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COMPANY LAW AS AN INSTRUMENT OF INCLUSION: RE-REGULATING STAKEHOLDER RELATIONS IN THE CONTEXT OF TAKEOVERS

ESRC Centre for Business Research, University of Cambridge
Working Paper No. 145

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September 1999

This Working Paper relates to the CBR Research Programme on Corporate Governance, Contracts and Incentives

Abstract

This paper considers a number of potential justifications for regulatory intervention aimed at overcoming 'contractual failure' in stakeholder relations. Two distinct functions of stakeholding are identified, in terms of 'contract' and 'innovation' respectively. These conceptions are linked to two distinct approaches to the regulation of stakeholder relations, one based on 'rights' and the other on 'cooperation'. The implications of an innovation based approach for reform of the law relating to hostile takeovers in the uk are considered. The paper concludes by suggesting that the effectiveness of regulation will depend on the capacity of legal rules and procedures to promote cooperation within stakeholder relations, in particular by generating markets for information.

Acknowledgements

This work was carried out as part of the ESRC core funded research of the ESRC Centre for Business Research.

COMPANY LAW AS AN INSTRUMENT OF INCLUSION: REGULATING STAKEHOLDER RELATIONS IN THE CONTEXT OF TAKEOVERS

1. Introduction

A company's stakeholders make up a web of relationships both with and within the company. The company depends on the continuing health of these relationships for its survival and prosperity. In many cases, a process of bargaining or mutual adjustment between the different stakeholders may be sufficient to ensure that the health of these relationships is maintained. Contracts, explicit and implicit, can allocate risks and rewards in such a way as to maximise returns on the investments made by all the parties. However, the terms upon which bargaining takes place do not always result in mutually-beneficial outcomes. Contracts are affected by uneven access to information, and hence to bargaining power. This in turn results in the imperfect allocation of risks and rewards, and hence to lost opportunities for all concerned.

In this paper, we consider a number of potential justifications for regulatory intervention aimed at overcoming what we may call 'contractual failure' in stakeholder relations. We identify two distinct functions of stakeholding which we characterise in terms of 'contract' and 'innovation'. We then show how these are linked to two distinct approaches to the regulation of stakeholder relations, one based on 'rights' and the other on 'cooperation'. After exploring the areas of takeovers and company reporting, we conclude by suggesting that the effectiveness of regulation will depend on the capacity of legal rules and procedures to promote cooperation within stakeholder relations, in particular by generating markets for information.

2. Defining the Company's 'Stakeholders' in the Context of Regulation

A common theme running through the different formulations of the stakeholder concept is their emphasis upon inclusion. The idea that many groups, and not simply the shareholders, have 'something directly at stake' in a company is given increasing importance in contemporary debate. Nevertheless, ideas of inclusiveness in the way companies are run and managed have been expressed in terms of 'stakeholding' only in the last 35 years. Despite the relatively recent application of the word 'stakeholder', a long underlying history of ideas and experiments has provided the intellectual support for the idea of stakeholding. Three particularly important influences from this history are noted here.

One major influence on stakeholder ideas has been the succession of efforts to improve relations between businesses and those whom businesses affect. These efforts go back at least to the beginning of the 19th century, and Robert Owen's attempts to humanise the working environment in his mills. A series of similar attempts have followed, including profit-sharing at J & J Taylor, governance by trusts at the Zeiss works and the John Lewis Partnership, health and safety monitoring by Mackenzie King in Canada, and conflict resolution by the Whitley councils in Britain.

A second major influence on the idea of stakeholding has been Christian thought. Even where inspiration is not explicitly taken from the Christian tradition, common themes can be found in Christian and stakeholding arguments: human imperfection; human novelty; self-consciousness and responsibility; and action on the basis of absolute principles. Similarities in philosophical concerns are backed by direct historical links. During the second world war, groups of Christian thinkers in the UK worked to promote a reconsideration of relations between society and industry.[1] A significant participant in these discussions, George Goyder, subsequently wrote a number of books

including *The Responsible Company*, in which he developed the idea of the 'social audit' and questioned the nature of shareholders' ownership rights. These ideas have continued in groups which have shaped the stakeholding debate today, such as the Centre for Tomorrow's Company.

A third major influence has been the development of modern management methods. These, particularly the methods for managing *self-organising groups*, have provided applicable content for stakeholder theory. The methods of self-organising groups were formalised by the Tavistock Institute in the UK, and by the National Training Laboratories in the US, shortly after the second world war. The methods were publicised in the joint journal *Human Relations*, and strongly influenced the development of human resource management. Self-organising groups offered methods for generating the 'tremendous energy and directive ability' (Bridger, 1990: 78) which had been observed in the 'link between participation and the release of creative forces' (ibid., 86). Chris Argyris, Warren Bennis and Russell Ackoff, key figures from organisation psychology, management theory and operations research respectively were all directly connected with this work on self-organising groups.

These components have all influenced the meanings given to stakeholding. Although apparently diverse, the different strands are connected by particular individuals and by common themes of interest. Working backwards in time, the connections between the various groups are clear. There has been a continuing cross-fertilisation of ideas among all those concerned with understanding the organisation. This interchange has offered the intellectual background, the rich soil out of which the idea of 'stakeholding' has grown.[2]

Why does 'inclusion' in a corporate context call for *regulation* of relations between different groups of stakeholders? The stakeholder approach, *whatever its moral justification,* has always required an

economic justification consisting of net benefits to the group, or society, that adopted it. From this point of view, we will suggest that a space for regulation exists because co-operation between the different stakeholders, which is the foundation of the company's success, cannot be completely contracted for. Law and regulation are needed to shape the bargaining process in ways which foster the well-being both of the company and, in the final analysis, of society too.

There are two broad economic justifications for basing regulation on the stakeholder concept. The first is an argument at the level of *contract*. Take the example of the employment relationship. In some long-term economic relations, high transaction costs (including the costs of negotiating, monitoring and enforcing express contracts) may impede the formation of contracts which would provide for an efficient sharing of risks and information between the parties. Where this is the case, the contractual interests of certain parties are under-protected (Shleifer and Summers, 1998; Winter, 1993). Here, the provision of legal rights for stakeholder groups could be seen as completing or perfecting the terms of the 'incomplete contracts' which the parties arrive at through autonomous bargaining. By these means, the contractarian model of stakeholder relations can give rise to a *rights-based* conception of the role of legal regulation. The definition of stakeholders is narrowed to 'those whose rights are affected by the firm' and the definition focuses upon what is 'due to' stakeholders because the firm imposes upon them costs or risks which cannot effectively be contracted for.

The second economic justification for basing regulation on stakeholder ideas is an argument orientated towards *innovation.* A growing body of research attests to the importance of close collaboration between firms, and between management and labour within firms, as a prerequisite for innovation (Deakin and Wilkinson, 1996). Because innovation requires planning for the long term, but at the same time involves radical uncertainty over the future, the success of collaborative ventures depends upon the willingness of both sides

to respond flexibly to changing circumstances. As a result, contractual relations are inevitably 'incomplete', so giving rise to a role for the law in supporting long-term cooperation (Deakin, Lane and Wilkinson, 1994). However, rather than seeing the role of the law in terms of the 'completion' or 'perfection' of incomplete contracts, its purpose now is to encourage *incompleteness*: to encourage a flow of information and cooperation which goes beyond the terms of any express or implied contract. The basis for this form of extra-contractual cooperation has been usefully termed 'goodwill trust' (Sako, 1992). While not ruling out space for a rights-based discourse, the emphasis instead is on procedural rules whose aim is to foster learning and creativity within stakeholder relations, rather than simply on redistributive measures which purport to create an optimal incentive structure for contracting (Deakin and Hughes, 1999).

If a company's stakeholders were simply understood as the 'affected parties', or 'those who can affect the firm,' then a contract-based approach would be sufficient to govern their relations. However, the fact that stakeholder relations have the potential for innovation has very important implications. In particular, it provides a link to the concept of inclusion, since inclusion is a means by which cooperation may be enhanced. Inclusion may sometimes require regulating the form that contracts and markets can take. It does not mean that stakeholders should always or automatically have absolute rights to information or control. Rather, because of their importance to the productive process, it means that it makes sense for markets, information systems and contracts to be designed in ways that help all stakeholders to give of their best.

The tension between the contract and innovation elements present in the concept of stakeholding has been evident in its history. Innovation, present in the earliest writings on stakeholding, was put aside for some time in the 1980s and early 1990s. Stakeholder author Edward Freeman visited the Stanford Research Institute (SRI) in the early 1980s. For a variety of reasons, not least that the US economy

was suffering a severe recession, discussions with researchers at the SRI led him to adopt their then harder line, rights-based approach to the idea of stakeholding. The definition of 'stakeholders' that he published referred to 'those groups without whose support the organisation would cease to exist' (Freeman, 1984: 31).

The 1984 definition emphasises that production requires the consent of a certain number of groups, which offer an implicit 'licence to operate' (RSA, 1994). Stakeholders are those who can cause the institution to collapse by withdrawing their cooperation. Because some stakeholders, such as employees, may be more vulnerable to risk than shareholders, these groups might even make claim to rights of quasi-ownership.[3] Claims might be in terms of shareholdings, vetoes over ownership transfers, or rights to information about company activities.

The definition, however, was rather more hard-line than Freeman needed, and as the debate developed, both he and other writers seemed uncomfortable with a rights-based version.[4] Especially in the 1990s, the discussion has turned back towards the innovation element, closing the circle with the original paper[5] published by researchers at the Stanford Research Institute which, in 1963, had emphasised co-operation: seeking ideas from people throughout the company, and balancing planning with intuitive judgement, experience and creative reasoning.

There is no doubt that concerns with cooperation, creativity and mutual benefit *could* be developed out of Freeman's 1984 definition. But this definition tends to encourage a view of stakeholders' rights operating primarily as a constraint on management. In order to provide some balance to this rights-based approach, we offer the following definition, emphasising that stakeholder participation can be the basis for cooperative innovation:

A company's stakeholders are those whose relations to the enterprise cannot be completely contracted for, but upon whose cooperation and creativity it depends for its survival and prosperity.

Our definition of stakeholding has implications for company law. The legal system provides a framework within which the contractual and innovation-based models of stakeholder relations are continuously tested. UK company law, like that of most other common law systems (such as those of north America and the Commonwealth), provides important rights to shareholders as the 'residual claimants' of the company, but currently provides relatively few such rights to other stakeholder groups. The question we wish to examine here is whether the exclusion of stakeholders who are not shareholders from participation in corporate decision-making can be justified on economic grounds.

A highly influential view of the company sees it as the focal point of a set of contracts or bargains, of varying degrees of explicitness, through which the wishes of all the stakeholders are expressed. According to this point of view, the interests of the different stakeholder groups are best represented (and reconciled) through bargaining. Company law plays a role in reducing transaction costs by supplying legal rules which operate as a kind of standard form contract, which the parties can modify or adjust to their own particular needs, but which rarely constrain or prohibit private contractual solutions. A principal focus for legal rules of this kind is to reduce the agency costs which arise from the separation of ownership (by shareholders) and control (by managers). Corporate governance is largely a matter, in this view, of addressing the difficulties which shareholders have in controlling managers whose interests and information may diverge from their own. These difficulties are limited wherever institutional investors are willing to intervene to demand changes in management policy, or where the market can use an outside disciplinary mechanism, such as the hostile takeover. Hence a

number of mechanisms – some legal, some extra-legal – are available for promoting efficient bargaining solutions.

Similarly, this line of thought argues that the wider stakeholders – employees, long-term customers and suppliers – are best protected by contractual mechanisms or, where bargaining is not feasible, by certain statutory provisions which control the exercise of contractual power (such as employment protection laws, in the case of employees, or laws governing late payment, in the case of commercial suppliers). What is not appropriate is to give such groups ownership or control rights within the framework of the company. To do this, it is said, would be to undermine the position of the shareholders as 'residual claimants', that is to say, as those who bear the ultimate risk of the company's failure and who, conversely, stand to gain most if the company succeeds (Macey and Miller, 1993).

Were the monitoring role of shareholders to be diluted, or shared with the other stakeholders, it is argued that the effect would simply be to entrench corporate managers against scrutiny of their behaviour. As we shall see in further detail below, this is the basis for the view that the introduction of controls over hostile takeover bids would reduce the effectiveness of shareholder scrutiny of managerial behaviour, thereby leading to a loss in overall efficiency. But even so, from this perspective, the issue confronting policy-makers in the area of corporate governance is: *how should the company be regulated so as to enhance its effectiveness as a mechanism for enhancing the overall wealth or well-being of all stakeholders?*

3. The Regulation of Hostile Takeovers in the UK

The nature of the task facing policy makers can be illustrated by considering the arguments for and against hostile takeovers. In other work, we have argued that the system currently operating in the UK exposes non-shareholder stakeholders in listed companies to undue risk in two ways (Deakin and Slinger, 1997). *Firstly*, it places the interests

of target shareholders above those of other stakeholder groups, to a greater extent than is warranted by the general law on directors' duties. As a result, the current law contributes to a system of incentives which encourages managers to favour the short-term financial interests of shareholders when faced with a hostile bid. *Secondly*, the law hampers the ability of potential target firms to put in place anti-takeover defences. This helps to perpetuate a situation in which virtually all publicly-quoted companies are 'in play', or subject to the market for corporate control, and hence to pressures on managers to retain the confidence of the market at all times.

Is this situation conducive to economic efficiency? In one view, the benefit of hostile takeovers is not only that they can directly alter practices at corporate underachievers, but that they can also encourage better performance in those companies which, as a result of the threat, improve their performance, and hence never have to face a bid. As the 'great white shark' of the corporate world, hostile takeovers encourage 'all the fish in the ocean to swim a little quicker'.[6]

The contrasting argument, made at least since the mid-1980s (Shleifer and Summers, 1988), is that hostile takeovers can undermine relations of goodwill trust between a company and its stakeholders. In addition to damage to the internal relations of the firm, a number of negative externalities may also be imposed on third parties. The publicity attracted by one hostile takeover bid can cause employees in other companies to place less faith in the value of their own implicit contracts. Where local communities are highly dependent on a particular employer, the costs of restructuring, which tend to follow on from takeovers, may fall unevenly on such groups. This is a kind of 'social pollution' whereby institutions beneficial to many, such as implicit contracts, are damaged by the privately-interested actions of the few. Hence one company's emphasis on maximising returns to shareholders at the expense of the under-protected, 'implicit' interests of other stakeholders, has effects beyond the individual takeover

situation, and is corrosive to the productive potential of many other, similarly-situated companies.

In addition, the hostile takeover mechanism, it is argued, operates through a relatively inefficient market. The relentless pressure of quarterly performance assessments for fund managers means that they cannot afford to take a long view of investment decisions. The balance of the econometric evidence is that the market assesses takeovers – in particular agreed bids - inefficiently, making consistent and sizeable errors in valuations of the bidder company, and not selecting the most poorly performing candidates for bids.[7] As a result, managers may be best advised to seek greater size, or to reduce long-term investment, to preserve their positions (Roll, 1986). This gives greater credence to the argument that employees may be wary about making long-term investments (such as those involved in acquiring firm-specific skills) in their relationship with the company. For all the reasons above, arguments are advanced for restrictions on hostile takeover bids.[8]

Arguments that regulations should be imposed, however, are often criticised by those most closely involved in the operation of the takeover system. In the course of our research on the takeover process, market professionals said to us:

> 'I am very strongly against the idea of requiring a positive proof of public interest. To whom would the proof be given? What standard of proof would be required? It would allow political intervention and it is dangerous to allow politicians to start to make this kind of decision.'

> 'I am absolutely against any blanket ban on takeovers - think of the comparison with your own personal property, and the government forbidding you the right to buy or sell it. The suggestion of requiring 75% approval for control change is rubbish - try applying it to Parliament! In any case,

> shareholders can vote for this kind of change if they so wish. Sand-in-the-works? I would not expect increasing transactions costs by putting "sand in the works" to have any effect on the takeover business.'[9]

Those we spoke to believed that takeovers permitted flexibility in reorganising economic arrangements. There was a belief that a bureaucratic assessment of costs and benefits would not offer the same thing. The chairman of a large UK plc said to us:

> 'The overall takeover process is extremely healthy. It does keep open the one serious option for change. I would if anything like to see more M&A [merger and acquisition] activity... and I would actually have a shorter version of the [takeover] process. Sixty days is too long.[10] Proof of positive public interest? This would be very difficult to prove, and to win the argument. It would block the capitalist process.'[11]

The argument here is not whether *any* regulation should be imposed. Regulation shapes the entire market from corporate control, from company law, through the Takeover Code, to the rights of employees under employment protection and (now) minimum wage legislation. The question is not whether *but how and to what extent* contractual arrangements between companies and others should be shaped by regulation, and to what extent they should be left open. It is on this issue that the difference between understanding stakeholders as rights-holders and understanding stakeholders as creative innovators becomes important.

If stakeholders are 'those whose rights are damaged,' the aim would be the identification of damage, and compensation. Yet if stakeholders are 'potentially creative innovators,' the aim would be to maximise the gains from innovation, and to share any gains in a way that continued to encourage innovation. From this point of view, the argument as to whether the disciplinary function of takeovers

outweighs the disruption and short-termism which they are said to cause, should not be settled solely in terms of rights to compensation. Regulation of stakeholder relations should strike a balance between accounting for past costs and benefits, and emphasising learning and adaptation for an uncertain future. For this reason, we should be wary of any particular distributive solution which is proposed for stakeholder relations. Instead, we should seek to create *frameworks* which can permit cooperative and innovative solutions to be found. A purely contractarian view of stakeholder relations – even a 'sophisticated' one which takes account of implicit contracts – is not capable of capturing the dynamic role of innovation within stakeholder relations.

4. Reforming Takeover Regulation

A number of proposals have been made at various times for protecting stakeholders from company takeovers. Some of them involve strengthening employee rights in general, and are not specific to takeover activity; for example, there is a strong case for granting employees protection against the abuse of pension funds. This issue has been addressed by recent pensions legislation[12] which has gone part of the way to giving employee representatives a clearer monitoring role in respect of pension fund management. Of greater interest for present purposes are proposals which relate directly to the balance of power between managers, shareholders and other stakeholders within corporate governance. Here, in the face of arguments that would give the market for corporate control free rein, stakeholder proponents have argued for drawing it back sharply: allowing more anti-takeover defences, including permitting cross-shareholdings; judging takeovers by the public interest criterion, with a greater role for the Monopolies and Mergers Commission; and creating a tax differential to encourage long-term retention of shareholdings. In response, it has been suggested that those regulatory changes which impose a particular redistributive solution may distort existing markets, increasing costs without generating sufficiently large

benefits by way of compensation. It is also argued that the UK is not an abstracted contracting environment, on to which solutions from other countries' systems (for example) can simply be grafted. The regulatory options, it is argued, have to be considered within an existing commercial culture.[13]

In our view, these objections are properly understood as arguments against certain forms of regulation, and not against regulation as such. We defined stakeholders above as those affected by the firm in ways which cannot completely be contracted for, yet who could potentially interact with the firm in co-operative, creative, mutually beneficial ways. This approach implies a need for a framework of rules to provide incentives for the sharing of risk and information and to foster long-term co-operation based on trust, rather than one which seeks to impose a particular solution on the contracting parties. What would such an approach imply in practice for the regulation of takeovers in the UK?

A theme running through the analysis of hostile takeovers is that both managers and shareholders make decisions on the basis of incomplete information. The best counter, then, to market and managerial myopia is the provision of a wider range, and a higher quality, of information about the company's activities. The criticism levelled by Richard Roll's 'hubris hypothesis' (Roll, 1986), for example, was not just that companies cut investment, but that they did so because of failures in the market for information. It has become accepted wisdom in parts of the City that companies in difficulty can restore share prices by instituting large-scale redundancies.[14] It could be argued that they thereby forfeit potential longer-term gains based on previous investments in skills and training. With better information of the effect of training cuts on staff morale, customer opinions, and retention ratios of both, the market would be able to allocate its capital more efficiently, and fewer myopic decisions would be made by both managers and by the representatives of institutional shareholders.

The role of advisers' incentives might also be considered here. Econometric studies show that expert advisers are involved in a business which, on average, *loses* money for the shareholders of the bidding firms, in particular in the case of agreed bids.[15] Even when agreed and hostile bids are analysed separately, mergers resulting from hostile bids lead on the whole to performance which is no better than the average performance in the industries in question. Viewed from this perspective, the failure of the market for corporate control to evaluate effectively the longer-term effects of mergers and takeovers is a clear instance of the reality of agency costs: those who own shares in bidder firms appear to be incapable of exercising adequate control over the managers who prepare and plan takeover bids.

How should shareholder representatives in potential bidder companies respond? Their options include (1) demanding better justifications from the companies they invest in for any takeover bids made; (2) encouraging the introduction of incentive fees based in whole or in part on the long-term relative stock market performance of the bidding company. On the evidence of past practice, however, the capacity of shareholders to perform this monitoring role must be in doubt. For whatever reason, there are few signs that UK institutions are prepared to counter this form of managerial myopia.

Under such circumstances, it is legitimate to question the widespread view that shareholders are, because of their role as 'residual claimants', best placed to perform the role of monitoring corporate managers. At the very least, we may be sceptical of the idea that the shareholders *alone of all the stakeholder groups* should play a significant monitoring role. Attention then turns to giving non-shareholder stakeholders a more prominent role, in order to balance the information arriving at the decision-making level.

As the situation stands, the nature and content of directors' fiduciary duties is a central issue. The interaction between the overlapping regulatory systems of the Takeover Code, the Companies Acts and the

common law results in a situation in which directors of target companies, faced with a bid, place the interests of shareholders clearly ahead of those other stakeholders. Although they have an obligation to act with regard to the interests of the company as a whole, directors find themselves owing specific duties to the shareholders, for example concerning the accuracy of information concerning the bid.

One option for reform is to clarify the law so that directors enjoy greater autonomy from shareholder pressure during takeover bids. There are models for such reform in the 'stakeholder' statutes passed by many US state jurisdictions in the late 1980s and early 1990s (see Deakin and Slinger, 1997). Similarly, the draft EC Directive on takeover bids (the 'Thirteenth Directive') requires the board of a target company to 'act in the interests of all the company, including employment' when responding to a bid.[16] Indeed, section 309 of the UK Companies Act 1985 requires directors to take the interests of the company's employees into account when discharging their duties to the company. In this vein, the Takeover Code could be amended so as to reflect more completely this provision of the Companies Act. However, changing the law relating to directors' duties is unlikely to have much practical effect in the absence of any moves to give other stakeholders, such as employees, legal standing to challenge decisions of boards. Nor would reformulating directors' duties in the way suggested help boards to decide how to resolve conflicts which may arise between the interests of the different stakeholder groups.

A more concrete proposal which has been made from time to time in the protracted debate over the draft Thirteenth Directive is to require both the bidder and the target companies to engage in a process of consultation with employee representatives during the course of the bid. Rule 24.1 of the Takeover Code merely requires the bidder company to state its intentions with regard to future relations with employees. Offer documents issued by bidders under the rules of the Code nearly always contain a statement to the effect that existing rights of employees will be fully respected. This says nothing more

than that the bidder company will respect the company's prior legal obligations to its employees; it has become a formality, which is represented in offer documentation by the use of a standard 'boilerplate' formula.[17] It says nothing about the protection of implicit but legally unprotected obligations.

Granting clearer protection to employee expectations (an 'implicit contract' approach) is one option open to legal reformers; in some US jurisdictions, rights of employees to employment protection are statutorily enhanced following a takeover (so-called 'tin parachute' rights).[18] Employees whose firms are subject to takeover are better protected than other similarly placed workers. The effect may be to deter certain types of 'breach of trust' by takeover bidders, but even then the best such laws can normally achieve is higher levels of compensation for those who lose their jobs in the aftermath of a change of management. In the UK, in contrast to the US, it is normal for employees to qualify for some form of compensation if they are made redundant whether or not their companies are taken over. This does not seem to have deterred takeover bidders to any degree. If anything, the presence of redundancy legislation may have helped to encourage a culture in which employees have come to accept loss of employment as a consequence of corporate restructuring, in return for severance payments and accelerated pension entitlements (Deakin and Wilkinson, 1999).

The proposal for consultation with employee representatives in the course of the bid could have a much more wide-ranging effect on the process of managerial decision-making. The legal meaning of consultation, in this context, requires the parties to consult with a view to making an agreement.[19] Statutory rights to information and consultation already exist in respect of decisions for large-scale redundancies,[20] and where a business is sold from one employer to another through a 'transfer of undertakings';[21] however, these rights do not extend to changes of control by share transfer.[22] The closure of this anomaly (for this is what it is, viewed from the vantage point of

employment law) would help to provide a basis for the monitoring of managerial conduct by employees. In recent drafts of the Thirteenth Directive, however, concerns about the possibility of lengthy and costly disruptions to bids led to the deletion of any references to employees' consultation rights. The only requirement, as under rule 24.1 of the Takeover Code, was that bidders should state their intentions with regard to the future treatment of employees.[23] These concerns about hampering bids appear overstated. That a requirement to consult with employee representatives would hamper certain bids is not, in itself, a good reason to oppose consultation. On the contrary, requiring bids to pass the threshold of consultation with employees could usefully deter precisely those bids whose financial raison d'être lies in expropriating rents from stakeholders who are not shareholders.[24]

Consultation during bids would be most effective if it were coupled with a general obligation to provide wider information about the treatment of employees. Here, a relevant model may be found in the 'balanced business scorecard' approach to company reporting. This recommends that companies should report on measures for customer satisfaction, dealer satisfaction, employee morale and empowerment, and environmental responsibility, alongside more traditional measures of financial performance (Kaplan and Norton, 1992, 1993, 1996). In the context of a takeover bid, the impact of the bid on other stakeholders - on customers, employees, suppliers, and possibly the local community - is arguably highly relevant to an assessment of its merits. The decisions of these constituencies will determine the company's long-term prospects. Both during takeover bids and more generally, it therefore seems legitimate to suggest that the reporting duties of both the target and the bidder company should be broadened to include a description of the identification and monitoring systems in place, auditors' evaluation of their effectiveness, and the company's performance to date in meeting the identified interests of its various stakeholders. Such an obligation could supplement the present duty to provide information to shareholders in the annual reports, and would

provide content for consultation with employee representatives during bid situations.

5. Conclusion

In this paper, we have suggested that regulation has a role in enhancing cooperation in stakeholder relations, and we have suggested how a modest reform to the current law governing takeover bids could mitigate some of the more disruptive effects of hostile bids. We argued that the interaction of law and regulation strongly protects target shareholders, leaving both bidder shareholders and, particularly, wider stakeholders relatively exposed to risk. At the same time, the takeover mechanism was strongly praised by some of our interviewees for its encouragement to corporate efficiency. Our general approach to takeovers has therefore been to identify interactions between legal and economic regulatory systems which produce damaging effects, and to address failures in those systems. We noted the dangers opened up by payments to advisers and managers that did not fully align their long-term interests with those of shareholders; and rules on communication by managers that focused their attention on shareholders during bids, dissuading them from communicating effectively with other stakeholders, particularly employees. All of these have consequences in takeover situations that could be addressed by reforms aimed at limiting the numbers of bids, but equally, their effects in bid situations could be addressed by general reforms aimed at enhancing the flow of information about and to non-shareholder stakeholders.

Particular solutions to the issue of stakeholder relations *can* be imposed on companies. Such imposed solutions might settle the contracting arrangements once and for all. But they also leave themselves open to problems arising from evolution within the economic environment. In so far as they emphasise rights at the expense of cooperation, they may encourage a conflictual approach to

dividing gains from the firm. The particular solutions might be appropriate at one time, but are vulnerable to change.

The reluctance to impose fixed solutions in the context of a changing and open-ended environment lay behind the argument for a greater range of information to be communicated to shareholders and stakeholders, and thereby into the public domain, on the question of stakeholder relations. The information approach allows space for the creation of local contracting arrangements, and emphasises the productive potential of cooperation between stakeholders. We have also argued for laws which promote consultative arrangements between companies and their wider stakeholders. The aim of such reforms would be to allow inclusive solutions to be sought. This seems to us to be the best way of expressing through a regulatory approach the essentially cooperative and creative concept of stakeholding.

Notes

1. Notably the Christian Frontier Council, organised by J. H. Oldham, who edited and wrote in the *Christian Newsletter*.

2. See Slinger, 1998, for a more detailed account of the development of stakeholder theory.

3. In the case of employees, whose specific investments in skills, location and social relations may make them extremely vulnerable to the costs of corporate restructuring, these 'investments' can be conceived of as being 'like' equity market investments.

4. Later writers, such as Elaine Sternberg, for example, have forced the issue by pinning stakeholding down to a strong rights-based version, and thereby provoked a reaction in those who sought to emphasise co-operation. See Sternberg, 1994.

5. Stewart, Allen and Cavender, 1963. See Slinger, 1998.

6. A market professional, interviewed by the authors for the ESRC Centre for Business Research (CBR) project on takeover regulation, 1995-96.

7. The extensive literature is summarised in Deakin and Slinger, 1997; see also Mueller and Sirower, 1998.

8. See Hutton, 1995; Plender, 1997: 260. For a contrary view, see Commission on Public Policy and British Business, 1997: 110.

9. A City financier, interviewed by the authors for the CBR research project on takeover regulation, 1995-96.

10. This is a reference to the period of time laid down by the City Code on Takeovers and Mergers for the conduct of bids. See Deakin and Slinger, 1997.

11. Interviewed by the authors for the CBR research project on takeover regulation, 1995-96.

12. In particular the Pensions Act 1995.

13. See Manser, 1990, where the arguments for and against takeover regulation are rehearsed, the author coming down strongly in favour of the latter.

14. For discussion of the reasons for this, and of the pressures on companies to meet capital market expectations, see Froud et al., 1999.

15. See Mueller and Sirower, 1998.

16. Article 5(1)(c). See *Official Journal of the European Communities*, C 378, 13.12.97.

17. See Deakin and Slinger, 1997.

18. Ibid.

19. See Deakin and Morris, 1998: 786-788.

20. This legislation dates back to 1975 and is currently contained in the Trade Union and Labour Relations (Consolidation) Act 1992. It is supported by a number of EC directives (in particular Directive 75/129 on Collective Redundancies).

21. The Transfer of Undertakings (Protection of Employment) Regulations 1981, implementing EC Directive 77/187 (the 'Acquired Rights Directive').

22. There is a provision for there to be annual consultation over merger plans between company representatives and representatives of employees in the Annex to the European Works Councils directive (Directive 94/45). However, this is unlikely to lead to significant employee participation in decision making on mergers: see Wheeler, 1997.

23. The amended proposal is published in the Official Journal of the European Communities, 1997, C 378, 13.12.97. The background to the proposal is explained in Commission document COM (97) 565 final. See also House of Lords Select Committee on the European Communities, *Takeover Bids*, 13th. Report, HL Paper 100, Session 1995-96.

24. For reasons of space we have to pass over here some important issues concerning the precise scope of a duty to consult as proposed in the text, and the remedies which the law should make available for a failure to consult.

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