Files for New Bonuses, Severance*, WASH. POST, Mar. 30, 2002, at D13 (reporting proposed bonuses for quickly selling assets).

150. Stuart C. Gilson et al., *Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default*, 27 J. FIN. ECON. 315 (1990).

151. See Stuart C. Gilson, *Management Turnover and Financial Distress*, 25 J. FIN. ECON. 246-49 (1989) (analyzing management turnover due to financial distress and the effect on managers).

fact remains, though, that Chapter 11 gives executives of financially distressed companies the option to take control of the agenda in a way that is unavailable when a country's bankruptcy law is more manager-displacing in character.

Let us turn now to insider/control-oriented corporate governance systems. As we have seen, the received wisdom in Germany and Japan is that banks constitute the focal point of the insider financial systems that prevail in the two countries.<sup>152</sup> With respect to corporate bankruptcy, neither country can be said to have a manager-driven regime.<sup>153</sup> Instead, managers are routinely displaced at the outset of bankruptcy, and corporate bankruptcy filings in both Germany and Japan will, in the vast majority of cases, result in liquidation. To be sure, the two countries do have procedures available under bankruptcy law for reorganizing a financially troubled company. Yet the German provisions do not contemplate a debtor-in-possession rescue. In Japan this option is possible, but there is no automatic stay in the event that such a rescue is commenced, and the relevant procedure has been largely moribund because of procedural complexities.<sup>154</sup> The upshot is that in both countries the executives of distressed companies cannot count on arranging a second chance under corporate bankruptcy law.

To fit Germany and Japan within the context of the evolutionary theory, assume for a moment that they offered a manager-driven bankruptcy regime like that in the U.S. This sort of arrangement could seriously undermine the leverage of a company's main bank. The problem would be that the managers of a troubled company could file for bankruptcy and attempt to pilot the restructuring process themselves. To be sure, the prospects for successful reorganization would be dim unless the bank was eventually persuaded to sign on. Still, bankruptcy would provide a mechanism that executives could use to keep a pivotal monitor of their corporation's affairs at bay.

By contrast, a manager-displacing bankruptcy regime powerfully reinforces the leverage of lenders. If the executives of a financially troubled company know that they will immediately lose their jobs if the company's main bank launches formal bankruptcy proceedings, they will listen closely to what representatives from the

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152. See *supra* notes 17-24 and accompanying text.

153. Skeel, *supra* note 2, at 1380-86.

154. *Id.* at 1385; Arthur J. Alexander, *Business Failures Rising in Japan as New Bankruptcy Law Takes Effect*, JAPAN ECON. INST. REP., June 9, 2000, at 9B.



bank have to say.<sup>155</sup> Manager-displacing bankruptcy law is thus a natural component of insider governance, and this combination is what we see in Germany and Japan.

As mentioned, in recent years, key features of insider/control-oriented financial systems have come under stress as part of a possible transition to an "outsider" bias.<sup>156</sup> Since the evolutionary theory contemplates a feedback loop between corporate governance and bankruptcy law,<sup>157</sup> it follows that the equilibrium which currently exists in Germany and Japan could be unstable. More precisely, the theory implies that if and when the control blocks held by "core" shareholders are unwound, a reconfiguration of bankruptcy law along manager-friendly lines could be in the cards.

Consistent with the implications of the evolutionary theory, there are hints of a transition towards a manager-driven bankruptcy regime in Germany and Japan. German companies were given a more robust reorganization option under the country's bankruptcy laws in the late 1990s, though the new procedure still lacks the "debtor-in-possession" feature that characterizes Chapter 11 in the U.S.<sup>158</sup> In Japan, steps are currently being taken to streamline the cumbersome debtor-in-possession reorganization option that now exists.<sup>159</sup> If outsider governance truly takes hold in these countries, the evolutionary theory predicts further changes in favor of manager-friendly bankruptcy law.

### *C. The Evolutionary Theory and "Family Capitalism"*

With the contours of the evolutionary thesis, one additional point deserves consideration, namely the relevance of the theory where a country has an insider/control-oriented system of governance but where banks do not play the sort of role typically ascribed to them in Germany and Japan. The topic merits consideration because, as we

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155. A countervailing factor bears mentioning. In a corporation with concentrated equity, the principal source of the firm's going-concern value may be the dominant shareholders acting in an entrepreneurial capacity. When a firm of this type files for bankruptcy but is worth preserving, the reorganization process arguably should offer, via a debtor-in-possession approach, the opportunity for the dominant shareholders to emerge from bankruptcy with their ownership and control rights intact. See Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 VA. L. REV. 921 (2001); Kenneth M. Ayotte, *Bankruptcy and Entrepreneurship: The Value of a Fresh Start* (July 5, 2002) (unpublished manuscript, on file with authors).

156. See *supra* notes 35-44 and accompanying text.

157. See *supra* text preceding note 122.

158. Skeel, *supra* note 2, at 1385.

159. Alexander, *supra* note 154, at 10B-12B.

have seen, classifying financial systems on the basis of whether they are "bank-based" or not is an exercise fraught with difficulties.<sup>160</sup>

If banks do not dominate an insider/control-oriented corporate economy, who does? Family-owned companies are typically a strong contender. We are not concerned in this instance with small, closely held business enterprises.<sup>161</sup> Instead, we are interested in large business enterprises where family members own a large block of shares and may well hold key managerial posts. Italy constitutes a classic example of a country where this sort of "family capitalism" predominates. For instance, according to figures from the mid-1990s, the largest shareholder in Italy's publicly quoted companies owns, on average, just over 50% of the shares, and a family is the most important blockholder in nearly one out of three of such firms. Ownership is even more concentrated among major business enterprises not quoted on the stock market.<sup>162</sup> At the same time, while bank loans are the largest net source of external finance for Italian companies, banks do not play a significant or active role in corporate governance.<sup>163</sup>

Various industrialized countries in Europe (e.g., France and Belgium) and East Asia (e.g., Taiwan and South Korea) share the Italian model of corporate governance to some degree.<sup>164</sup> Given the prevalence of "family capitalism," it is worthwhile to consider how this pattern of ownership and control fits together with the evolutionary theory. As a starting point, it is important to bear in mind how governance problems differ depending on whether a corporation quoted on the stock market has widely dispersed share ownership or has shareholders who own enough equity to exercise "inside" influence.

In a widely held company, executives can potentially take advantage of the latitude afforded to them by passive shareholders to

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160. See *supra* notes 25-34 and accompanying text.

161. Such firms raise distinctive issues that are beyond the scope of this Article.

162. Marcello Bianchi, Magda Bianco & Luca Enriques, *Pyramidal Groups and the Separation of Ownership and Control in Italy*, in *THE CONTROL OF CORPORATE EUROPE*, *supra* note 26, at 154.

163. See *supra* note 29 and accompanying text; Carpenter & Rondi, *supra* note 29, at 367.

164. On ownership and control patterns in continental Europe, see *THE CONTROL OF CORPORATE EUROPE*, *supra* note 26; Faccio & Lang, *supra* note 5. On banking arrangements, see CHARKHAM, *supra* note 12, at 145-46; Patrick Fridenson, *France: The Relatively Slow Development of Big Business in the Twentieth Century*, in *BIG BUSINESS AND THE WEALTH OF NATIONS*, *supra* note 93, at 207, 227-28 (discussing France); see generally Claessens et al., *supra* note 34. On South Korea and Taiwan, see Alice H. Amsden, *South Korea: Enterprising Groups and Entrepreneurial Government*, in *BIG BUSINESS AND THE WEALTH OF NATIONS*, *supra* note 93, at 336, 361-62; RICHARD WHITLEY, *DIVERGENT CAPITALISMS: THE SOCIAL STRUCTURING AND CHANGE OF BUSINESS SYSTEMS* 160-61, 169-70 (1999).

impose agency costs by acting in an ill-advised or self-serving manner. On the other hand, when control in a company is highly consolidated, managerial accountability is unlikely to be a matter of great urgency. One consideration is that controlling shareholders are likely to have a financial stake that is large enough to motivate them to keep a careful watch on what is going on.<sup>165</sup> Also, "core" investors should have sufficient influence to gain access to high-quality information concerning firm performance and to orchestrate the removal of disloyal or ineffective managers if things go awry.<sup>166</sup>

Still, while unaccountable executives seem unlikely to pose a serious problem in companies with a dominant blockholder, a different danger exists.<sup>167</sup> Core investors may collude with management to extract, via "rent-seeking," private benefits of control.<sup>168</sup> For instance, a controlling shareholder might engineer "sweetheart" deals with related firms in order to siphon off a disproportionate share of a public company's earnings. Alternatively, an entrepreneur motivated by vanity, sentiment, or loyalty might continue to run the business for too long or might transfer control to family members who are ill-suited for the job.<sup>169</sup>

Minority shareholders clearly may be vulnerable to expropriation in the manner just described.<sup>170</sup> However, they are not the only potential victims; those lending money to the company are also at risk.<sup>171</sup> We have already seen that there can be "agency costs of debt" when managers take actions that are calculated to benefit

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165. Coffee, *supra* note 62, at 661-62; Ronald J. Daniels & Jeffrey G. MacIntosh, *Toward a Distinctive Corporate Law Regime*, 29 OSGOODE HALL L.J. 863, 884 (1991); Brian R. Cheffins, *Current Trends in Corporate Governance: Going from London to Milan via Toronto*, 10 DUKE J. COMP. & INT'L L. 5, 33 (1999).

166. Cheffins, *supra* note 165, at 33; Sanford M. Jacoby, *Corporate Governance in Comparative Perspective: Prospects for Convergence*, 20 COMP. LAB. L. & POL'Y J. (forthcoming 2001); Daniels & MacIntosh, *supra* note 165, at 884-85.

167. Becht & Mayer, *supra* note 26, at 6-7; Brian R. Cheffins, *Minority Shareholders and Corporate Governance*, 21 CO. LAW. 41, 41-42 (2000); Clifford G. Holderness, *A Survey of Blockholders and Corporate Control*, 8 FED. RES. BANK N.Y. ECON. POL'Y REV., May 2002, at 4-5.

168. See Lucian Arys Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127, 130, 142 (1999) (discussing "rent-seeking"); LUCIAN A. BEBCHUK, *A RENT-PROTECTION THEORY OF CORPORATE OWNERSHIP AND CONTROL 2* (Nat'l Bureau of Econ. Res., Working Paper No. 7203, 1999). For evidence as to the relative size of such benefits across jurisdictions, see DYCK & ZINGALES, *supra* note 106, at 13-14.

169. On these and other examples, see Cheffins, *supra* note 165, at 33-34; La Porta et al., *supra* note 27, at 4.

170. La Porta et al., *supra* note 27, at 4.

171. Employees and suppliers are also potential victims, in theory. These constituencies remain, however, continually useful to a successful company and are thus at a lesser risk of being mistreated. *Id.*

shareholders at the expense of lenders.<sup>172</sup> When dominant shareholders collude with management, the dynamics will be somewhat different since the anticipated benefits will run directly to corporate "insiders"<sup>173</sup> rather than collectively to equity owners. Still, the effect on lenders will be much the same since the risk of default will be greater, all else being equal.

Those lending to a company with a dominant family owner presumably will be aware of the particular risks associated with this sort of firm and can therefore take certain precautions. For instance, as we will see, concentrated debt (i.e., a small group of lenders) can potentially be an effective counterweight to concentrated share ownership.<sup>174</sup> Bankruptcy rules, however, can also serve as a beneficial corrective mechanism.

To understand the role bankruptcy law can play, it is important to recognize that with a publicly quoted company dominated by a family, potential abuse of manager-friendly bankruptcy procedures is a serious possibility. The reason is that, if the incumbent management team has the support of the family, this coalition of management and family owners will be well placed to dictate how matters proceed in the event of financial distress. By initiating a debtor-in-possession corporate reorganization, the insiders should be able to remain in control at least so long as the rescue effort is ongoing.

The situation is quite different with a manager-displacing bankruptcy law. Under these circumstances, the creditors will have much greater leverage since it will fall to them to decide whether the firm should continue. Certainly, if key lenders determine that the business is fundamentally sound and conclude that those in charge were capable and unlucky rather than lazy or dishonest, one option would be to save the existing business via a workout arranged outside of bankruptcy. On the other hand, if serious doubts exist as to the economic viability of the company or the qualities of those in charge, the lenders can dictate the outcome which will probably suit them best: an orderly liquidation. The upshot is that a manager-displacing bankruptcy framework aligns well with an insider/control-oriented system of ownership and control, regardless of whether or not banks contribute fundamentally to corporate governance or not.

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172. See *supra* note 115 and accompanying text.

173. On the terminology, see La Porta et al., *supra* note 27, at 4 (defining and discussing "insiders").

174. See *infra* notes 336-50 and accompanying text.

The reality of family-dominated governance can be much messier than this brief overview suggests. Consider South Korea. From the foregoing, it might be thought that the family-controlled business enterprises which dominate the country's economy<sup>175</sup> would inevitably end up in liquidation in the event of financial distress. In fact, the South Korean government tends to intervene in the event of financial distress, rather than permitting troubled industrial leaders to fail.<sup>176</sup> It is not possible to address the implications of governmental rescues of financially distressed firms at this point. Still, it is worth noting here that when such activity is prevalent, other aspects of government policy may overwhelm bankruptcy law's contribution to corporate governance. Correspondingly, political factors may displace the equilibrium that evolutionary theory implies should exist, notwithstanding how a country's system of ownership and control is configured.

#### IV. THE EVOLUTION OF ENGLISH CORPORATE BANKRUPTCY LAW

##### *A. The Evolutionary Theory and the U.K.: The Hypothesis to Be Tested*

As we have seen, the U.K. is something of a "problem child" for theories that seek to account for the incidence of dispersed share ownership on the basis of national politics or corporate law.<sup>177</sup> Is this also the case with the evolutionary theory? In this section and the two that follow, we consider this issue.

Again, the received wisdom is that the U.K. has an outsider/arm's-length system of corporate governance.<sup>178</sup> Also, Britain, like the United States, has a "shareholder economy" where private enterprise is about maximizing profits for those who invest.<sup>179</sup> Moreover, as is the case in the U.S., a series of legal and institutional mechanisms serves to align managers' interests with those of shareholders. These mechanisms include the market for managerial

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175. Of particular importance are family-owned "financial cliques" known as "chaebols." On their attributes and importance, see WHITLEY, *supra* note 164, at 141-44.

176. See, e.g., Curtis J. Milhaupt, *Property Rights in Firms*, 84 VA. L. REV. 1145, 1183-84 (1998) ("Korean firms are, in a very meaningful sense, monitored and disciplined politically. . . . Political agents have responded to failure by staging both hostile and negotiated takeovers of unsuccessful firms.").

177. See *supra* notes 77-106 and accompanying text.

178. For a closer examination of this proposition, see *supra* notes 4-8 and *infra* Part V.

179. See *supra* note 75 and accompanying text.

talent, performance-sensitive executive compensation schemes, and an active market for corporate control.<sup>180</sup>

Admittedly, several of the factors that induce executives to take shareholder interests into account do not operate with identical intensity in the U.S. and the U.K. For instance, managerial service contracts in the U.S. are more highly "incentivized" than those in Britain.<sup>181</sup> On the other hand, the market for corporate control should potentially have a stronger disciplinary aspect in Britain, because U.K. companies have less scope to take defensive measures to fend off hostile takeover bids.<sup>182</sup> Still, the key point for our purposes is that British executives operate under constraints that motivate them to maximize shareholder value. Concomitantly, like their U.S. counterparts, they have incentives to implement risky strategies which, if successful, will offer a substantial "upside" but which also could threaten the viability of the company if things go wrong.<sup>183</sup>

Given the manner in which the U.K. corporate economy is configured, the evolutionary theory of bankruptcy law would predict that the regime governing financially distressed companies is likely to exhibit manager-driven characteristics. Otherwise, executives would face the unpalatable "lose-lose" scenario described in Part III.<sup>184</sup> Let us be a bit more precise with our prediction by taking timing into account. The U.K. corporate economy evolved toward dispersed share ownership in the decades immediately following World War II.<sup>185</sup> The posited complementarity between manager-friendly bankruptcy law and dispersed share ownership suggests that over the same period the regulation of corporate financial distress would have become increasingly manager-driven in orientation.

Did events in fact unfold in this fashion? Or is this another instance in which the U.K. qualifies as a "problem child?" As we will see now, a review of the evolution of English insolvency law<sup>186</sup>—the

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180. For an overview of how these aspects function in the U.K. context, see CHEFFINS, *supra* note 115, at 112-14, 117-22.

181. See Conyon & Murphy, *supra* note 127, at F646-47 (comparing the composition of CEOs' total pay in the United States and the United Kingdom).

182. Simon Deakin & Giles Slinger, *Hostile Takeovers, Corporate Law, and the Theory of the Firm*, 24 J.L. & SOC'Y 124, 137-41 (1997).

183. *But see Confidence in the Boardroom*, FIN. TIMES (London), Dec. 28, 2001, at 12 (decrying the lack of "buccaneers at the top of U.K. listed companies").

184. See *supra* note 138 and accompanying text.

185. See *supra* notes 88-93 and accompanying text.

186. We refer interchangeably to "English law," "U.K. law," and "British law." Technically, the latter two terms are misnomers, as the United Kingdom of Great Britain and Northern Ireland is in fact divided into three legal systems: England and Wales, Scotland, and Northern Ireland. However, these distinctions may safely be glossed over for present purposes. It is sensible to refer primarily to English law because many more companies are incorporated in

terminological equivalent of U.S. corporate bankruptcy law<sup>187</sup>— supports the latter view. Indeed, the evidence suggests that as share ownership was becoming more widely dispersed in the U.K., the legal rules governing corporate financial distress went in the opposite direction from that predicted by the evolutionary theory. To see why this is the case, it is convenient to consider chronologically the leading methods available to deal with corporate financial distress under English law.<sup>188</sup> Those available prior to the mid-1980s will be considered first. Reforms taking place at that time will then be analyzed. The section will conclude by discussing possible future changes to the law.

*B. Legal Regulation of Corporate Financial Distress: Procedures Available Prior to the Mid-1980s*

English corporate insolvency law has developed through bursts of legislative activity interspersed with incremental development by the judiciary. Regardless of the source of law, the tendency has been for innovations to be introduced alongside existing procedures, rather than as their replacements.<sup>189</sup> The resulting plethora of procedures is apt to confuse the uninitiated. To simplify our exposition, we will introduce the law by explaining how it would apply in a series of stylized examples involving a hypothetical financially distressed company.

English corporate insolvency law's first period of legislative innovation occurred during the middle of the nineteenth century. Concurrent with the creation of a facility for incorporating limited liability companies by straightforward means, corporate insolvency law was "born" in the mid-nineteenth century.<sup>190</sup> The pivotal innovation Parliament made was introducing a mechanism by which a

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England and Wales than elsewhere in the U.K. See DEPARTMENT OF TRADE AND INDUSTRY, COMPANIES IN 2000-2001 24 (2002). Moreover, there are only very minor differences between insolvency law in England and Wales, as compared with Scotland or Northern Ireland.

187. Under English law, "bankruptcy" refers solely to individual insolvency proceedings, whereas corporate proceedings are referred to as "corporate insolvency." In view of the likely readership of this Article, the American terminology is used to minimize confusion.

188. The survey offered here is not comprehensive. Some additional procedures are discussed briefly in the footnotes.

189. For this reason, all statutory references to specific provisions are to the latest consolidating legislation, the Insolvency Act, 1986, c. 45 (Eng.) (as amended).

190. On the evolution of general incorporation legislation in England, see PAUL L. DAVIES, GOWER'S PRINCIPLES OF MODERN COMPANY LAW 38-46 (6th ed. 1997). On the origins of English corporate bankruptcy law, see IAN F. FLETCHER, THE LAW OF INSOLVENCY 10-13 (2d ed. 1996) and V. MARKHAM LESTER, VICTORIAN INSOLVENCY: BANKRUPTCY, IMPRISONMENT FOR DEBT, AND COMPANY WINDING-UP IN NINETEENTH-CENTURY ENGLAND 222-28 (1995).

court could order the winding up of a company that was unable to pay its debts. Under the descendant procedure in the U.K.'s current insolvency legislation,<sup>191</sup> a judge granting such an order will appoint a liquidator whose duty is to ensure "that the assets of the company are got in, realized and distributed to the company's creditors."<sup>192</sup> This process has much in common with proceedings launched under Chapter 7 of the United States Bankruptcy Code,<sup>193</sup> and both are commonly referred to simply as "liquidation."<sup>194</sup>

Let us use an example to illustrate the practical effect of liquidation for an English company and its managers. Assume our company is failing to meet its financial obligations as they fall due. Unpaid creditors potentially could seek to enforce their claims by suing on the outstanding debt and by obtaining court orders authorizing the seizure and sale of specified corporate assets. A creditor who anticipates receiving more of what is owed if there is an orderly liquidation as opposed to a piecemeal scramble for assets can respond by petitioning the court for an order to wind up the firm.

The granting of a winding-up order will have two principal effects. The first is that unsecured creditors will be precluded from proceeding further with enforcement actions.<sup>195</sup> This "automatic stay" assists in the preservation of any going-concern value and correspondingly should increase the amount available collectively for distribution to those making a claim under the liquidation.<sup>196</sup> The second is that the company's directors will be automatically removed from office,<sup>197</sup> thus leaving the liquidator free to wind up the company's affairs in the manner that will yield the best return for

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191. §§ 122(1)(f), 124, 125.

192. § 143(1).

193. 11 U.S.C. ch. 7 (2000).

194. On the classification of Chapter 7 and winding up as "liquidation procedures," see LEGAL DEPT OF THE INT'L MONETARY FUND, ORDERLY & EFFECTIVE INSOLVENCY PROCEDURES 18-51 (1999); UNCITRAL WORKING GROUP ON INSOLVENCY, DRAFT LEGISLATIVE GUIDE ON INSOLVENCY LAW PART TWO: CORE PROVISIONS OF AN EFFECTIVE AND EFFICIENT INSOLVENCY REGIME, UN Doc A/CN.9/WG.V/WP.54/Add.1, at 3-4 (2001) (describing principal features of "liquidation procedures"). U.K. companies can also be wound up voluntarily as a result of a resolution passed by the shareholders. With an insolvent company, this sort of vote usually follows a threat by a creditor to petition for winding up unless the vote is taken. See DAVIES, *supra* note 190, at 838-43.

195. Insolvency Act, 1986, §§ 128, 130(2), 183, 184 (Eng.).

196. The classic analysis of the efficiency-enhancing properties of an automatic stay is THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 7-19 (1986).

197. See *Measures Bros. v. Measures*, [1910] 2 Ch. 248 (Eng. C.A.). In a voluntary liquidation, discussed *supra* note 194, the employment of those acting as directors is not terminated automatically, but the appointment of a liquidator means that all of their powers cease. § 103.



creditors.<sup>198</sup> Once the liquidator has completed selling the company's assets and has distributed the proceeds to outstanding claimants, the company will be dissolved. The upshot is that liquidation is clearly a "manager-displacing" procedure.<sup>199</sup>

A crucial limitation of winding up as a means of realizing value for creditors making a claim, and a fundamental difference from the operation of Chapter 7 bankruptcy proceedings in the U.S., is that a winding-up order does not stay enforcement action by secured lenders.<sup>200</sup> Instead, a creditor with a security interest is entitled to stand outside the bankruptcy process, and the liquidator must be careful not to interfere with the rights that exist to enforce the security.<sup>201</sup> The pivotal right a secured creditor has, once there has been a default, is a license to seize and sell the security to satisfy the amount owed.<sup>202</sup> Often, an enforcement agent known as a "receiver" will be appointed to exercise the rights in question.<sup>203</sup>

To illustrate, let us again consider our hypothetical. If our financially distressed company had used part of its assets as collateral for secured debts, the liquidator would have to hand over the relevant assets to receivers who had been validly appointed. Once the collateral had been disposed of, if the proceeds were sufficient to satisfy the claims of the secured creditors, the liquidator would be entitled to the surplus.<sup>204</sup> Otherwise the liquidator—and the unsecured creditors on whose behalf the liquidator acts—would receive nothing.

The power that secured creditors have to seize and sell collateral can potentially create havoc for a financially troubled

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198. The liquidator might, if desirable, continue the firm's operations and auction its business as a going concern. He has the power, subject to the court's permission, to continue trading if he considers it to be necessary for the beneficial winding up of the company's affairs. § 167, sched. 4, ¶ 5.

199. Again, a "creditors' voluntary winding up" is an alternative to the court-supervised winding-up procedure described in the text. See *supra* note 194 and accompanying text. The lack of court involvement means that it is typically quicker and cheaper to complete. Furthermore, it does not invoke a stay of creditors' claims. Still, since each creditor retains the option to trigger court-supervised liquidation should any enforcement action be taken, the prospect of an application to the court is typically sufficient to deter putative enforcement actions. Moreover, the outcome of a creditors' voluntary winding up is functionally equivalent to a court-supervised winding up for both the company (liquidation) and for the directors (cessation of their powers in favor of a liquidator appointed by creditors). Correspondingly, the procedure is not examined in detail in the text.

200. *In re David Lloyd & Co.*, (1877) 6 Ch. D. 339, 343-46 (Eng. C.A.); cf. 11 U.S.C. § 362(a)(5) (2000) (stating that automatic stay extends to enforcement of security in U.S. Chapter 7 proceedings).

201. FLETCHER, *supra* note 190, at 633.

202. ROY GOODE, *COMMERCIAL LAW* 689-91 (2d ed. 1995).

203. On the appointment of a receiver in this context, see *id.* at 692-93.

204. FLETCHER, *supra* note 190, at 633.

company, since conducting business in an orderly fashion will be difficult if various parties are exercising claims against key assets on a piecemeal basis.<sup>205</sup> Matters, however, can proceed differently if one creditor (or a cohesive coalition of creditors acting collectively) has a security interest in all of a company's assets.<sup>206</sup> In this case, only one receiver will need to be appointed to realize the security. Marshalling the assets in one hand should, in turn, facilitate an orderly response to the company's financial crisis.

English law ultimately evolved in a manner that was very favorable to the enforcement of security by one party. In the mid-nineteenth century English lawyers began to draft clauses for clients granting security against all present and future property, and in short order hospitable judges recognized the validity of such instruments.<sup>207</sup> Known as a "floating charge," this type of security interest did not have a direct counterpart in the U.S. until the adoption of the Uniform Commercial Code in the various states. U.S. judges were unwilling to accept the idea of an all-encompassing floating lien until legislation implementing Article 9 of the Uniform Commercial Code specifically authorized the use of security encompassing all of a debtor's present and future property.<sup>208</sup> Even now, the English floating charge offers an important advantage as compared with its American floating lien counterpart: in England there is no equivalent to the federally imposed stay of enforcement in bankruptcy.<sup>209</sup>

Also noteworthy was that English judges permitted the holder of a floating charge, upon default, to put a receiver in place without recourse to the courts.<sup>210</sup> By virtue of changes made by the Insolvency Act 1986, a receiver appointed under a floating charge covering the whole, or substantially the whole, of the company's assets is treated as an "administrative receiver" and is deemed to have various duties and

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205. See Roy M. Goode, *Is the Law Too Favourable to Secured Creditors?*, 8 CAN. BUS. L.J. 53, 59 (1983-84); David C. Webb, *An Economic Evaluation of Insolvency Procedures in the United Kingdom: Does the 1986 Insolvency Act Satisfy the Creditors' Bargain?*, 43 OXFORD ECON. PAPERS 139, 143-46 (1991).

206. See John Armour & Sandra Frisby, *Rethinking Receivership*, 21 OXFORD J. LEGAL STUD. 73, 86-91 (2001); Frank H. Buckley, *The American Stay*, 3 S. CAL. INTERDISC. L.J. 733, 755-58 (1994); Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645, 669-75 (1992).

207. See *In re Panama, New Zealand & Austl. Royal Mail Co.*, (1870) 5 Ch. App. 318 (Eng. C.A.); GOODE, *supra* note 202, at 730-31.

208. See, e.g., *Benedict v. Ratner*, 268 U.S. 353, 359-61 (1925); *Zartman v. First Nat'l Bank of Waterloo*, 82 N.E. 127, 129 (N.Y. 1907).

209. U.C.C. §§ 9-204 cmt. 2, 9-205 (2001).

210. Holders of a floating charge had the option of applying to the court for the appointment of a receiver, but there were few advantages to doing so. L.C.B. GOWER, *THE PRINCIPLES OF MODERN COMPANY LAW* 419-20 (1954).

powers to manage the company's business.<sup>211</sup> To see how this version of private receivership works as an insolvency procedure, let us return to our hypothetical while changing the facts slightly. Assume now that the company has raised most of its debt finance by borrowing from a bank. The bank has secured the amount owing to it by having the company grant a floating charge over all present and future property.<sup>212</sup>

Our company now becomes financially distressed, thus entitling the bank to launch formal enforcement proceedings under the security agreement.<sup>213</sup> If the bank decided to exercise its rights, it likely would terminate the company's management powers by appointing an administrative receiver<sup>214</sup> who would take control of the collateral.<sup>215</sup> The receiver would then decide on a strategy to maximize the recovery of the secured creditor.<sup>216</sup> The receiver's options would include shutting down operations immediately so as to sell individual assets on a breakup basis, continuing to trade with the intention of auctioning the business as a going concern, or perhaps of initiating a corporate rescue operation designed to restore the company to profitable trading.<sup>217</sup>

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211. See Insolvency Act, 1986, c. 45 §§ 29(2) (Eng.) (as amended) (defining the term "administrative receiver"), 39-49 & sched. 1 (discussing the powers and duties of an administrative receiver). Receivers appointed under security agreements that do not cover such a wide range of collateral are also subject to certain statutory duties but have no statutorily implied powers of management. c. 45 §§ 28-48; see also ROY GOODE, *PRINCIPLES OF CORPORATE INSOLVENCY LAW* 206, 212-15 (1997); Armour & Frisby, *supra* note 206, at 75-79. Even though administrative receivers are regulated by legislation, the manner in which they conduct their affairs remains very different from the similarly named U.S. proceeding that was known as an "equity receivership" and was the ancestor of current Chapter 11. Among other distinctions, the courts never relinquished control over the appointment process in equity receiverships. See DAVID A. SKEEL, JR., *DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA* 56-60 (2001) (outlining the role of courts of equity in early railroad receiverships).

212. As a practical matter, the bank might also take a "fixed" charge against key identifiable items of corporate property, such as the company's real estate, capital machinery, and accounts receivable. It would do this because a floating charge's priority position will typically be weak compared with other security interests a debtor grants. See CLARE CAMPBELL & BRIAN UNDERDOWN, *CORPORATE INSOLVENCY IN PRACTICE: AN ANALYTICAL APPROACH* 111 (1991).

213. For more detail on when the holder of a floating charge will be entitled to take enforcement proceedings under the security agreement, see *id.* at 114-15.

214. On this and other types of intervention, see GOODE, *supra* note 202, at 738.

215. The appointment of a receiver will cause the floating charge to "crystallize," which results in the charge becoming a fixed charge against property covered by the security agreement. On when crystallization occurs and related issues, see GOODE, *supra* note 202, at 736-41.

216. In doing so, the receiver owes fiduciary duties primarily to the secured creditor, rather than to the company or to the creditors as a whole. See Armour & Frisby, *supra* note 206, at 77.

217. On the powers of an administrative receiver, see GOODE, *supra* note 211, at 234-37. On the possibility of a receiver organizing a corporate rescue, see FLETCHER, *supra* note 190, at 420.

In theory, despite enforcement proceedings under a floating charge, one of the company's unsecured creditors could petition to have our company wound up.<sup>218</sup> The advent of winding up would not terminate the administrative receivership. Instead, the receiver would remain free to exercise its powers in relation to the assets subject to the floating charge.<sup>219</sup> Since a liquidator must stand on the sidelines until the administrative receivership is complete, in all likelihood there would be nothing left to sell on behalf of the unsecured creditors.<sup>220</sup> Given that the company probably would be nothing more than an "empty husk," the unsecured creditors would likely not waste their time securing such an appointment. Ultimately, the assetless shell would simply be removed from the Register of Companies on grounds of nonactivity.<sup>221</sup>

What would be the fate of the managers of our hypothetical company during an administrative receivership? There is a good chance they would remain in office formally at least for the duration of the process.<sup>222</sup> Still, the effect of the appointment of an administrative receiver is to divest a company's directors of their management powers during the receivership.<sup>223</sup> Since our company likely would be an "empty husk" once the receivership was concluded, the appointment of the administrative receiver would be the end of the road for the managers of our company.<sup>224</sup>

From the foregoing, it should be evident that prior to the mid-1980s formal regulation of corporate financial distress under English law was, to use the terminology of the evolutionary thesis, "manager-displacing." Again, as we have just seen, for the managers of our hypothetical company, appointment of a receiver under a floating

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218. A court cannot refuse to make a winding-up order on the grounds that the company's assets have been mortgaged to the hilt. Insolvency Act, 1986, c. 45 § 125(1) (Eng.) (as amended); GOODE, *supra* note 211, at 106 n.42.

219. *In re Potters Oils Ltd.*, [1986] 1 All E.R. 890, 890; *Sowman v. David Samuel Trust Ltd.*, [1978] 1 All E.R. 616, 617; *In re Northern Garage, Ltd.*, [1946] 1 Ch. 188, 189.

220. On the outcome in the unlikely event of a surplus, see GOODE, *supra* note 211, at 263-64.

221. Companies Act, 1985, §§ 652, 652A (Eng.). It is a precondition of such removal that the company's creditors be informed and do not object. Where there are no assets, there is no reason to object. Furthermore, no one will be willing to act as liquidator if there are no assets, as there will be nothing from which to pay them.

222. A supervening winding-up order would, however, result in the automatic removal of the company's directors. See *supra* note 199 and accompanying text.

223. See GOODE, *supra* note 211, at 230 (identifying some limited exceptions).

224. An exception to this could occur where the managers, acting through a new corporate vehicle, buy the assets from the receiver and then go back into business. On the regulation of this sort of practice, which could cause considerable dissatisfaction on the part of the unpaid unsecured creditors of the original company, see FLETCHER, *supra* note 190, at 489, 664-67.

charge would almost certainly put them on the sidelines. The granting of a winding-up order would prove even more decisive outcome, since it would result in their automatic removal.

Let us now return to the evolutionary theory. It posits that manager-displacing bankruptcy laws are complementary to concentrated share ownership.<sup>225</sup> Throughout the opening decades of the twentieth century, this sort of congruence was evident in the U.K. In larger business enterprises, including those with publicly quoted shares, the founders and/or their heirs generally retained a sizeable percentage of the voting equity and played an influential role in managerial decisionmaking.<sup>226</sup> With this sort of "insider" governance, the evolutionary theory would predict that bankruptcy law would be manager-displacing, and this was indeed the outcome.

Later events, however, create an apparent paradox for the evolutionary theory. As time progressed, family control became less pervasive in larger U.K. companies, and at some point between the 1950s and 1980s the divorce between ownership and control became sufficiently wide for Britain to acquire its outsider/arm's-length governance regime.<sup>227</sup> The evolutionary theory would predict that this trend should have been accompanied by a shift toward "manager-driven" bankruptcy law. Comprehensive reform of corporate bankruptcy law did not occur, however, in tandem with the shift toward dispersed share ownership. Instead, the status quo prevailed until the middle of the 1980s.<sup>228</sup> At this point, significant changes were made. Did this transition yield manager-driven bankruptcy law which the evolutionary theory would predict? As we will see, the answer is no.

### C. Corporate Bankruptcy Reform in the Mid-1980s

In 1977, the U.K.'s Trade Secretary responded to growing dissatisfaction with the law governing corporate and personal bankruptcy by establishing a Review Committee on Insolvency Law and Practice.<sup>229</sup> Known as the "Cork Committee," after its chair, Sir Kenneth Cork, it published its report in 1982.<sup>230</sup> The reform process

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225. See *supra* note 155 and accompanying text.

226. Cheffins, *supra* note 97 at 466-67.

227. *Id.* at 467-68.

228. On the absence of major legislative initiatives until this point in time, see FLETCHER, *supra* note 190, at 13-14.

229. *Id.* at 14-15.

230. INSOLVENCY LAW REVIEW COMM., INSOLVENCY LAW AND PRACTICE: REPORT OF THE REVIEW COMMITTEE, 1982, Cmnd. 8558.

culminated in the enactment of wide-ranging reforms in the Insolvency Act 1985.<sup>231</sup> This legislation, in turn, was quickly superseded by the Insolvency Act 1986, which governs corporate bankruptcy today.<sup>232</sup>

In assessing the extent to which the reform of corporate bankruptcy law in the mid-1980s conformed with the manager-driven transition that the evolutionary theory would predict, two aspects are particularly relevant. The first is the introduction of a new insolvency procedure, known as "administration."<sup>233</sup> The fact that the purpose of this new procedure was to foster corporate rescues by giving financially distressed firms "breathing space" from their creditors<sup>234</sup> might be thought to imply that the mid-1980s did see a move in a more manager-friendly direction for English corporate bankruptcy law. Consistent with this notion, there are indeed some similarities between the administration procedure and the manager-driven Chapter 11 of the United States Bankruptcy Code. Both function under judicial supervision; both are supposed to serve the interests of all creditors rather than a particular class (e.g., those with security); and both are explicitly designed to rehabilitate ailing firms.<sup>235</sup> For the purposes of the evolutionary theory, however, the differences are of greater importance.<sup>236</sup>

To see how administration works, let us return to our hypothetical financially distressed company. Let us alter the facts again, incorporating assumptions that are more realistic for a large British firm with publicly quoted shares. Instead of borrowing from a single bank holding a floating charge, our company has now raised its debt financing from a range of lending institutions. A substantial fraction of the loans are unsecured and syndicated, meaning that

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231. Insolvency Act, 1985, c. 65 (Eng.). On the motives underlying the enactment of the legislation, see BRUCE G. CARRUTHERS & TERENCE C. HALLIDAY, *RESCUING BUSINESS: THE MAKING OF CORPORATE BANKRUPTCY LAW IN ENGLAND AND THE UNITED STATES* 112-23 (1998).

232. On the transition from the Insolvency Act 1985 to the Insolvency Act 1986, see FLETCHER, *supra* note 190, at 19-20.

233. See generally Dan Prentice et al., *Administration: Part II of the Insolvency Act 1986*, in *CURRENT DEVELOPMENTS IN INTERNATIONAL AND COMPARATIVE CORPORATE INSOLVENCY LAW* ch. 5 (Jacob S. Ziegel ed., 1994).

234. Andrew Campbell, *Company Rescue: The Legal Response to the Potential Rescue of Insolvent Companies*, 5 *INT'L COMP. & COM. L. REV.* 16, 16-18 (1994); Gabriel Moss, *Comparative Bankruptcy Cultures: Rescue or Liquidation? Comparison of Trends in National Law—England*, 23 *BROOK. J. INT'L L.* 115, 120-21 (1997).

235. Julian R. Franks & Walter N. Torous, *Lessons from a Comparison of US and UK Insolvency Codes*, 8 *OXFORD REV. ECON. POL'Y* 70, 74, 78-79 (1992).

236. On the differences, see Campbell, *supra* note 234, at 21-22; Moss, *supra* note 234, at 121-23.

dozens of banks will have taken a share of a given loan.<sup>237</sup> The firm also has some secured debt but has not granted a floating charge, so the various secured creditors only have claims against specified assets.<sup>238</sup>

An important difference under these new facts is that there will not be a creditor that has a security interest over all of the company's present and future assets. Under these circumstances, an administrative receiver, who again would have had the option of keeping the business running with the objective of auctioning it as a going concern or organizing a corporate rescue, cannot be appointed.<sup>239</sup> As we have seen, prior to 1985 the outcome in circumstances where there was no creditor with an all-encompassing security interest would either have been an inefficient piecemeal liquidation or a winding-up order.<sup>240</sup> The administration procedure introduced by the Insolvency Act 1985 was designed to help in situations like this. The intention was that an administrator appointed by the court would have powers akin to a receiver appointed under a floating charge and thus would be suitably positioned to orchestrate, if possible, the survival of the business via a sale to a third party or a corporate rescue.<sup>241</sup>

For an administration order to be open to our company, a petition would have to be made to the court by the company itself, by its directors, or by one of its creditors.<sup>242</sup> The judge, in turn, would be entitled to make an administration order if doing so would be likely to achieve the survival of the company as a going concern, a better realization of the assets than in winding up, or a beneficial reorganization of the company's debt structure.<sup>243</sup> If the court granted the administration order,<sup>244</sup> it would impose a moratorium on the

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237. On London's syndicated loans market, see Seth Armitage, *Banks' Information About Borrowers: The Stock Market Response to Syndicated Loan Announcements in the UK*, 5 APPLIED FIN. ECON. 449, 451-52 (1995); *Udder Madness: British Insolvency Reform*, ECONOMIST, March 1, 1997, at 72, 72-73.

238. On why larger U.K. companies tend not to grant all-encompassing security interests, see CARRUTHERS & HALLIDAY, *supra* note 231, at 163, 195.

239. See *supra* notes 214-17 and accompanying text.

240. See *supra* note 205 and accompanying text.

241. CARRUTHERS & HALLIDAY, *supra* note 231, at 115-16; FLETCHER, *supra* note 190, at 419-20.

242. Insolvency Act, 1986, c. 45, § 9(1) (Eng.) (as amended). Note that a secured creditor who would be entitled to appoint an administrative receiver can veto the making of an administration order, but there is no such creditor in the scenario we are considering at present. On this potential veto, see sections 9, 10.

243. § 8(3).

244. The chances of success will be high. Harry Rajak, *The Challenges of Commercial Reorganizations in Insolvency: Empirical Evidence from England*, in CURRENT DEVELOPMENTS IN

enforcement of creditors' rights and remedies including those arising from security interests.<sup>245</sup> This freeze on creditor rights is roughly equivalent to the automatic stay under Chapter 11 of the U.S. Bankruptcy Code.<sup>246</sup> The idea is that those seeking to rehabilitate companies must have a "breathing period" to develop an orderly plan for action without having to fight a rearguard battle with creditors eager to seize corporate assets.<sup>247</sup>

While proceedings conducted under Chapter 11 and under administration orders do share an automatic stay, the resemblance between the two ends abruptly when attention is paid to the treatment of directors.<sup>248</sup> One of the major features of Chapter 11 is that management of the company is left in charge. The premise underlying this debtor-in-possession rule is that the incumbent executives have crucial detailed knowledge of the company's operations and customers. The contrast with administration is stark, since English insolvency law is predicated on the assumption that the last people to leave in control of a failing business are those who were responsible for the company's plight in the first place. Correspondingly, the Insolvency Act 1986 requires that the administration of a company be placed in the hands of an external manager (an "administrator") who must be a qualified insolvency practitioner.<sup>249</sup>

With respect to our hypothetical company, the absence of a debtor-in-possession feature akin to that of Chapter 11 means that, upon the granting of an administration order, the administrator would take control of the company and manage its affairs.<sup>250</sup> The company's incumbent directors and officers might well remain in post. They would be obliged, however, to cooperate with the administrator, and they would not be permitted to exercise any of their managerial powers in a way that might interfere with the administrator.<sup>251</sup> Moreover, it would be the administrator's prerogative to remove the incumbent directors and appoint replacements.<sup>252</sup> The upshot is that, while the appointment of an administrator might facilitate the

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INTERNATIONAL AND COMPARATIVE CORPORATE INSOLVENCY LAW, *supra* note 233, at 191, 204, tbl. 8.4.

245. Insolvency Act, 1986, § 11(3) (Eng.). For instance, there will be an absolute bar on the appointment of an administrative receiver, and a winding-up petition cannot be brought.

246. 11 U.S.C. § 362 (2000).

247. CARRUTHERS & HALLIDAY, *supra* note 231, at 153, 178.

248. GOODE, *supra* note 211, at 274.

249. Insolvency Act, 1986, §§ 13, 388, 389 (Eng.).

250. §§ 14(1), 17, sched. 1.

251. § 14(4).

252. § 14(2)(a).



preservation or rehabilitation of the business conducted by our hypothetical company, the administration order would not offer the executives the "manager-driven" outcome that Chapter 11 provides.

A second aspect of the reform of English insolvency law which took place in the mid-1980s that is relevant to our analysis of the evolutionary theory involves the sanctioning of irresponsible or dishonest directors.<sup>253</sup> As part of the reform effort, Parliament gave the judiciary new powers to punish directors for misconduct related to the operation of their companies. More specifically, the introduction of rules concerning "wrongful trading" made it easier for a judge to impose personal liability on directors of failed companies.<sup>254</sup> Also, Parliament considerably expanded the grounds upon which a court could order that an individual be disqualified from serving in the capacity of director in the future.<sup>255</sup>

To illustrate the effects of these changes, consider again our hypothetical company. Assume our directors allowed the business to continue to operate when they should have known it had no reasonable prospect of survival. Unless they took every reasonable step to avoid insolvent liquidation, they would have engaged in wrongful trading as defined by the Insolvency Act 1986.<sup>256</sup> The liquidator of the company would then have the option of seeking an order requiring the directors to contribute personally to the assets available to the creditors.<sup>257</sup>

If there were a finding of wrongful trading, civil liability would not be the only potential sanction for the directors. An order could also be made under the Company Directors Disqualification Act 1986 disqualifying them from serving on a corporate board for a period of up to fifteen years.<sup>258</sup> In addition, there might be other grounds for disqualification. Of greatest practical importance, the directors could face a disqualification penalty if their company ended up insolvent

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253. For background on the development of the legislation, see CARRUTHERS & HALLIDAY, *supra* note 231, at 269-83.

254. See Insolvency Act, 1985, c. 65, § 45 (Eng.).

255. The grounds for disqualification were expanded under sections 12-19 of the Insolvency Act 1985.

256. Insolvency Act, 1986, c. 45, § 214(2)-(3) (Eng.). On when a director "ought to know" that a company will not avoid insolvent liquidation, see section 214(4).

257. § 214(1). In practice, applications for wrongful trading declarations are rare. On why this is the case, see CHEFFINS, *supra* note 115, at 545-46.

258. § 10.

and they had engaged in conduct rendering them "unfit" to serve as directors.<sup>259</sup>

A director's conduct does not have to be dishonest for there to be "unfitness" under the Company Directors Disqualification Act 1986. Instead, it is sufficient if the individual has been lax in attending to accounting matters, has irresponsibly delegated managerial powers, or otherwise has engaged in conduct demonstrating recklessness.<sup>260</sup> If a judge, upon an application from the Department of Trade and Industry, ultimately finds any of the directors of our hypothetical company to be unfit to serve in that capacity, the judge becomes obliged to disqualify them for a period of between two and fifteen years.<sup>261</sup>

The introduction of liability for wrongful trading and the expansion of the grounds for disqualification meant that for managers the consequences of financial distress were potentially more severe than prior to the mid-1980s. This outcome is directly contrary to what the evolutionary theory would predict, since share ownership had become progressively more diffuse prior to the introduction of these reforms. Still, it may be that Britain was, by the mid-1980s, in a period of temporary disequilibrium that continues to this day but which will not persist much longer. The U.K. has recently made further changes to its corporate insolvency law. If these changes have made the regime more manager-driven, that would lend credibility to the temporary disequilibrium story and ultimately provide support for the evolutionary theory. Correspondingly, it is appropriate to conclude this section by examining the relevant developments to see if the U.K. insolvency laws are in fact moving belatedly in the direction implied by the evolutionary theory.

#### *D. Recent Developments*

The U.K. government recently conducted a review of corporate rescue procedures.<sup>262</sup> The resulting reform proposals were

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259. Company Directors Disqualification Act, 1986, §§ 6-9 (Eng.). On the practical importance of this ground for disqualification, see J.H. FARRAR & B.M. HANNIGAN, *FARRAR'S COMPANY LAW* 345, 348 (4th ed. 1998).

260. *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] 2 BCLC 63 (Ch. D. 1995); *Re Linvale Ltd.* [1993] BCLC 654 (Ch. D. 1993); *Re Sevenoaks Stationers (Retail) Ltd.* [1991] BCLC 325, 330, 337 (Eng. C.A. 1990).

261. § 6.

262. *INSOLVENCY SERV., A REVIEW OF COMPANY RESCUE MECHANISMS* (1999); *INSOLVENCY SERV., A REVIEW OF COMPANY RESCUE AND BUSINESS RECONSTRUCTION MECHANISMS: REPORT BY THE REVIEW GROUP* (2000) [hereinafter *INSOLVENCY SERV., REPORT BY THE REVIEW GROUP*];

subsequently enacted as the Enterprise Act 2002.<sup>263</sup> With respect to corporate bankruptcy,<sup>264</sup> the most important change concerns the abolition of the administrative receivership and its replacement with an expanded form of administration procedure.<sup>265</sup> The government's view, according to the White Paper that preceded the Act, was that banks could be too quick to use their rights under floating charges to appoint receivers.<sup>266</sup> Correspondingly, the government sought to channel corporate financial distress through administration, on the assumption that this would serve to level the playing field for creditors and give more scope for corporate rescues.<sup>267</sup> For our purposes, though, the pivotal point is that the recent reforms will have little effect on the position of managers. Those in charge will be sidelined by the appointment of an administrator just as surely as they would be by an administrative receivership.

With the reform of bankruptcy law, a trend of greater relevance for the evolutionary theory is a possible shift toward explicitly authorized DIP corporate rescues. A mechanism of this sort has in fact also recently been enacted for "small" U.K. companies, defined on the basis of annual turnover, total assets and liabilities, and the number of people employed.<sup>268</sup> However, since our focus is on the sort of large enterprises that are susceptible to dispersed share ownership, the details of the new scheme will not be considered here.

Another recent reform proposal might have led to the introduction of a procedure that would have allowed a corporate restructuring to occur with a debtor-in-possession for larger U.K. companies. The status of this proposal, however, is unclear. In 2000, a

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U.K. DEPT OF TRADE & INDUS., PRODUCTIVITY AND ENTERPRISE: INSOLVENCY—A SECOND CHANCE, Cmnd. 5234 (2001).

263. See Enterprise Act 2002, available at <http://www.legislation.hmsso.gov.uk/acts/acts2002.htm>.

264. A shake-up of the personal bankruptcy regime was also proposed. For details, see U.K. DEPT OF TRADE & INDUS., *supra* note 262, at 1-8.

265. Enterprise Act 2002, § 250 (Eng.) (setting out new §§ 72A-72F for the Insolvency Act 1986, abolishing administrative receivership except for project finance and certain capital market transactions); § 248 & sched. 16 (repealing Part II of the current Insolvency Act 1986 and replacing it with a new sched. B1); U.K. DEPT OF TRADE & INDUS., *supra* note 262, 9-12.

266. U.K. DEPT OF TRADE & INDUS., *supra* note 262, at 9.

267. See HANSARD, HOUSE OF COMMONS DEBATES, Apr. 10, 2002, Col. 53 (Ms. Patricia Hewitt, Secretary of State for Trade and Industry), available at <http://www.publications.parliament.uk/pa/cm200102/cmhansrd/vo020410/debindx/20410-x.htm>; HANSARD, Col. 97 (Mr. Ross Cranston).

268. Insolvency Act, 2000, § 1, sched. 1 (Eng.). A "small" company is defined by section 247 of the Companies Act 1985 as one which satisfies two or more of the following three criteria: (i) Its annual turnover is not greater than £2.8m; (ii) its balance sheet total is not more than £1.4m; and (iii) it does not employ more than fifty persons. The relevant provisions of the Act will come into force on January 1, 2003.

review group that had been established by a government agency to assess reform of the U.K.'s corporate bankruptcy laws offered its views on the topic.<sup>269</sup> Prompted by lobbying in favor of a mechanism akin to Chapter 11, the review group considered whether a DIP reorganization procedure should be made available for larger companies.<sup>270</sup> The review group thought the idea was interesting, but left further consideration of the matter to a steering group that had been established in 1998 to coordinate reform of the U.K.'s companies legislation. The steering group subsequently declined the invitation to evaluate the case for reform, reasoning that bankruptcy policy was beyond its terms of reference.<sup>271</sup>

The debtor-in-possession proposal considered by the review group in 2000 is not included in the Enterprise Act 2002. This does not mean that changes to the law are entirely out of the question. It is possible that if the DIP procedure that will be made available to "small" companies is a success, the relevant procedures could ultimately be "rolled out" for larger business enterprises as well.<sup>272</sup> If this happened, or even if it seemed likely to happen, the shift would provide strong support for the evolutionary hypothesis. However, an alternative possibility is that enactment of the various reforms in the Enterprise Act 2002 could disperse the momentum in favor of reform and postpone serious consideration of the DIP proposal for larger companies for a considerable period of time. At this point, it is therefore premature to say that English bankruptcy law is, or soon will be, configured in the manner this theory would predict.

Let us summarize where things stand after considering the "law on the books." Throughout the early part of the twentieth century, matters fell into line with the evolutionary thesis, since share ownership was concentrated and bankruptcy law was manager-displacing. This alignment, however, was disrupted as dispersed share ownership became the norm in the decades following World War II.

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269. INSOLVENCY SERV., REPORT BY THE REVIEW GROUP, *supra* note 262.

270. *Id.* at 13. The idea behind the proposal is to build on an existing "cramdown" mechanism known as the "scheme of arrangement." Under a scheme of arrangement, a plan of reorganization is confirmed between creditors and a company, but there is no scope for a stay of creditors' claims. The procedure is, therefore, often used in conjunction with an administration order. Under the proposed reform, a debtor company would have the scope to implement a stay of claims during the negotiation of a scheme of arrangement. This would, in effect, create a DIP reorganization procedure.

271. COMPANY LAW REVIEW STEERING GROUP, MODERN COMPANY LAW FOR A COMPETITIVE ECONOMY: FINAL REPORT (VOL. I.) 279 (2001).

272. See TRADE AND INDUSTRY SELECT COMMITTEE, SECOND REPORT 1999-2000 SESSION: DRAFT INSOLVENCY BILL, HC 112 ¶ 24 (Dec. 20, 1999). Such a change already has some support among U.K. lawyers. Martin Burns, *UK Insolvency Reform is on the Way*, HIGH YIELD REP., Aug. 6, 2001, available at 2001 WL 8014496.

Insolvency law was amended in the 1980s, but contrary to what the evolutionary theory would predict, the relevant changes were "unfriendly" to management. Reform is again taking place, but it is too early to assess the final results. It follows that in order to reconcile the British experience with the evolutionary theory, one must go beyond the law on the books. The next section of this Article therefore examines whether the conventional thinking on the pattern of ownership and control in U.K. companies is correct.

#### V. DOES THE U.K. HAVE AN INSIDER/CONTROL-ORIENTED SYSTEM OF OWNERSHIP AND CONTROL?

On the basis of the received wisdom concerning the configuration of share ownership in U.K. companies, the British experience clearly poses a challenge to the argument that a manager-driven bankruptcy regime is integrally related to a corporate economy dominated by widely held companies. It may still be possible, however, to reconcile the theory with the facts. One way this might be done is by subjecting to critical scrutiny the assumption that the U.K. has an outsider/arm's-length system of ownership and control. While Britain is typically grouped together with the United States as a country where widely held companies dominate the corporate economy, ownership of corporate equity is more concentrated in the U.K. than it is in the U.S.<sup>273</sup> Possibly, then, Britain has been miscast as an outsider/arm's-length country. If this is in fact the case, then its manager-displacing bankruptcy regime would align with its system of ownership and control in the manner that the evolutionary theory predicts.

The collective ownership stake of institutional investors (e.g., pension funds, insurance companies, and the British equivalents of mutual funds, referred to as investment trusts and unit trusts) highlights why it should not be taken for granted that U.K. corporate governance functions on an outsider/arm's-length basis. In the United States, institutional shareholders own approximately 50% of the shares of the country's publicly quoted companies, with the remainder held directly by individual investors.<sup>274</sup> In the U.K., in contrast, the equivalent figure is more than 70%.<sup>275</sup> Correspondingly, with companies lacking a "core" shareholder, the potential for control by a

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273. Black & Coffee, *supra* note 78, at 2002; CHEFFINS, *supra* note 115, 638-39.

274. Brian R. Cheffins, *Michaud v. National Bank of Canada and Canadian Corporate Governance: A "Victory" for Shareholder Rights*, 30 CAN. BUS. L.J. 20, 52 (1998).

275. REPORT OF THE COMMITTEE ON CORPORATE GOVERNANCE, ¶ 5.1 (1998); Laura Colby, *Investment Militants*, INSTITUTIONAL INVESTOR, Apr. 1999, at 28.

group of institutions should be greater in Britain than it is in the U.S. Sociologist John Scott, for instance, has cited institutional ownership to argue that in U.K. public companies where there is not a dominant owner, control exists by a "constellation of interests."<sup>276</sup> Moreover, Geof Stapledon, an Australian legal academic, has asserted in a study of institutional investors in Britain and Australia that "the highly diffuse ownership structure described by Berle and Means [does] not exist in the vast majority of quoted U.K. . . . companies."<sup>277</sup>

Aside from the fact that institutional shareholders in the U.K. own a higher overall percentage of corporate equity than their counterparts in the U.S., in other ways the conditions in Britain are better suited for such investors to exercise control on a coordinated basis. One consideration is ownership concentration. In Britain, it is common for a company's twenty-five largest institutional investors to own a majority of the shares. In the U.S. the same number of institutions will typically only own about one-third of the equity in a corporation.<sup>278</sup> This concentration means it will be easier in Britain to form a coalition that has voting power sufficient to get management's attention.<sup>279</sup>

The legal environment is also potentially significant. In the U.S., securities law imposes certain constraints and restrictions on investors that impede the formation of institutional coalitions in relation to particular corporations.<sup>280</sup> In Britain, communication between financial institutions that own corporate equity is largely unregulated.<sup>281</sup>

While the differences between Britain and the U.S. need to be acknowledged, it is one thing to point to the potential for control in the U.K. and another to say that this prospect is turned into reality on any sort of consistent basis.<sup>282</sup> Admittedly, it does seem that

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276. SCOTT, *supra* note 12, at 48-50, 83-89; John Scott, *Corporate Control and Corporate Rule: Britain in an International Perspective*, 41 BRIT. J. SOC'Y 351, 354-55, 359-65 (1990).

277. G.P. STAPLEDON, INSTITUTIONAL SHAREHOLDERS AND CORPORATE GOVERNANCE 10 (1996); *see also* John Holland, *Financial Reporting*, INSTITUTIONAL INVESTOR, June 1998, at 27; Paul Davies, Shareholder Value, Company Law and Securities Markets Law 12-13 (2001) (unpublished manuscript, on file with authors).

278. CHEFFINS, *supra* note 115, at 638-39. For similar figures focusing on the five largest holdings, *see* Julian Franks et al., *Who Disciplines Management in Poorly Performing Companies*, 10 J. FIN. INTERMEDIATION 209, 219 (2001).

279. CHEFFINS, *supra* note 115, at 638-39; John C. Coffee, *The SEC and the Institutional Investor: A Half-Time Report*, 15 CARDOZO L. REV. 837, 852-53 (1994).

280. *See, e.g.*, BLACK, *supra* note 8, at 461 (expressing doubts, however, on the importance of law); Coffee, *supra* note 279, at 877-82.

281. STAPLEDON, *supra* note 277, at 271-72.

282. Paul Davies, *Institutional Investors in the United Kingdom*, in CONTEMPORARY ISSUES IN CORPORATE GOVERNANCE 69, 82 (D.D. Prentice & P.R.J. Holland eds., 1993).

institutional investors in the U.K. are more inclined to exercise influence on a joint basis than their American counterparts. An "activist" institutional investor in the U.S. will typically pursue its own agenda and act as a "lone wolf" or "Lone Ranger."<sup>283</sup> In contrast, in Britain, it is by no means extraordinary for institutional shareholders to coordinate their efforts and deal with corporate management on some sort of collective basis.<sup>284</sup> Also, if a U.K. public company has an unhealthy balance sheet and is seeking to correct matters by issuing fresh equity to existing shareholders (a "rights issue"), institutions owning equity will quite often require a management shake-up before agreeing to purchase additional shares.<sup>285</sup> Such demands typically will be taken very seriously since "the time you really get a chance to have an influence on the company is if they want money."<sup>286</sup>

Still, on balance, it remains fair to characterize the predominant approach to corporate governance in the U.K. as outsider/arm's-length.<sup>287</sup> For instance, the special case of companies with unhealthy balance sheets does not provide adequate grounds for disqualifying Britain from this category. Shareholder discipline is also tightened in the U.S. in such firms, albeit more often via the purchase of share blocks by potentially active investors than by way of conditions attached to the provision of new equity financing.<sup>288</sup>

More generally, a review of institutional investment commissioned by the U.K. government and conducted by Paul Myners provides strong evidence that an outsider/arm's-length verdict is appropriate for Britain. Myners, whose report was published in 2001, acknowledged that in the past few years there had been a considerable movement toward an activist stance by institutional investors.<sup>289</sup> Still,

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283. BLACK, *supra* note 8, at 461; John C. Coffee, Jr., *The Folklore of Investor Capitalism*, 95 MICH. L. REV. 1970, 1977-78 (1997).

284. STAPLEDON, *supra* note 277, at 125-27; Black & Coffee, *supra* note 78, at 2050-52; cf. JOHN HOLLAND, THE CORPORATE GOVERNANCE ROLE OF FINANCIAL INSTITUTIONS IN THEIR INVESTEE COMPANIES 34-36 (1995) (ACCA Research Report, No. 46).

285. STAPLEDON, *supra* note 277, at 129-30; Franks et al., *supra* note 278, at 210-11, 228, 245-46; Julian R. Franks & Sergey V. Sanzhar, Equity Issues by Distressed Firms 2 (2002) (unpublished manuscript, on file with authors).

286. Quoted in STAPLEDON, *supra* note 277, at 129. For similar quotes, see Franks et al., *supra* note 278, at 228.

287. See, e.g., STAPLEDON, *supra* note 277, at 231, 253, 279 (questioning whether the Berle-Means corporation is dominant in the U.K., but concluding that the ultimate controllers of U.K. companies are arm's-length shareholders).

288. Franks et al., *supra* note 278, at 242-43; Triantis & Daniels, *supra* note 108, at 1086.

289. PAUL MYNERS, INSTITUTIONAL INVESTMENT IN THE UK: A REVIEW 89 (2001). On this trend, see also John Parkinson, *Evolution and Policy in Company Law: The Non-Executive Director in THE POLITICAL ECONOMY OF THE COMPANY*, *supra* note 108, at 233, 239 n.27; Annie

he said the initiatives taken by those acting on behalf of the institutions left much to be desired. To quote from the report:

It remains widely acknowledged that concerns about the management and strategy of major companies can persist among company analysts and fund managers for long periods of time before action is taken.<sup>290</sup>

According to Myners, this pattern was prevalent because interventionist strategies were unlikely to deliver the quick results financial professionals desired and because there was a culture in the investment community of wanting to avoid confrontations with companies.<sup>291</sup> Also pertinent were potential conflicts of interest, stemming primarily from the fact that an institutional investor would not want to acquire a reputation as a governance "troublemaker" when an affiliate was offering investment banking services to corporate clients.<sup>292</sup>

The Myners Report's verdict on institutional passivity is consistent with views expressed by other observers. Paul Davies, currently a professor at the London School of Economics, wrote in 1991 that a "systematic and continuous relationship between institutional shareholders and management had yet to evolve."<sup>293</sup> Jack Coffee and Bernard Black, two U.S. law professors, noted in a 1994 article on Britain that "the complete passivity announced by Berle and Means" was absent but remarked upon "the reluctance of even large shareholders to intervene."<sup>294</sup> According to a 1995 research report on institutional investors, there was some intervention on specific corporate governance issues (e.g., executive remuneration and the separation of the chairman of the board of directors and the chief executive), but institutions only second-guessed managerial strategy formulation in the event of a crisis.<sup>295</sup> A 1998 survey of the financial directors of the U.K.'s one hundred largest companies indicated that while routine questioning of management by financial professionals

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Pye, *Corporate Boards, Investors and Their Relationships: Accounts of Accountability and Corporate Governing in Action*, 9 CORP. GOV.: INT'L REV. 186 (2001).

290. MYNERS, *supra* note 289, at 89. For anecdotal evidence supporting this view, see David Blackwell & Francesco Guerrera, *Dancing to the Music of Shareholders' Discontent*, FIN. TIMES (London), June 22, 2000, at 31.

291. MYNERS, *supra* note 289, at 91. For more on the institutional investment "culture," see Alan Clements, *Cadbury: Owners Must Speak*, FIN. TIMES (London), Dec. 18, 1995, at 10. For further background on why U.K. institutional investors are reluctant to intervene, see generally Parkinson, *supra* note 289, at 239-40; Helen Short & Kevin Keasey, *Institutional Shareholders and Corporate Governance in the United Kingdom*, in CORPORATE GOVERNANCE: ECONOMIC AND FINANCIAL ISSUES 18, 26-38 (Kevin Keasey et al. eds., 1997).

292. MYNERS, *supra* note 289, at 91.

293. Paul L. Davies, *Institutional Investors: A U.K. View*, 57 BROOK. L. REV. 129, 139 (1991).

294. Black & Coffee, *supra* note 78, at 2086.

295. HOLLAND, *supra* note 284, at 34-36, 43-46.



was becoming more common, “[S]hareholders rarely . . . tried to use their muscle to make changes behind the scenes.”<sup>296</sup> Finally, two recent studies by financial economists cast doubt on the monitoring role played by institutional shareholders. One reveals that the presence or absence of a pension fund owning three percent or more of a company’s outstanding equity makes no difference to corporate performance,<sup>297</sup> and the other indicates that institutions owning large blocks of shares do not accelerate management turnover in poorly performing companies.<sup>298</sup>

Given the available evidence, the verdict on U.K. institutional investors offered by a columnist in the *Financial Times* newspaper in 1997 appears apt: “A certain very British reserve . . . unmistakably remains.”<sup>299</sup> Correspondingly, despite the potential for control by institutional shareholders, Britain is correctly classified as a country with an outsider/arm’s-length corporate economy. It follows, in turn, that recategorizing the U.K.’s system of ownership and control is not a convincing way to bring the British experience into line with the thesis that a manager-driven bankruptcy regime is integrally related to a corporate economy dominated by widely held companies.

#### VI. REASSESSING THE U.K.’S CORPORATE BANKRUPTCY REGIME: IS IT “MANAGER-DRIVEN” IN PRACTICE?

As we have now seen, English corporate insolvency law is strongly manager-displacing, and the U.K.’s system of ownership and control is properly classified as outsider/arm’s-length. Yet, because examining bankruptcy law “on the books” does not yield a full account of the way in which financial distress is addressed in U.K. companies, it would be premature to conclude that the evolutionary hypothesis, as originally configured, is falsified with respect to Britain. Instead, firms that actually end up bankrupt under the Insolvency Act 1986 are just the tip of the proverbial iceberg. While there will be companies that cease to function after financial distress, there will also be others

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296. Jane Martinson, *Shares in the Action*, FIN. TIMES (London), Apr. 27, 1998, at 21 (discussing the results of a survey conducted by the *Financial Times*).

297. Mara Faccio & M. Ameziane Lasfer, *Do Occupational Pension Funds Monitor Companies in Which They Hold Large Stakes?*, 6 J. CORP. FIN. 71 (2000).

298. Rafel Crespi-Cladera & Luc Renneboog, *United We Stand: Corporate Monitoring by Shareholder Coalitions in the UK 19 (2002)* (unpublished manuscript, on file with authors); see also Franks et al., *supra* note 278, at 228, 233, 245.

299. *Challenging Chaps* (Lex Column), FIN. TIMES (London), Nov. 10, 1997, at 20.

where a "workout" will be successfully negotiated, and potentially profitable trading will be able to resume.<sup>300</sup>

Statistical evidence suggests that informal workouts are of particular importance in a British context. On average 3.65% of U.S. corporations went into bankruptcy proceedings during any given year during the 1990s. The equivalent figure for Britain was only 1.85%.<sup>301</sup> It seems unlikely that a disparity of this sort occurred as a result of U.S. companies encountering financial distress more often than their U.K. counterparts, particularly since American macroeconomic conditions were, if anything, better than Britain's during the 1990s.<sup>302</sup> A more plausible explanation is that financially distressed companies in the U.S. are more likely to initiate formal bankruptcy proceedings than their British counterparts. Empirical evidence indicating that publicly quoted firms in the U.K. that suffer this fate are poorer performers (in terms of equity returns over the years preceding filing) than their U.S. counterparts suggests such is probably the case.<sup>303</sup>

Why, all else being equal, are financially distressed companies in the U.K. less likely to end up in formal bankruptcy proceedings? One plausible explanation for the disparity is that American law offers more scope for a corporate rescue than its English counterpart. Correspondingly, worthwhile turnaround candidates are dealt with under formal bankruptcy procedures much more frequently in the U.S. than in Britain.<sup>304</sup> To elaborate, in the U.S., for a corporation that enters Chapter 11, managers continue to run the business, and some type of rehabilitation effort typically will be contemplated. In the U.K., on the other hand, the invocation of corporate insolvency law has typically been treated as the end of the road for a company.<sup>305</sup> Formal

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300. See generally David Clementi, *Debt Workouts for Corporates, Banks and Countries: Some Common Themes*, 11 FIN. STABILITY REV. 203, 204-05 (2001); Pen Kent, *Corporate Workouts—A UK Perspective*, 6 INT'L INSOLVENCY REV. 166 (1997).

301. Stijn Claessens & Leora Klapper, *Bankruptcy Around the World: Explanations of its Relative Use*, at 27 (June 2002) (unpublished paper, on file with authors).

302. One consideration might be that British companies are less highly leveraged than those in America, but the difference seems small compared to the disparity in corporate bankruptcy rates. See Raghuram G. Rajan & Luigi Zingales, *What Do We Know about Capital Structure? Some Evidence from International Data*, 50 J. FIN. 1421, 1428-30, 1438 (1995).

303. VAUGHN S. ARMSTRONG & LEIGH A. RIDDICK, EVIDENCE THAT DIFFERENCES IN BANKRUPTCY LAW AMONG COUNTRIES AFFECT EQUITY RETURNS (Kogod Sch. of Bus., Amer. Univ. Working Paper, Nov. 2000).

304. Recently, though, the trend has been in favor of liquidation in the U.S. Riva D. Atlas, *A Trend Toward Liquidation, Not Company Reorganization*, N.Y. TIMES, Nov. 30, 2001, at C1.

305. As noted earlier, *supra* notes 150-51, U.S. managers frequently are replaced during the course of Chapter 11 cases. But, at least initially, they retain control, whereas in the U.K., managers lose control as a matter of course once formal bankruptcy procedures are initiated. See *supra* notes 222-24, 250-52 and accompanying text.

bankruptcy proceedings are thus not a hospitable forum for the rehabilitation of financially distressed but potentially viable companies. Admittedly, the administration procedure discussed in Part IV is designed to assist efforts to save companies. There has, however, been an "abnormally low incidence of usage" of this procedure.<sup>306</sup>

Debt structure likely constitutes another factor that creates a bias in favor of informal workouts in the U.K.. To understand why, a bit of background is required.<sup>307</sup> All else being equal, the transaction costs associated with an informal debt workout should increase with the number of creditors involved since the collective-action difficulties will be greater. This prediction is borne out by a range of studies on financially distressed companies that show a private renegotiation is more likely to be attempted where debt is concentrated in the hands of relatively few lenders.<sup>308</sup>

Let us turn now to the U.S. and the U.K. In the U.K., bank loans are the dominant form of corporate borrowing.<sup>309</sup> Public issues of loan capital, comprising unsecured debt or debentures secured by means of a charge on corporate assets,<sup>310</sup> have typically not been a major source of external finance.<sup>311</sup> In contrast, in the U.S., a public market for the equivalent form of debt, referred to as "bonds," is well established and is important for larger corporations seeking to raise cash.<sup>312</sup>

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306. FLETCHER, *supra* note 190, at 479. This is also the case with company voluntary arrangements, another potential rescue alternative available under the Insolvency Act 1986. See GOODE, *supra* note 211, at 335.

307. See Robert A. Haugen & Lemma W. Senbet, *The Significance of Bankruptcy Costs to the Theory of Optimal Capital Structure*, 33 J. FIN. 383 (1978).

308. Sris Chatterjee et al., *Resolutions of Financial Distress: Debt Restructurings via Chapter 11, Prepackaged Bankruptcies, and Workouts*, 25 FIN. MGMT. 5, 12-13 (1996) (noting that firms with complex debt structure are less likely to propose a workout); Stuart C. Gilson et al., *Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default*, 27 J. FIN. ECON. 315, 354 (1990) (finding that distressed firms with high levels of public debt are less likely to achieve workouts). *But see* Julian R. Franks & Walter N. Torous, *A Comparison of Financial Recontracting in Distressed Exchanges and Chapter 11 Workouts*, 35 J. FIN. ECON. 349 (1994) (finding that financially distressed firms with bank debt are no more likely to achieve workout than those with public debt).

309. Corbett & Jenkinson, *supra* note 24, at 82-83; Peter Brierley & Gertjan Vleighe, *Corporate Workouts, the London Approach and Financial Stability*, 7 FIN. STABILITY REV. 168, 175 (1999); ALAN BEVAN & JO DANBOLT, *DYNAMICS IN THE DETERMINANTS OF CAPITAL STRUCTURE IN THE UK* (Univ. of Glasgow Dept. of Acct. & Fin., Working Paper Series, 2000).

310. On the terminology, see ANDREW ADAMS, INVESTMENT 67-68 (1989).

311. ROGER LISTER & ELIZABETH EVANS, *THE CORPORATE BORROWING DECISION* 92 (1988) (describing the unsophisticated efforts at "bond rating" in the U.K.); Corbett & Jenkinson, *supra* note 24, at 82-83.

312. Jenny Corbett & Tim Jenkinson, *German Investment Financing: An International Comparison*, in *COMPETITION AND CONVERGENCE IN FINANCIAL MARKETS* 101, 113-16 (Stanley

One should not overestimate the extent to which debt is concentrated in Britain. Notably, U.K. public companies do not borrow primarily from a main bank. Instead, the loans in question will typically be syndicated, since banks need to comply with regulatory requirements limiting the maximum size of any single loan relative to bank capital and want to diversify the default risk associated with lending very large sums.<sup>313</sup> Still, even syndicated debt is unlikely to be as diffusely held as corporate bonds.<sup>314</sup> Correspondingly, for the typical publicly quoted company, debt will be more concentrated in the U.K. than it is in the U.S. It follows that private debt workouts are more likely to be feasible in Britain.

One of the authors of this Article has, in an empirical study, investigated the informal processes invoked when financial distress compels large U.K. companies to carry out debt restructuring.<sup>315</sup> One key finding was that, while each restructuring does differ in certain respects, there is a striking degree of homogeneity in the way in which private debt restructuring is approached. More precisely, in most instances negotiations about debt "workouts" for large U.K. companies are structured in accordance with what is known in the banking community as the "London Approach."<sup>316</sup>

The London Approach is relevant to our analysis, because it may offer to U.K. companies a manager-friendly substitute to formal bankruptcy law. To the extent it does so, the U.K. would fall more closely into line with what the evolutionary theory would predict. Again, the law on the books suggests that Britain is a manager-displacing jurisdiction,<sup>317</sup> which does not fit with the evolutionary theory because the country has a dispersed share ownership structure. On the other hand, if an informal process such as the London

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W. Black & Mathias Moersch eds., 1998) (documenting greater use of bonds finance by U.S. firms than British firms during the period from 1970 to 1994); William R. Emmons & Frank A. Schmid, *Corporate Governance and Corporate Performance*, in *CORPORATE GOVERNANCE AND GLOBALIZATION* 59, 78 (Stephen S. Cohen & Gavin Boyd eds., 1998) ("Simply put, firms in the United States and Canada issue significant amounts of bonds but nowhere else in the G7 countries is this true."); Corbett & Jenkinson, *supra* note 24, at 84-85; McLaughlin, *supra* note 32; Saidenberg & Strahan, *supra* note 24, at 1.

313. Steven A. Dennis & Donald J. Mullineaux, *Syndicated Loans*, 9 *J. FIN. INTERMEDIATION* 404, 407-408 (2000); *see also supra* note 237 and accompanying text (discussing syndicated loans).

314. Dennis & Mullineaux, *supra* note 313, at 404-05.

315. John Armour & Simon Deakin, *Norms in Private Insolvency: The 'London Approach' to the Resolution of Financial Distress*, 1 *J. CORP. L. STUD.* 21 (2001).

316. *Id.* The London Approach has also been widely documented in the practitioner literature. *See, e.g.*, Pen Kent, *The London Approach*, 33 *BANK OF ENG. Q.B.* 110 (1994); T.H. DONALDSON, *MORE THINKING ABOUT CREDIT* 44-69 (1995).

317. *See supra* Part IV.

Approach is a pivotal manager-driven substitute for formal bankruptcy proceedings, then Britain should no longer be a "problem child" for the evolutionary theory.

To explain what happens in a London Approach workout, let us reconsider the last stylized example we referred to in Section IV.<sup>318</sup> Recall that this hypothetical involves a large company with publicly quoted shares that has borrowed from banks by way of unsecured syndicated loans and also has some debt that is secured via security interests over specified assets. The company has now become financially distressed and the banks are aware of this. Unless the situation is obviously hopeless, the banks will likely organize a London Approach workout.

Invocation of the London Approach typically involves two distinct phases.<sup>319</sup> First, the banks who have participated in the syndicated loans will agree amongst themselves to a "standstill," during which no enforcement actions will be taken against the corporate debtor. This informal moratorium will last for a relatively short period of time—measured in months—during which a team of accountants, appointed by the banks, will investigate the company's finances. If the team determines that the underlying business is not viable as a going concern, then bankruptcy proceedings—usually administration—will commence.<sup>320</sup> On the other hand, if the accountants ascertain that key aspects of the company are sound enough to resume profitable trading in due course, the workout will move to the second stage.

The second stage of the London Approach consists of the negotiation and implementation of a restructuring plan. A "lead bank"—typically the bank with the largest exposure<sup>321</sup>—will coordinate the rescue effort and act as a conduit for information from the company and the investigating accountants to other participating lenders, and vice versa.<sup>322</sup> Assuming that our company reaches the

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318. See *supra* note 237 and accompanying text. Even more so than in earlier examples, it should be noted that actual practice in any given instance may vary widely from the highly stylized facts set out in the text.

319. See generally *Armour & Deakin, supra* note 315, at 34-35; *Kent, supra* note 300, at 172-173.

320. Often a subsection of the firm's business will not be economically viable. However, it is usually possible to liquidate the relevant assets or subsidiary company without putting the rest of the group into insolvency proceedings.

321. In larger cases, the role of lead bank will be shared among a "steering committee" composed of several banks drawn from a range of constituencies.

322. The terminology is borrowed from that used in arranging syndicated loans. Syndicated bank loans are usually structured so that initial negotiations with the debtor are carried out with only one bank, which then solicits participations from other banks in the marketplace. The

second stage of the London Approach, various outcomes might follow. One possibility is a financial reorganization designed to restructure the debt burden. Typically, any reductions in return ("haircuts") that banks agree to take as a result will be divided pro rata in proportion to expected returns in a hypothetical liquidation judged from the time of the commencement of the standstill. More radically, the company might face sweeping operational restructuring and/or a program of divestment designed to raise cash. Since the initiation of the London Approach is typically kept secret, with the key participants entering confidentiality agreements, our company's trade creditors, employees, and individual shareholders probably would be unaware of the attempted rescue unless and until these sorts of activities are undertaken.

The key to the success of a London Approach renegotiation is that, primarily via reputational sanctions that apply to "repeat players," bank participants adhere to the "rules."<sup>323</sup> To be more precise, with respect to the standstill that marks the first stage of the London Approach, the banks will fall into line with respect to a particular company even when they might do better by immediate enforcement.<sup>324</sup> Furthermore, the banks will not undermine the distributional norm of pro rata allocation by engaging in "holdout" strategies designed to extract a larger slice of the pie. To the extent that they do squabble over who gets what, their dispute will be disguised as disagreements about appropriate valuations or about the legal priorities in insolvency. The result is that the lead bank should be well situated to negotiate with the financially troubled company as the agent for all of the bank lenders.

A London Approach rescue effort has certain similarities with a reorganization conducted under Chapter 11. For example, both are debtor-in-possession procedures, since the directors of the financially troubled company will continue to manage the company throughout the restructuring. Also, the primary objective in both is to reverse the fortunes of a financially troubled company. Moreover, in most rescues carried out under the London Approach and Chapter 11, key creditors

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institution performing this function is referred to as the "lead bank." See generally PHILIP R. WOOD, *INTERNATIONAL LOANS, BONDS AND SECURITIES REGULATION* (1995).

323. Various explanations for participants' adherence to the London Approach norms are considered in Armour & Deakin, *supra* note 315, at 40-46.

324. This might be the case, for example, where a minor participant in a syndicated loan is also a major secured lender to a particular trading subsidiary. Adherence to the standstill will mean that the creditor cannot enforce its security, which will restrict its ability to realize the optimum value for its collateral.

receive a lower return and/or are paid later than was originally agreed.

Still, while there are similarities between Chapter 11 and the London Approach, the latter is not manager-driven in the same way as the former. With Chapter 11, a company's executives can commence the procedure themselves and invoke a judicially administered automatic stay. Management can therefore create breathing space for a rescue regardless of skepticism on the part of the creditors.

Under the London Approach, the situation is considerably different. With this procedure, while managers will take the initial step to notify banks of their desire to achieve a workout, they will not be able to do anything without the cooperation of the lenders. Correspondingly, British executives cannot invoke the London Approach in a strategic fashion to keep creditors at bay in the same way that their U.S. counterparts can with Chapter 11.<sup>325</sup> Also, while the Chapter 11 process is judicially administered and can only be terminated by court order,<sup>326</sup> with a London Approach rescue, participating banks can decide collectively to abandon the plan at any point and petition for administration or liquidation. The managers who are sidelined as a result of such a choice have no effective recourse.<sup>327</sup>

It is worth noting that banks that have entered into a London Approach rescue will not reverse the choice lightly. The primary deterrent is that abandoning the privacy of a London Approach in favor of formal bankruptcy proceedings will probably constitute a highly negative signal that will cause the value of the troubled company's assets to drop precipitously.<sup>328</sup> Still, even though banks will hesitate before authorizing a switch out of the London Approach, the fact remains that managers of a financially troubled company are

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325. This suggests that managers are more likely to be displaced in the early stages of a London Approach rescue than in U.S. Chapter 11. Because of the secrecy of the London Approach process, however, it is impossible to do more than speculate on the point.

326. 11 U.S.C. § 1121 (2000) (providing conditions for conversion or dismissal).

327. An administrative receivership is unlikely to occur since publicly quoted companies rarely grant floating charges. See *supra* note 238 and accompanying text.

328. For evidence from the U.S. that the magnitude of these so-called indirect costs of bankruptcy are of a very high order of magnitude, see Gongmeng Chen & Larry J. Merville, *An Analysis of the Underreported Magnitude of the Total Indirect Costs of Bankruptcy*, 13 REV. QUANTITATIVE FIN. & ACCT. 277 (1999); David M. Cutler & Lawrence H. Summers, *The Costs of Conflict Resolution and Financial Distress: Evidence from the Texaco-Pennzoil Litigation*, 19 RAND J. ECON. 157 (1988).

more dependent on creditor goodwill under the London Approach than under Chapter 11.<sup>329</sup>

The greater vulnerability of managers under the London Approach is made more acute by an additional factor: the involvement of shareholders. Those owning equity will want any sort of corporate rescue to succeed because they will receive nothing if a company is liquidated with its liabilities exceeding its assets.<sup>330</sup> It may be, however, that a financially troubled firm will need an injection of cash to have a serious chance of resuming profitable trading. In the U.K., a potentially important source of funding in this context will be a rights issue, which involves a fresh issue of shares to existing investors.<sup>331</sup> As we have seen, though, when a financially distressed company conducts a rights issue, institutional shareholders will often require a management shake-up before agreeing to participate.<sup>332</sup> Correspondingly, executives who might otherwise be able to keep their jobs during a London Approach workout could be terminated as a result of institutional activism.

In conclusion, a holistic appraisal of the options facing a U.K. publicly quoted company that is financially distressed requires that account be taken of informal restructuring. Under the London Approach, which is the procedure most often invoked with troubled large business enterprises, incumbent executives can usually anticipate remaining in office so long as the banks that are participating have faith in the management team. Hence, Britain is not as unfriendly to executives of financially distressed companies as Part IV's review of the law on the books implies.

Still, while taking into account informal workouts justifies a partial reappraisal of the regime governing financially distressed companies in the U.K., it would be going too far to label Britain as a manager-driven jurisdiction. The key point is that executives in U.K. companies lack sufficient control over the procedures that can be invoked in the event of financial distress to justify any such conclusion. In Britain, managers of a financially troubled company are obliged to stand to one side if creditors choose to rely on an

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329. We do not mean to suggest that creditors are completely without influence under Chapter 11. On the leverage that creditors have, see *supra* notes 148-49 and accompanying text (discussing constraints on managers of Chapter 11 corporations).

330. In a typical London Approach workout, old equity will retain about 15% of the firm's value. Armour & Deakin, *supra* note 315, at 36.

331. Franks & Sanzhar, *supra* note 285, at 3, tbl. 1 (documenting that over the period from 1989 to 1998, approximately 3.5% of seasoned equity issues by U.K. public companies were "distressed"; the issue prospectus suggested that the company would not otherwise be able to continue as a going concern).

332. *Supra* note 285 and accompanying text.



administrator, if an administrative receiver is appointed, or if a successful petition for winding up is made.<sup>333</sup> Under the London Approach, while senior executives typically retain their posts, the banks that participate always have the option of terminating the procedure and resorting to formal bankruptcy proceedings. Also, if fresh funds are being sought from existing shareholders, key investors may require a managerial shake-up before they will proceed. The upshot is that even once the London Approach is taken into account, Britain is considerably less manager-friendly than the evolutionary theory would predict for a country with dispersed share ownership. The U.K., then, remains a "problem child," which implies that the theory should be recast. The next section of this Article takes up this task.

#### VII. DEFINING THE EVOLUTIONARY THESIS IN LIGHT OF THE U.K. EXPERIENCE

In the last three sections, we have explored British corporate governance through the lens of the evolutionary thesis. Once we moved beyond a black-letter account of the insolvency regime in the U.K. and looked at the treatment of financially distressed companies in practice, some of the initial puzzles disappeared—but not all. Britain, then, remains a somewhat awkward fit for the evolutionary theory of corporate governance and corporate bankruptcy. To bring matters into line, we must either adjust the theory or demonstrate that the U.K. is an aberration.

Toward the end of this section, we suggest a statistical test that could be employed to discover whether the U.K. is an outlier.<sup>334</sup> First, however, we take a different approach. We begin by reconfiguring the evolutionary theory in the light of the British experience. The key addition to our analysis is a richer account of the relationship between equity and debt in a company's capital structure. As noted earlier, the corporate governance literature has tended to focus principally, and at times exclusively, on stock and stockholders.<sup>335</sup> Our analysis of the London Approach suggests, however, that the nature of a firm's debt—in particular, whether the debt is concentrated or diffuse—may also have crucial governance implications. It is this insight—the need to incorporate debt structure

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333. See *supra* notes 222-24, 250-52 and accompanying text.

334. See *infra* notes 405-11 and accompanying text.

335. See *supra* notes 107-08 and accompanying text.

more fully into the analysis—that serves as the starting point for the reconfiguration of the evolutionary thesis that follows.

*A. Adding Debt Structure to the Evolutionary Theory*

When seeking to bring the concentration or diffusion of debt into the corporate governance equation, it is helpful to use equity structure as a reference point. Let us begin with firms with concentrated share ownership. The tendency here will be for there to be a relatively small number of debtholders. The reasoning is as follows. If a dominant faction holds a controlling block of shares, these shareholders will either hold key executive positions or will be able to exercise considerable influence over the management team.<sup>336</sup> This coordination of ownership and control can reduce managerial agency costs,<sup>337</sup> but it can also magnify conflicts of interest between shareholders and creditors (financial agency costs). Why might this be the case? The key problem is that concentrated shareholders can expropriate value from the firm's debtholders by increasing the riskiness of the firm or by taking other actions that benefit equity at the expense of debt.<sup>338</sup> Concentrated debt will create informational and monitoring advantages for key lenders and thus will function as a check on such behavior.<sup>339</sup> In contrast, if a firm's debtholders are scattered,<sup>340</sup> collective-action problems will hamper the disciplining of dominant blockholders. It follows that there is an affinity between concentrated equity and concentrated debt ("CE/CD"), whereas the combination of concentrated equity and diffuse debt ("CE/DD") creates a mismatch that can exacerbate the agency costs associated with debt.<sup>341</sup>

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336. According to La Porta et al., *supra* note 6, at 500, in 69% of large, family-owned corporations, family members participate in management.

337. See *supra* notes 165-66 and accompanying text.

338. For other examples of financial agency costs, see sources cited *supra* notes 114-18.

339. CAMPBELL R. HARVEY ET AL., THE EFFECT OF CAPITAL STRUCTURE WHEN EXPECTED AGENCY COSTS ARE EXTREME (Nat'l Bureau of Econ. Res., Working Paper No. 8452, 2001) (providing an empirical study of emerging market firms using stock pyramids and showing the value of concentrated debt as a monitoring mechanism).

340. We should emphasize that the diffusion is relative. Even in the U.S., holdings of publicly issued debt tend to be more concentrated than stock. See, e.g., Marcel Kahan, *The Qualified Case Against Mandatory Terms in Bonds*, 89 NW. U. L. REV. 565, 583-86 (1995) (stating that institutional investors hold most corporate bonds).

341. For a model that reaches similar conclusions about the relationship between debt and equity in a firm's capital structure, see Jan Mahrt-Smith, *The Interaction of Capital Structure and Ownership Structure* (May 2000) (unpublished manuscript, on file with authors). Other important articles addressing the trade-off between concentrated and dispersed debt include: Patrick Bolton & David S. Scharfstein, *Optimal Debt Structure and the Number of Creditors*, 104 J. POL. ECON. 1 (1996) and ARTURO BRIS & IVO WELCH, THE OPTIMAL CONCENTRATION OF

This argument should not be overstated. Financial agency costs will not go entirely unchecked if a firm with concentrated equity issues diffuse debt. For instance, if controlling owners want to raise debt publicly in the future, reputational constraints will help deter them from extracting excessive benefits.<sup>342</sup> As one investment banker has said, "The practical implications [of reputation] are that if borrowers have treated bondholders fairly in the past, it is more likely that bondholders will be supportive in the future."<sup>343</sup> Contractual terms also play a role.<sup>344</sup> For instance, debentures that a corporation issues can restrict the borrower's right to issue dividends and can require it to comply with designated financial ratios.<sup>345</sup> In addition, such instruments typically provide that an indenture trustee will act as intermediary on behalf of the debtholders. This arrangement facilitates monitoring and enforcement and thereby addresses some of the collective-action problems noted above.<sup>346</sup> Still, since trustees suffer from infirmities that constrain their ability to regulate the conduct of corporate borrowers,<sup>347</sup> it is reasonable to infer that a

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CREDITORS (Nat'l Bureau of Econ. Res., Working Paper No. 8652, 2001). Both Bolton and Scharfstein's and Bris and Welch's models differ from our analysis in that they assume that the company has only a single manager-shareholder and thus do not consider the interaction between concentrated or diffuse equity and the structure of the company's debt.

342. RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 520 (6th ed. 2000) ("A firm or individual that makes a killing today at the expense of a creditor will be coldly received when the time comes to borrow again."); cf. Lucian Bebchuk et al., *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, in *CONCENTRATED CORPORATE OWNERSHIP* 295, 305-06 (Randall K. Morck ed., 2000) (making the same argument in relation to equity).

343. Aline van Duyn, *Investors in Bonds Ask Companies for a Little Respect*, FT FUND. MGMT., May 13, 2002, at 3 (quoting Karl Bergqvist, head of credit investment at Barclays Capital).

344. On U.S. practices, see, e.g., Joanne C. Duke & Herbert G. Hunt III, *An Empirical Examination of Debt Covenant Restrictions and Accounting-Related Debt Proxies*, 12 J. ACCT. & ECON. 45 (1990); Morey W. McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW. 413 (1986); Clifford W. Smith & Jerrold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117 (1979). On U.K. practices, see, e.g., Martina Asmar & John Cowan, *Convertible and Exchangeable Bonds*, PRACT. L. CO., June 2001, 21, 28-31; David B. Citron, *Financial Ratio Covenants in UK Bank Loan Contracts and Accounting Policy Choice*, 22 ACCT. & BUS. RES. 322, 326 (1992); Judy F.S. Day & Peter J. Taylor, *Evidence on the Practice of UK Bankers in Contracting for Medium-term Debt*, J. INT'L BANKING L. 394, 397 (1995).

345. See, e.g., Citron, *supra* note 344, at 323-24; Day & Taylor, *supra* note 344, at 397-98; Avner Kalay, *Stockholder-Bondholder Conflict and Dividend Constraints*, 10 J. FIN. ECON. 211, 214-16 (1982).

346. For an optimistic appraisal of what trustees might do, see Yakov Amihud et al., *A New Governance Structure for Corporate Bonds*, 51 STAN. L. REV. 447, 469-92 (1999) (describing the duties and powers of a hypothetical "supertrustee").

347. In the U.S., for instance, indenture trustees engage in very little meaningful monitoring, since their powers are limited by the Trust Indenture Act of 1939. 15 U.S.C. § 77 (2000). In the U.K., where the law is more liberal, trustees are nevertheless normally

company with concentrated ownership will be able to obtain debt financing more readily from a small group of lenders than from the market at large.<sup>348</sup>

In comparison with insider-controlled firms, firms with diffuse share ownership should rely less on bank lenders and more on publicly issued debt. To rephrase, there should be a general tendency toward dispersed equity and diffuse debt ("DE/DD"). One reason is the transaction costs associated with tapping public markets. All else being equal, a corporation that relies on financial intermediaries to distribute equity to the public and which conforms with regulatory requirements associated with having publicly quoted shares should not find it unduly burdensome to do the same with regard to debt, and vice versa.<sup>349</sup>

The dynamics associated with monitoring will also be pertinent. Again, for companies with a major blockholder, concentrated debt can be a valuable counterweight against the threat of expropriation by the dominant faction. If managers stand to benefit financially from pursuing speculative ventures that could generate handsome profits, a widely held company could be a vehicle for wealth transfers from creditors to shareholders.<sup>350</sup> Still, overall, the containment of financial agency costs is likely to be less critical for firms with diffuse equity. Note that for this sort of company, a risk associated with concentrated share ownership is not present, namely that key shareholders will engage in self-dealing transactions and related types of self-serving conduct. Because monitoring to control misbehavior associated with a dominant blockholder is a major feature of loans by concentrated lenders such as banks, companies with dispersed equity may find it cheaper to issue public debt. Stated differently, with financial agency costs being relatively low, bank monitoring may not be cost justified.

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constrained by the terms of bond issues to seek approval of a majority of diffuse bondholders in order to renegotiate debt agreements. See WOOD, *supra* note 322, at 179-81.

348. We are not going so far as to suggest that the optimal number of lenders in a firm with concentrated equity is one. On why it might be better to borrow from a group of banks, rather than one, see VOLPIN, *supra* note 29 (providing a model and empirical evidence suggesting that the average number of banks used by firms is inversely related to the effectiveness of the nation's shareholder protections); see also Steven Ongena & David C. Smith, *What Determines the Number of Bank Relationships? Cross-Country Evidence*, 9 J. FIN. INTERMEDIATION 26, 51 (2000) (noting that the number of bank relationships is higher in countries with inefficient judiciary and weak creditors' rights).

349. A related idea is that markets for publicly issued, unsecured debt may provide valuable information to scattered shareholders about the prospects of the firm. See Barry Adler, *An Equity-Agency Solution to the Bankruptcy-Priority Puzzle*, 22 J. LEG. STUD. 73, 75 (1993).

350. See *supra* notes 115, 171-72 and accompanying text; CHEFFINS, *supra* note 115, at 521-22, 528.

One additional factor tending to create a DE/DD bias might be the preferences of outside shareholders. Those who own shares in a company with widely dispersed share ownership should, because of diversification, usually be risk neutral toward the strategies companies pursue. The firm's senior executives, in contrast, will have most of their eggs in one basket, since their human capital will be tied up in the firm.<sup>351</sup> Under such circumstances, the continued survival of the company will matter greatly to them. The fear of financial ruin will, in turn, tend to discourage those in charge from pursuing risky but potentially lucrative business opportunities.<sup>352</sup>

Since a company is less likely to default on its debts if management shuns risky projects, creditors will view in a favorable light the cautious approach which managers will tend to take in relation to pursuing new ventures.<sup>353</sup> The congruence of interest between managers and creditors will, however, be worrisome for diversified shareholders. By virtue of the risk neutrality fostered by diversification, they will want the company to undertake projects with the highest expected monetary value, regardless of whether pursuing such ventures could jeopardize the company's future.<sup>354</sup> The fears shareholders have are likely to be particularly acute for a company with concentrated debt. Under such circumstances, the powerful and influential lenders will be ideally situated to ally themselves with the risk-averse executives, since managerial risk aversion can be rewarded with favorable interest rates and even implicit guarantees of support in the event of financial distress.<sup>355</sup> On the other hand, a coalition of this nature will be more difficult to establish if a company's debt is widely dispersed. It follows that, all else being equal, a company with dispersed debt should be able to raise equity capital at a lower cost than a firm with concentrated debt.

It should not be assumed from the foregoing discussion that diffuse equity can never coexist with concentrated debt. As we will see shortly, in the U.K., the norm for publicly quoted companies is a DE/CD arrangement. Also, it is certainly possible for firms to be structured along CE/DD lines. Consider, for instance, the leveraged

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351. CHEFFINS, *supra* note 115, at 123; Gilson, *supra* note 151, at 248-49.

352. CHEFFINS, *supra* note 115, at 123-24; see also Hideki Kanda, *Debt holders and Equity holders*, 21 J. LEG. STUD. 431, 434-35 (1992).

353. CHEFFINS, *supra* note 115, at 124.

354. *Id.*

355. See, e.g., Gorton & Schmid, *supra* note 118, at 46-47 (describing rent-seeking by banks in Germany); Raghuram G. Rajan, *Insiders and Outsiders: The Choice Between Informed and Arm's-Length Debt*, 47 J. FIN. 1367, 1367-70 (1992) (presenting a model stressing costs of concentrated lenders arising from their increased ability to extract rents).

buyout phenomenon in the U.S. in the 1980s and thereafter.<sup>356</sup> Most leveraged buyouts are financed in large part by the issuance of publicly traded, sub-investment grade debt known as "junk bonds."<sup>357</sup> In addition to adding a large amount of debt, LBOs transform the equity of the target firm, replacing widely scattered shareholders with a much more concentrated ownership structure. The result is a CE/DD arrangement, although in practice the LBO structure has tended to be transitory in nature.<sup>358</sup>

Given that business enterprises can be both DE/CD and CE/DD—but that there should be a general tilt toward DE/DD—which path are companies more likely to follow if and when they evolve away from CE/CD? The experience in the United States suggests that companies are more likely to have diffuse debt before they have dispersed share ownership. With the country's first truly large business enterprises—nineteenth-century railroads—publicly traded debt was a more important source of finance than equity.<sup>359</sup> When the country's industrial enterprises first began to raise funds from the public in a serious way at the close of the nineteenth century, the focus was again on fixed-income instruments, albeit of a distinctive character.<sup>360</sup> Such firms, in order to attract funding from investors, issued preferred shares that entitled holders to participate at a stipulated rate on a priority basis when dividends were distributed.<sup>361</sup>

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356. For an overview of the structure of leveraged buyouts, see, e.g., Douglas W. Diamond, *Seniority and Maturity of Debt Contracts*, 33 J. FIN. ECON. 341, 362 (1993); Steven N. Kaplan & Jeremy Stein, *The Evolution of Buyout Pricing and Financial Structure in the 1980s*, 108 Q.J. ECON. 313 (1993).

357. LBOs also use a large amount of senior bank debt, which is highly concentrated. This makes them a hybrid structure for our purposes. For an analysis of the shifts in the relationship between senior bank and junk bond financing in LBOs, see, e.g., Jay R. Allen, *LBOs—The Evolution of Financial Structures and Strategies*, J. APPLIED CORP. FIN., Winter 1996, at 18, 19 (describing a "pronounced shift from the use of [junk bonds] as a source of LBO funds" in the early 1990s, and a shift "toward capital structures composed entirely of senior bank debt and sponsor equity capital"); Kaplan & Stein, *supra* note 356, at 313-14, 330-31 (noting that LBOs of the late 1980s used more junk bond financing and less senior debt and were more likely to fail than earlier LBOs).

358. Most LBOs are taken public again within a few years. See, e.g., Steven N. Kaplan, *The Staying Power of Leveraged Buyouts*, J. APPLIED CORP. FIN., Spring 1993, at 15, 24 (stating that the majority of LBOs probably function "as a kind of shock therapy for accomplishing one-time changes" and finding that the LBOs in his study remained private for a median of 5.5 years).

359. See Jonathan Barron Baskin, *The Development of Corporate Financial Markets in Britain and the United States, 1600-1914*, 62 BUS. HIST. REV. 199, 216-19 (1988); Coffee, *supra* note 14, at 27; see also SKEEL, *supra* note 211, at 48-52 (describing the role of investment banks in railroad finance).

360. Baskin, *supra* note 359, at 222.

361. *Id.* at 219-22; see also Thomas R. Navin & Marian V. Sears, *The Rise of a Market for Industrial Securities, 1887-1902*, 29 BUS. HIST. REV. 105, 116-19, 131-32 (1955).

Why did diffuse debt precede the dispersion of equity? More generally, why is it more likely that the path away from CE/CD to DE/DD will be via CE/DD than DE/CD? One factor is that, as markets for corporate securities are beginning to develop, the investing public will find fixed-income instruments easier to evaluate than claims against the future earning potential of companies.<sup>362</sup> The attitude of the dominant shareholders is perhaps a second and possibly even more important determinant.<sup>363</sup> For a corporation, a pivotal distinction between raising capital via debt and equity is that reliance on the latter implies a dilution of control by existing shareholders, whereas reliance on the former does not. For members of a family, losing their grip on a business is painful because of feelings of loss of power, respect, and value.<sup>364</sup> Also, an unwinding of control means that core investors forgo the opportunity to extract, via rent-seeking, private benefits of control.<sup>365</sup> It follows, in turn, that all else being equal, companies with a dominant faction will rely on diffuse debt so as to postpone an unravelling of the controlling block.

Our argument that the path away from CE/CD to DE/DD will be via CE/DD is congruent with an information-based approach to corporate finance known as the "pecking-order" hypothesis.<sup>366</sup> Essentially, this approach posits that firms progress up the "pecking order" of finance as they mature. When business enterprises are just starting out, they typically must rely on the wealth of the proprietors and retained earnings, since potential financiers cannot find out anything about the business. A successful beginning will create, however, the opportunity to rely on bank debt. Banks become willing to lend funds because a track record will be emerging and because information asymmetries can be addressed by monitoring (e.g., periodic credit checks). As a business enterprise matures further obtaining finance from outside investors becomes an increasingly feasible proposition. This will initially take the form of debt instruments with protective covenants. The final step in the pecking

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362. Baskin, *supra* note 359, at 216, 219, 224.

363. *Id.* at 214-15, 220.

364. Philip Lawton, *Berle and Means, Corporate Governance and the Chinese Family Firm*, 6 AUSTL. J. CORP. L. 348, 358 (1996); *The Generation Game*, ECONOMIST, Mar. 4, 2000, at 65; Fergal Byrne, *Keeping the Squabbles Out of Succession*, FIN. TIMES (London), Oct. 12, 2000, at 18.

365. On "rent-seeking," see *supra* notes 168-69 and accompanying text.

366. On the terminology, see Stewart C. Myers, *The Capital Structure Puzzle*, 39 J. FIN. 575, 581 (1984). On the substance of the hypothesis, see *id.* at 581-90; Charles W. Calomiris, *The Costs of Rejecting Universal Banking: American Finance in the German Mirror, 1870-1914*, in COORDINATION AND INFORMATION: HISTORICAL PERSPECTIVES ON THE ORGANIZATION OF ENTERPRISE 257, 262-63 (Naomi R. Lamoreaux & Daniel M.G. Raff eds., 1995).

order will be the issuance of equity on the stock market, with financial professionals acting as intermediaries to provide credible signals concerning a corporation's value.

The experience in continental Europe may well provide a testing ground for our conjectures concerning the path towards a DE/DD equilibrium. Though the corporate bond market is still very young on the continent, the past decade has seen a dramatic increase in the issuance of public debt.<sup>367</sup> For instance, in 2001 alone, the market grew by nearly 10%.<sup>368</sup> At the same time, of course, there has been much discussion of evolving share ownership patterns in Europe.<sup>369</sup> However, while it is becoming more common for European companies to join the stock market, and the numbers of individuals who own shares is growing, it is standard practice in continental Europe for companies that go public to retain a strongly concentrated ownership structure.<sup>370</sup> If this pattern continues, controlling shareholders will remain important even if the current move to the stock market remains on track.<sup>371</sup> Hence, it seems likely that continental Europe will be in a CE/DD situation before any sort of switch to the Anglo-American pattern of share ownership takes place.

Since our analysis suggests that there is a DE/DD equilibrium, it is fair to infer that we predict that when dispersed debt replaces concentrated debt as the norm in a corporate economy, dispersed equity will follow. The path we have in mind is set out in a stylized form in the first matrix in the Appendix. However, we do not want to press the point too strongly. It may be that any sort of link between dispersed debt and dispersed equity is a fragile one that can be disrupted easily by other variables. Assume, for instance, that the "law matters" thesis is right and the protection afforded to minority shareholders is a pivotal determinant of ownership structures.<sup>372</sup>

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367. See, e.g., McLaughlin, *supra* note 32, at M9; Hoffman et al., *supra* note 32, at M6; Sarah Laitner, *Bond Issues Buoyed to a Record High by Rate Cuts and Bear Market*, FIN. TIMES (London), Dec. 27, 2001, at 13; Aline van Duyn, *Investors in Bonds Ask Companies for a Little Respect*, FIN. TIMES (London), May 13, 2002, Fund Management Section, at 3.

368. Van Duyn, *supra* note 343, at 3. A possible constraint on the growth of the market for corporate debt is that rules prevent many institutional investors from holding bonds that are not highly rated. See *Sauce for the Goose*, ECONOMIST, Dec. 23, 1999, at 31-32.

369. See *supra* notes 35-40 and accompanying text.

370. MARC GOERGEN, *CORPORATE GOVERNANCE AND FINANCIAL PERFORMANCE: A STUDY OF GERMAN AND UK INITIAL PUBLIC OFFERINGS 51-56, 78-83* (1998) (drawing distinctions between Germany and the U.K.); Marco Pagano et al., *Why Do Companies Go Public? An Empirical Analysis*, 53 J. FIN. 27, 56-80 (1998) (Italy); Martin Holmén & Peter Högfeldt, *A Law and Finance Analysis of Initial Public Offerings 18-19, 23* (2000) (unpublished manuscript, on file with authors) (Sweden).

371. Cheffins, *supra* note 165, at 35-36.

372. See *supra* notes 62-69 and accompanying text.



Persistently weak corporate law could therefore leave continental Europe in a CE/DD situation.

To complete our initial discussion of the reconfigured evolutionary thesis, we need to integrate our analysis of dispersed and concentrated debt with the original version of the thesis. The original version predicted a link between insider control (i.e., concentrated equity) and manager-displacing bankruptcy law. The discussion here suggests that debt structure will also be part of the equation. Again, in a company with concentrated debt, lenders are likely to be able to address financial agency costs better than if the debt were diffuse. A manager-displacing bankruptcy law fits well in this environment, since creditors can use the threat of bankruptcy, with its unpleasant consequences for managers, as a useful "lever" to encourage executives to take lenders' interests into account.<sup>373</sup> Conversely, a manager-friendly bankruptcy law akin to Chapter 11 would tend to undermine the position of concentrated creditors, since managers of financially distressed companies can respond to lender demands by instigating a debtor-in-possession corporate rescue.<sup>374</sup> Thus we would expect an affinity between manager-displacing bankruptcy law and CE/CD financial structures. We have translated our argument into diagrammatic form in the second matrix in the Appendix.

Switching to circumstances where diffuse equity prevails, the original version of the evolutionary theory suggested that this system of ownership and control is complementary to manager-driven bankruptcy law. The analysis in this section adds an additional element to the package—dispersed debt. Our analysis of financial agency costs suggests, as reflected in the second matrix in the Appendix, an affinity between this sort of arrangement and an outsider/arm's-length system of ownership and control. The key variable is that the disciplinary role associated with bankruptcy law will no longer be highly pertinent. Because of collective-action problems, numerous creditors each holding small claims will have difficulty coordinating to exercise the "threat" of a manager-displacing bankruptcy procedure. As noted earlier, the presence of a trustee representing bondholders' interests diminishes but does not eliminate this problem. Correspondingly, a manager-displacing bankruptcy regime will probably be much less useful as a "lever," than it would be where concentrated debt is the norm.

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373. See *supra* note 155 and accompanying text; Skeel, *supra* note 2, at 1344-46.

374. See Douglas G. Baird & Randal C. Picker, *A Simple Noncooperative Bargaining Model of Corporate Reorganizations*, 20 J. LEG. STUD. 311, 321-24 (1991).

The point can be put more strongly: A manager-displacing bankruptcy procedure could prove enormously costly for a troubled firm where dispersed debt is prevalent. The driver in this instance is that a firm can become financially distressed due to factors beyond the control of its managers and which, despite a severe short-term impact, do not undermine its fundamental viability as a business enterprise.<sup>375</sup> For example, a firm may suffer an unexpected (but temporary) decline in demand for its products. Alternately, there may be unanticipated shifts to new technology within the relevant industry or dramatic increases in the costs of raw materials.<sup>376</sup> A firm suffering from these adverse changes in its operating environment might default on its debt obligations before it has an opportunity to respond effectively. Then, unless its lenders are able to agree on an out-of-court restructuring, it will be destined for liquidation since the bankruptcy regime is manager-displacing.

Note that in this example, the firm's difficulties are primarily due to bad luck rather than bad management, a situation which empirical work suggests is quite common.<sup>377</sup> Automatic removal of the incumbent management team in bankruptcy will mean that those with the greatest experience running the firm will no longer be able to do so, thus potentially reducing the returns to creditors. What is more, it will mean that *ex ante*, managers will be forced into the "lose-lose" scenario described earlier.<sup>378</sup> If they take risks that do not pay off simply because of bad luck, they face dismissal, but if they do not, then they will suffer as a result of governance mechanisms designed to encourage them to take risks on behalf of shareholders.

These risks to management should not be nearly as acute where concentrated rather than diffuse debt is the norm. If a firm with such a debt structure experiences an unexpected shock that adversely affects its operating environment, the lenders will tend to be well informed about what has transpired and should be able to coordinate a response to the crisis.<sup>379</sup> Correspondingly, if a financially distressed firm is worth saving, then the key lenders should be fairly well placed to orchestrate an out-of-court restructuring (e.g., via the

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375. Such a firm is said to be financially, but not economically, distressed. On the terminology, see, e.g., Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 580-81 (1998).

376. On reasons why firms may become financially distressed, see CAMPBELL & UNDERDOWN, *supra* note 212, at 17-23; STUART SLATTER, *CORPORATE RECOVERY: A GUIDE TO TURNAROUND MANAGEMENT* 24-59 (1984).

377. Khanna & Poulsen, *supra* note 137, at 938 (comparing managers of distressed firms which fail take similar actions to those of distressed firms which avoid failure).

378. See *supra* notes 138 and accompanying text.

379. See *supra* notes 307-08 and accompanying text.

London Approach) and to decide whether or not the managers should have a continuing role if the turnaround is successful.

To recapitulate: A manager-displacing bankruptcy law should be a valuable governance lever to concentrated creditors. Conversely, such a lever is of little use to dispersed creditors, who will find it difficult to coordinate so as to employ it. Moreover, a manager-displacing bankruptcy law may be a positive liability where dispersed debt is the norm, as the inability of creditors to coordinate on the resolution of financial distress may lead to the inappropriate removal of good managers. A possible by-product of this tension could be the enactment of manager-friendly bankruptcy law. If reform in fact occurs, the hypothesized affinity between dispersed debt and manager-friendly bankruptcy law will have been achieved.

### *B. U.K. Governance Through the Lens of the Refined Theory*

We have just seen that diffuse debt and dispersed equity are complementary, as are concentrated debt and concentrated equity. Moreover, the most likely path from CE/CD to DE/DD is via diffuse debt and concentrated equity. The current pattern in Britain runs directly contrary to what we predicted. As we have seen, larger British companies tend to rely on syndicates of banks and other lenders for their debt finance, rather than issuing debt securities.<sup>380</sup> Our tentative conclusion concerning the country's corporate debt structure is therefore that it is concentrated. At the same time, the U.K. has an outsider/arm's-length system of ownership and control.<sup>381</sup> Correspondingly, the overall pattern is DE/CD, a combination that does not occupy an obvious position in our analytical framework.

How can this be accounted for? The likely explanation involves the particular economic conditions in the U.K. in the 1970s and 1980s. To understand why, it is helpful to recall some historical background.<sup>382</sup> As the twentieth century opened, the U.K. had an insider/control-oriented system of ownership and control. In the decades after World War II, a transition to an outsider/arm's-length regime took place. We have argued that with this sort of transition, an intermediate step is likely to be a shift from concentrated debt to dispersed debt. It may well be that there was this sort of pattern in the U.K. In the period immediately following World War II, U.K.

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380. See *supra* note 313 and accompanying text.

381. See *supra* Part V.

382. See *supra* notes 88-90 and accompanying text.

companies raised large amounts of cash by issuing debentures.<sup>383</sup> Certainly, "[i]n the 1960s the bond market was an important source of finance for industrial and commercial companies."<sup>384</sup> For instance, from 1965 to 1967, over 80% of the capital raised on the public markets involved debt issues.<sup>385</sup>

Matters changed radically on the debt side in the 1970s. From 1973 onwards, corporate bond issues largely ceased, primarily due to "sharp increases in inflation and interest rates."<sup>386</sup> The key reason that inflation made a difference was the uncertainty that was created. Companies will use debentures to borrow for long periods at fixed rates when they are confident that current interest rates are in line with their expectation of future rates. In an inflationary period, however, prospects are so uncertain that a future fall in interest rates beyond that implied by current rates is a serious possibility. Correspondingly, they will prefer to borrow from banks at floating rates, even if the immediate cost is higher.<sup>387</sup> High interest rates remained the norm in the U.K. until the closing years of the 1990s, thus compelling companies to resort increasingly to borrowing from banks.<sup>388</sup> The disruptive environment that undermined the corporate bond market was in place as Britain's shift to an outsider/arm's-length system of ownership and control was completed and became firmly entrenched. The end result was the DE/CD pattern we have observed.

Now let us bring the U.K.'s bankruptcy law regime into the picture. As we have seen, until World War II, the situation in the U.K. was consistent with the evolutionary thesis because insolvency procedures displayed the manager-displacing features we would expect to be associated with insider governance.<sup>389</sup> The period when bankruptcy law deviated from the predicted pattern was in the decades following World War II. The problem was that, while ownership was taking on a strongly dispersed character, the U.K.'s

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383. For statistics, see W.A. THOMAS, *THE FINANCE OF BRITISH INDUSTRY 1918-1976*, 155 (1978). For pre-World War II data, see A.T.K. GRANT, *A STUDY OF THE CAPITAL MARKET IN BRITAIN FROM 1919-1936*, 166 (2d ed. 1967).

384. *The UK Corporate Bond Market*, BANK OF ENG. Q.B. 54, 54 (1981).

385. E. VICTOR MORGAN & W.A. THOMAS, *THE STOCK EXCHANGE: ITS HISTORY AND FUNCTIONS* 211 (2d ed. 1969). The strong bias in favor of debt during this period was largely a result of the introduction of the corporation tax in 1965. *Id.*; *The UK Corporate Bond Market*, *supra* note 384, at 54.

386. *The UK Corporate Bond Market*, *supra* note 384, at 56.

387. *Id.* at 55.

388. CHEFFINS, *supra* note 115, at 70; GEOFFREY HOLMES & ALAN SUGDEN, *INTERPRETING COMPANY REPORTS AND ACCOUNTS* 60 (4th ed. 1990).

389. See *supra* note 226 and accompanying text.

bankruptcy regime retained its manager-displacing orientation.<sup>390</sup> We have now seen that throughout much of the same period, inflation was crippling the market for corporate debt. These patterns might well be related.

The U.K.'s insolvency regime has been criticized because it does not sufficiently provide for the rehabilitation of financially troubled but potentially viable businesses.<sup>391</sup> With larger companies, however, the difficulties posed by the law have been alleviated considerably by the London Approach. Again, British firms are often restructured under this scheme, which means that bankruptcy law, with its bias in favor of liquidation, does not come into play. It seems reasonable to speculate that the London Approach "safety valve" has muted to some degree any momentum in favor of adoption of a Chapter 11 regime in the U.K.<sup>392</sup>

It is necessary to note that the London Approach might well have been a product of the particular environment the U.K. offered after the 1960s. Again, the onset of inflation in the early 1970s probably gave larger U.K. companies a more concentrated debt structure than would have otherwise prevailed. This development is important for understanding the advent of the London Approach. Crucial to the London Approach is the relatively limited number of lenders, each of which has a substantial interest in a troubled firm's debt. In this milieu, the lenders will have enough at stake to justify participating in a rescue attempt. Also, because all concerned will tend to know who the other players are, informal negotiations can occur quite readily. As a result, those involved can coordinate a decision to restructure a troubled firm among themselves without the need for judicial oversight or a formal automatic stay. The upshot is that the concentrated nature of U.K. corporate debt has helped to create the right conditions for London Approach rescues.

Let us bring matters up-to-date and offer some tentative predictions. Inflation has been largely under control in the U.K. in the past few years.<sup>393</sup> If we are correct that there is a link between share ownership patterns and debt structures, a by-product of this benign economic environment in outsider/arm's-length corporate Britain

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390. See *supra* notes 227-28 and accompanying text.

391. See, e.g., Michael Grylls, *Insolvency Reform: Does the UK Need to Retain the Floating Charge?*, J. INT'L BANKING L. 391, 391-94 (1994); D. MILMAN & D.E.M. MOND, SECURITY AND CORPORATE RESCUE 3-10 (1999).

392. See Brierley & Vleighe, *supra* note 309, at 175-77.

393. *Country Briefing for Britain*, ECONOMIST, available at [www.economist.com](http://www.economist.com) (stating that the average annual rate of inflation in the U.K. during the period from 1997 to 2001 was 1.3%).

should be a shift towards diffuse debt. Bank financing is comparatively costly, as we have seen, at least for companies with publicly traded stock.<sup>394</sup> The reconfigured evolutionary theory correspondingly suggests that, among larger U.K. companies, a general trend toward increasing issuance of public debt seems likely.

Any such switch would have potentially important implications for U.K. corporate insolvency law. As debt structures in U.K. companies become increasingly diffuse, carrying out successful London Approach rescues will become more difficult.<sup>395</sup> Again, the successful operation of London Approach hinges on a relatively small number of "repeat players." The increasing use of public debt could seriously undermine the London Approach technique, since scattered bondholders cannot coordinate nearly as easily outside of bankruptcy as a syndicate of lenders.<sup>396</sup>

With the London Approach "buffer" eroding, concerns can be expected to grow that larger U.K. companies do not have sufficient scope to orchestrate a turnaround in the event of financial distress. As we have seen, U.K. bankruptcy laws are well designed for liquidating insolvent firms, but they are less effective at preserving the going-concern value of a firm that has encountered financial rather than economic distress.<sup>397</sup> If debt finance becomes too diffuse for troubled firms to make use of the London Approach, the need for reorganization-oriented bankruptcy rules will become increasingly clear. Creditors can therefore be expected to lobby for a loosening of the bankruptcy framework, and managers would welcome such a change.<sup>398</sup> If such pressure develops and ultimately yields the creation of a Chapter 11 option for larger firms, the end result would be what our refined evolutionary theory of corporate bankruptcy and corporate

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394. See *supra* note 349 and accompanying text.

395. Brierley & Vleighe, *supra* note 309, at 175; Armour & Deakin, *supra* note 315, at 48-49; Kent, *supra* note 316, at 175-77.

396. Even if bondholders were represented by a trustee, the need to obtain bondholders' approval for any significant restructuring would undermine the parties' ability to maintain the level of secrecy that currently characterizes the London Approach. The process would also require a significantly more complicated vote, since all of the bondholders would be entitled to have their say as to whether the restructuring should go forward. For these reasons, it seems unlikely that those lending funds to U.K. companies through the medium of public debt markets would seek to create opportunities for London Approach rescues by way of contractual terms.

397. See *supra* notes 304-06 and accompanying text.

398. Historically, managers have not been major lobbyists on bankruptcy issues even in the manager-friendly U.S. context. See SKEEL, *supra* note 211, at 81-82 (explaining that managers generally do not expect their firm to wind up in bankruptcy and therefore do not focus on bankruptcy issues). Creditors, on the other hand, figure prominently in the legislative process, as well as in actual cases. For similar observations on lobbying with respect to recent U.S. and U.K. reforms, see CARRUTHERS & HALLIDAY, *supra* note 231, at 102-06, 133-38.

governance would suggest: diffuse share ownership, dispersed debt, and manager-driven bankruptcy law.

The available evidence suggests that these various predictions are turning out to be true. To start, there is evidence that banks already are losing their near hegemony over debt finance for widely held U.K. firms. In recent years, British firms have increasingly turned to other institutional lenders, such as insurers and pension funds, for debt financing.<sup>399</sup> Although the market for public debt remains much smaller than in the U.S.,<sup>400</sup> it has significantly increased in recent years. In the words of one U.K. commentator, the "trend for companies to diversify funding sources away from banks and other lending institutions continues apace [,] and this is expected to remain a theme over the next few years."<sup>401</sup> With respect to law reform, there has been some lobbying of the type the reconfigured evolutionary theory would predict. For instance, a working group representing bankers who orchestrate corporate rescues, and their professional advisers, has called for changes that offer greater support for turnaround efforts.<sup>402</sup> Moreover, the U.K. government might well be responsive to such entreaties. As we have already seen, there has been discussion of the possibility that a debtor-in-possession rescue mechanism that might be made available to small companies could be rolled out for large business enterprises in the not-too-distant future.<sup>403</sup>

We should emphasize that each of our speculations assumes that there are no dramatic, macroeconomic shocks in the interim. Corporate governance is obviously only one factor in the overall corporate environment, and it may be swamped by larger events such as technological change or economic crisis. Indeed, events in the U.K. neatly illustrate the point, because the inflation that the country experienced in the 1970s and 1980s likely yielded the corporate debt structures that we have sought to account for in this Article.

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399. Brierley & Vleighe, *supra* note 309, at 175 chart 2 (referring to chart 2 and explaining that in 1990 under 20% of the debt of U.K. corporations was raised in the form of bonds, rising to 35% by 1999).

400. See generally Saldenberg & Strahan, *supra* note 24, at 1-2.

401. Gary Jenkins, *The Year When Corporate Bonds Finally Came of Age*, SUNDAY BUS. (London), Dec. 16, 2001, at 29. The increasing number of banks that participate in syndicated loans can also be seen as consistent with this prediction. Large syndicates are a partial substitute for public debt, though they are likely to remain more costly and entail more oversight than a true public issuance.

402. More specifically, the International Federation of Insolvency Professionals ("INSOL") Lenders' Group has called for a stay to be added to the "scheme of arrangement" provisions. See *supra* note 270 and accompanying text.

403. See *supra* note 272 and accompanying text.

Let us draw things together. We have offered a new version of the evolutionary theory of corporate governance and corporate bankruptcy. The crucial addition is a focus on dispersed versus concentrated debt. This variation, in turn, allows us to account for developments in the U.K. Under the original version of the evolutionary thesis, Britain poses a problem because the country has dispersed share ownership and manager-displacing bankruptcy law. This part has offered the missing piece of the equation: corporate debt structure. For reasons we have offered here, there should be a tendency in favor of diffuse equity and dispersed debt. While an outsider/arm's-length system of ownership and control took hold in Britain in the decades following World War II, and might otherwise have shifted U.K. governance in this direction, by virtue of inflationary conditions the debt structures of U.K. companies became more, rather than less, concentrated in nature. The predominant role banks played in corporate lending in turn allowed for use of the London Approach, which served to mute pressure for adoption of manager-friendly bankruptcy laws.

### *C. Testing Aspects of the Evolutionary Theory*

Since this Article has examined largely neglected links between corporate bankruptcy and corporate governance and since we have focused primarily on one country, the U.K., the analysis offered here must be treated as preliminary in nature. Certainly, additional research and analysis is required to determine whether the propositions we have advanced stand up under close scrutiny. This section correspondingly sketches out an agenda for empirical testing of this Article's predictions. We will begin by considering how we might ascertain whether the U.K. is an outlier under the original evolutionary hypothesis and will then turn our attention to aspects of the revised version of the thesis.<sup>404</sup>

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404. We assume in this section and throughout the Article that companies are governed by a single nation's corporate governance and bankruptcy framework. Globalization has obviously complicated this assumption, since increasing numbers of companies operate on an international scale, and companies in one country may be able to adopt or make use of the laws of another country in various ways. Ed Rock has argued, for instance, that Israeli high-tech start-ups often seek to be listed on NASDAQ in order to commit themselves to satisfying U.S. disclosure requirements. Edward B. Rock, *Securities Regulation as a Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure*, 23 *CARDOZO L. REV.* 675 (2002). For an extensive discussion of this phenomenon, which emphasizes its limitations, see Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 *UCLA L. REV.* 781, 816-831 (2001) (referring to the strategy as "piggybacking"). Similarly, and in line with the predictions of the evolutionary theory, there is anecdotal evidence that managers of multinational corporations facing financial distress are opting, where possible, to file for bankruptcy in the U.S. because of



The evolutionary thesis, as initially configured, suggests that dispersed equity fits with a manager-driven bankruptcy process and that concentrated share ownership is complementary to a bankruptcy regime with a liquidation bias.<sup>405</sup> Since circumstances in the U.K. do not fit with these predictions, we have offered a more fully developed version of the thesis. Strictly speaking, however, this might not have been necessary, because Britain might be a statistical outlier that should not be given undue weight in a search for an underlying pattern.<sup>406</sup> A way to test for this would be to use data on share ownership structures in various countries and match these figures with a bankruptcy law index.

This sort of exercise would not be unprecedented. As part of a study published in 1998, La Porta, Lopez-de-Silanes, Shleifer, and Vishny assessed whether there was a correlation between "creditor rights" in bankruptcy and ownership concentration.<sup>407</sup> They found there was no statistically significant link between the two variables.<sup>408</sup> The test they ran, however, was probably too crude to offer any sort of definitive verdict on the propositions advanced here. The aspects of a corporate bankruptcy regime that seem to be most pertinent for the evolutionary theory are the extent to which managers can set the agenda upon the onset of financial distress and the ease with which finance may be obtained by a firm in DIP proceedings. The La Porta study did take the former element into account by asking whether management stays in place during a reorganization. Still, this factor was only one variable in their creditor rights matrix,<sup>409</sup> and the latter variable was not considered. It may be that a test which isolated these

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its favorable legal regime. See Jean Eaglesham, *Best Go West When Times are Bad*, FIN. TIMES (London), Feb. 4, 2002, at 16. ("If you are going to go bust, do it in America. That—put crudely—is the message many troubled multinationals . . . appear to have taken to heart."). Although these trends do not affect our general thesis as to the relationship between capital structure and bankruptcy, they do make it somewhat more difficult to test the theory empirically, since existing studies assume that the companies in any given country are governed by that nation's approach to corporate governance.

405. See *supra* notes 137-58 and accompanying text.

406. On the manner in which outliers should be treated for the purpose of regression analysis, see D.H. Kaye, *The Dynamics of Daubert: Methodology, Conclusions, and Fit in Statistical and Econometric Studies*, 87 VA. L. REV. 1933, 2012-13 (2001).

407. Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1134-40, 1148-50 (1998).

408. *Id.* at 1150.

409. *Id.* at 1135. The other variables that were taken into account were "no automatic stay," "secured creditors get paid first," and "restrictions for going into reorganization." *Id.*

factors would yield the sort of correlation that the evolutionary theory predicts.<sup>410</sup>

Another consideration is that the test we are proposing would not focus solely on the law on the books. Instead, there should be due recognition of the fact that the formal rules can look quite different from the procedures that are actually employed by the parties. The experience in the U.K. is illustrative. The La Porta study categorized Britain as a country where management does not stay in a reorganization.<sup>411</sup> This is a fair characterization of the U.K.'s statutory framework.<sup>412</sup> Still, the classification is problematic once the London Approach is taken into account, because executives of a financially troubled company typically remain in office when the procedure is launched. The British situation illustrates that a full test of the propositions that dispersed equity fits with a manager-driven bankruptcy process and that concentrated share ownership is complementary to a manager-displacing bankruptcy regime requires that account be taken of "informal" responses such as the London Approach as well as the law on the books.

The key element this Article has added to the evolutionary theory of corporate governance and corporate bankruptcy is the role played by debt structure. Two further predictions that follow from this aspect of our analysis are as follows: First, there should be a correlation between equity diffusion (concentration) and debt diffusion (concentration), and second, there should be a correlation between manager-friendly bankruptcy laws and diffuse debt structure. We have already discussed the extent to which the U.K. experience fits with these predictions,<sup>413</sup> but ideally testing of a more general nature should be conducted. A problem, however, is that measuring debt concentration is not straightforward. In studies on the distribution of corporate equity, data filed with securities regulators are typically used to identify the largest blocks of shares within individual companies.<sup>414</sup> Adopting a similar approach with debt is not possible,

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410. The situation in Japan illustrates the importance of the managerial control factor and the risk of obtaining misleading results when it is not emphasized. In the LaPorta et al. study, Japan qualifies as a nation with weak creditor rights in bankruptcy (scoring two out of four). *Id.* at 1137, tbl. 4. Yet, during the period covered by the study, Japanese bankruptcy cases were far more creditor-oriented than debtor-oriented. Although Japanese bankruptcy law provided a reorganization option, the vast majority of cases resulted in liquidation and the prompt displacement of incumbent managers. For discussion, see Skeel, *supra* note 2, at 1382.

411. La Porta et al., *supra* note 407, at 1136, tbl. 4.

412. See *supra* notes 222-24 and accompanying text.

413. See *supra* notes 380-403 and accompanying text.

414. Becht & Mayer, *supra* note 26, at 38.

because companies are not legally obligated to identify the amount owed to particular creditors.<sup>415</sup>

Despite the difficulties associated with measurement, there are a couple of methods that can potentially be adopted to get a sense of how concentrated debt is within a particular corporate economy. One method is to focus on whether bonds issued by leading companies have been (or have not been) rated by Moody's, Standard and Poor's, or another rating agency. The idea here is that a rating implies an established secondary market for a company's debt, which in turn connotes debt dispersion.

Another proxy for debt concentration could be long-term debt. This type of debt is likely to take the form of publicly issued bonds, so its extensive use implies diffusion. Work done by economists Raghuram Rajan and Luigi Zingales illustrates that using data on long-term debt is feasible. In a study published in 1995, they provide aggregate balance sheet data for nonfinancial firms in the G7 countries.<sup>416</sup> In so doing, under liabilities, they differentiate between long-term and short-term debt.<sup>417</sup> The evolutionary theory would predict that this figure should be relatively high for the U.S. since America has the greatest ownership dispersion. Interestingly, Rajan and Zingales' study reveals that U.S. firms do in fact have relatively high levels of long-term debt.<sup>418</sup> It would be intriguing to perform statistical tests on time-series data across a wider range of countries, perhaps controlling for various other factors such as inflationary conditions, banking regulation and so on. Similar proxies could be used in conjunction with the index of the "manager-friendliness" of bankruptcy laws proposed above<sup>419</sup> to test for a correlation between debt structure and bankruptcy law.

An additional way forward would be case studies of individual countries. Clearly, future events in the U.K. will offer a test for our

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415. Helen Short, *Ownership, Control, Financial Structure and the Performance of Firms*, 8 J. ECON. SURVEYS 203, 231 (1994) ("Unfortunately, at the present time, an empirical analysis of the concentration and identity of debtholders is impossible in the U.K., as firms are not obliged to disclose such information to the public.").

416. Rajan & Zingales, *supra* note 302, at 1421, 1428, tbl. II.

417. *Id.*

418. According to their figures, U.S. firms in 1991 had the second-highest aggregate level of long-term debt amongst the G7 countries: 23.3% of the financial claims in the aggregate balance sheets. *Id.* By way of comparison, the correlative figures for other G7 countries were 9.8% in Germany, 12.1% in Italy, 12.4% in the U.K., 15.7% in France, 18.9% in Japan, and 28.1% in Canada. *Id.* For another example of empirical work on debt structure that provides information on particular countries, see Antonios Antoniou et al., *Determinants of Corporate Capital Structure: Evidence from European Countries* (2002) (unpublished manuscript, on file with authors). The authors, however, do not provide data on long-term debt versus short-term debt.

419. See *supra* notes 411-12 and accompanying text.

analysis. We would predict that, if current benign economic conditions continue, U.K. companies will move increasingly toward diffuse debt, the viability of the London Approach will be threatened, and there will be pressure for the adoption of a U.K. version of Chapter 11 for larger companies. Recent work by Leora Klapper has identified another country that might merit special attention: the Philippines. As Klapper points out, researchers could test the evolutionary thesis by examining "whether changes in bankruptcy codes such as a change in the Philippines allowing management to stay in reorganization affect ownership concentration."<sup>420</sup> Canada could serve as yet another useful case study. Since the 1980s, Chapter 11-style restructurings have become popular in Canada through the creative use of existing legislation and statutory reform.<sup>421</sup> During the same time period, the equity of major Canadian firms has become increasingly diffuse.<sup>422</sup> For the purposes of evaluating the reconfigured evolutionary theory offered here, it would be intriguing to know if these trends are related.

#### CONCLUSION

The U.K. poses a great puzzle for major contemporary theories of comparative corporate governance. With respect to Mark Roe's work on financial services regulation and social democracy, Britain contradicts the pattern his analysis would predict. The situation is the same with the "law matters" thesis. While it implies that an outsider/arm's-length governance system cannot emerge until shareholder protections are fully in place, diffusion of share ownership in the U.K. came before the country's lawmakers adopted important protections for minority shareholders.

The evolutionary account of corporate governance and corporate bankruptcy law is not immune from the U.K. puzzle, either. The theory predicts that an outsider/arm's-length system of ownership and control will be accompanied by manager-driven bankruptcy.

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420. Leora Klapper, *Corporate Governance, Creditors, and Insolvency 2* (2002) (unpublished manuscript, on file with authors) (prepared for GCGF Research Meeting, Washington, D.C., Apr. 5, 2002).

421. See Lynn M. LoPucki & George G. Triantis, *A Systems Approach to Comparing US and Canadian Reorganization of Financially Distressed Companies*, in *CURRENT DEVELOPMENTS IN INTERNATIONAL AND COMPARATIVE CORPORATE INSOLVENCY LAW* 109, 118-19 (Jacob S. Ziegel ed., 1994).

422. See Ronald J. Daniels & Edward M. Iacobucci, *Some of the Causes and Consequences of Corporate Ownership Concentration in Canada*; in *CONCENTRATED CORPORATE OWNERSHIP* *supra* note 342, at 81, 93 n.26; Randall K. Morck et al., *Inherited Wealth, Corporate Control, and Economic Growth: The Canadian Disease*, in *CONCENTRATED CORPORATE OWNERSHIP*, *supra* note 342, at 319, 360-61; Yun M. Park et al., *Controlling Shareholder and Executive Incentive Structure: Canadian Evidence*, 17 *CAN. J. ADMIN. SCI.* 245, 248, tbl. 2 (2000).

Britain, however, mixes diffuse stock ownership with manager-displacing bankruptcy provisions. On closer inspection, the puzzle disappears to a certain extent, since many publicly held U.K. firms are reorganized via the London Approach, an informal process organized by banks where executives retain day-to-day control. Still, since executives in British companies cannot control the agenda in the way that Chapter 11 permits in the U.S., Britain is considerably less manager-driven than the evolutionary theory would predict for a country with dispersed share ownership. The U.K., then, remains a problem child, which implies that the theory should be recast.

To make sense of the patterns that exist in Britain, this Article has reconfigured the evolutionary account to focus more explicitly on the role of debt in corporate governance. The reconfigured theory suggests that debt and equity will both tend toward diffusion in an outsider/arm's-length system and toward concentration in an insider system. Britain appears to be in a state of transition in this respect. Although share ownership in larger U.K. companies is widely dispersed, debt finance remains quite concentrated. Based on the analysis in this Article, we speculate that U.K. debt markets will become more diffuse over time and will ultimately fall into line with the country's dispersed pattern of share ownership. This sort of transition, in turn, could have important implications for U.K. bankruptcy law, since pressure will likely build for the establishment of an increasingly manager-driven process. The end result might then be that the predicted alignment between an outsider/arm's-length system of ownership and control and manager-friendly bankruptcy laws will occur.

The final word we will offer is in keeping with the spirit of this symposium, which is that bankruptcy, like capital structure, is a crucial piece of the corporate governance milieu within which large business enterprises function. Governments around the world are paying increased attention to the legal protection afforded to minority shareholders so as to develop strong equity markets.<sup>423</sup> It cannot be taken for granted, however, that reforming corporate law will provide the "jump start" that is required for countries to develop strong equity markets.<sup>424</sup> Instead, supporting institutions are also likely to

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423. See HENRIK CRONQVIST & MATTIAS NILSSON, AGENCY COSTS OF CONTROLLING MINORITY SHAREHOLDERS 2 (Stockholm Sch. of Econ., Econ. Res. Inst. (EFI), Working Paper Series in Econ. & Fin. No. 364, 2001), available at <http://swopec.nns.se/hastef/abs/hastef0294.htm>.

424. On the "jump start" terminology, see Brian R. Cheffins, *Law as Bedrock: The Foundations of an Economy Dominated by Widely Held Public Companies*, OXF. J. LEGAL STUD. (forthcoming 2003) (manuscript at 22, on file with authors).

matter.<sup>425</sup> The analysis offered by this Article suggests that the approach that a country takes toward bankruptcy law might well be part of the equation.<sup>426</sup> It may also make sense to focus first on creating a market for public debt, given the general reluctance of controlling shareholders to relinquish control. It is beyond the scope of this Article to speculate further on this point. It should be evident, though, that corporate debt deserves serious analytical scrutiny as part of the intense academic debate that has arisen over different systems of ownership and control.

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425. See Black, *supra* note 66, at 1565; Choi, *supra* note 69, at 1694.

426. Cf. Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 815 (2001) (refraining from treating bankruptcy law as a "core institution" for strong securities markets but acknowledging that it is a pivotal variable with debt markets).

**Appendix**  
**The Reconfigured Evolutionary Theory: Capital Structure**

		Debt	
		Concentrated	Dispersed
Equity	Concentrated	<ul style="list-style-type: none"> <li>+ <b>Low managerial agency costs</b></li> <li>+ <b>Financial agency costs effectively constrained (lender monitoring limits blockholder misbehavior)</b></li> <li>- <b>High borrowing costs</b></li> </ul>	<ul style="list-style-type: none"> <li>+ Low managerial agency costs</li> <li>- Blockholder misbehavior</li> <li>- Lender monitoring impaired</li> </ul>
	Dispersed	<ul style="list-style-type: none"> <li>+ Conducive to lender monitoring</li> <li>- Potentially high managerial agency costs</li> <li>- Counterproductive alliances between creditors and management</li> <li>- High borrowing costs</li> </ul>	<ul style="list-style-type: none"> <li>+ <b>Financial agency costs effectively constrained (creditor/management alliances difficult to foster; no blockholder misbehavior)</b></li> <li>+ <b>Low borrowing costs</b></li> <li>+ <b>Transaction cost efficiencies</b></li> <li>- Potentially high managerial agency costs</li> </ul>

Equilibrium "zones" in bold

### The Reconfigured Evolutionary Theory: Equity/Debt Structure and Bankruptcy Law

		Bankruptcy Law	
		Manager-Displacing	Manager-Driven/Friendly
Debt/ Ownership Structures	"CE/CD"	<ul style="list-style-type: none"> <li>+ <b>Bankruptcy law provides useful governance lever for creditors</b></li> <li>+ <b>Informal reorganization easy to coordinate</b></li> </ul>	<ul style="list-style-type: none"> <li>- Potential abuse of statutory reorganization option</li> </ul>
	"DE/DD"	<ul style="list-style-type: none"> <li>- Leverage offered by liquidation option is of less practical significance</li> <li>- Liquidation of suitable rescue candidates more likely</li> <li>- "Lose/lose" scenario for managers</li> </ul>	<ul style="list-style-type: none"> <li>+ <b>"Breathing space" for firms that would be saved if informal reorganization were possible</b></li> <li>+ <b>Provides a safety net for executives seeking to maximize shareholder value</b></li> </ul>

Equilibrium "zones" in bold