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CORPORATE OWNERSHIP STRUCTURE AND THE EVOLUTION OF BANKRUPTCY LAW IN THE US AND UK

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Abstract

The past decade has seen intense academic debates over possible explanations for the different systems of corporate ownership and control that exist in developed economies. Yet the role of bankruptcy as a mechanism of corporate governance has received relatively little attention. Furthermore, many theories have failed to account successfully for events occurring in the UK, notwithstanding its similarity to the US. In response, this paper offers an account of the complementarities between bankruptcy law and ownership structure, which it is argued can explain developments in both the UK and the US. By identifying the effects of concentration or dispersion in firms' capital structure (across both equity and debt), and by analysing implications of these capital structure choices for bankruptcy, the paper develops a richer account of the corporate governance patterns we see in different nations.

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Introduction

The corporate world today subdivides into rival systems of dispersed and concentrated ownership, with different corporate governance structures characterizing each (Coffee, 1999a). The United States falls into the former category and major industrial rivals such as Japan and Germany are members of the latter. The past decade has seen intense academic debates over possible explanations for the different systems of ownership and control in key developed economies. Anecdotal evidence which suggests that market forces may be serving to destabilize traditional business structures and foster some form of convergence in a US 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 provides the United States with a companion in the dispersed ownership category since, as is the case in the US, 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 that have been 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 has been done, however, events occurring in the UK have tended to cast doubt upon rather than lend support to the relevant hypothesis. This has been the case, for instance, with theories concerning financial services regulation, political ideology and minority shareholder protection.

The purpose of this Article is to refer again to the British experience to test an additional hypothesis that has been offered to explain why the corporate economy in the US is organized differently than it is in countries such as Germany and Japan. Corporate bankruptcy, it has been said, is the “crucial missing piece in understanding corporate governance”. According to this thesis, an “evolutionary” account of corporate governance, a country’s system of bankruptcy law is either “manager-driven” or “manager-displacing”, with the former offering executives of a financially troubled firm substantial scope to launch a rescue effort and the latter having a strong bias in favour of liquidation. The thinking, in very basic terms, is that a manager-driven bankruptcy regime is complementary to dispersed share ownership and its manager-displacing counterpart aligns with a governance regime where concentrated ownership prevails. Given the configuration of the UK’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 public 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 UK’s system of ownership and control may function in a manner different than the received wisdom implies. Second, Britain’s bankruptcy regime may operate in a manager-driven fashion despite the apparent bias in favour of liquidation. Third, the relationship between bankruptcy and corporate governance might need to be rethought in light of the British experience. This paper examines each of these possibilities and ultimately argues that the third option is the correct one. It will be seen, however, that 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 has important implications for both policy and future research.

The key addition to the theory is a more complete analysis of debt in the overall corporate governance framework. Like equity, the focus of most of the existing debate, debt finance can be either concentrated (as when firms borrow from one or a syndicate of banks) or dispersed (as when they issue public debt). By identifying the effects of concentration or dispersion in firms' equity and debt finance, and the implications of these capital structure choices for bankruptcy, the Article develops a richer account of the corporate governance patterns we see in different nations.

The Article is organized as follows. Section I begins by providing a brief overview of the world's rival systems of ownership and control. Section II identifies and elaborates on the UK's status as a theoretical "problem child" by analysing efforts that have been made to explain corporate governance arrangements by way of financial services regulation, political ideology and minority shareholder protection. The third section of the Article then offers a synopsis of the thesis that corporate bankruptcy is the "crucial missing piece in understanding corporate governance". Section IV provides an overview of Britain's bankruptcy regime. This overview, which demonstrates that Britain's approach is manager-*displacing*, rather than manager-driven as the evolutionary theory would predict, shows that the UK lives up to its "problem child" status in the bankruptcy context as well as various others.

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 UK corporate governance has not been mischaracterized by the existing literature. The sixth section of the paper assesses whether it is appropriate to think of the UK as a manager-displacing bankruptcy regime, given that financially troubled large companies can carry out workouts pursuant to informal guidelines known as the "London Approach." The prominence of the London Approach suggests that the UK approach to corporate insolvency is less manager-displacing in practice than the formal rules would suggest, but it does not fully solve the UK governance puzzle.

To provide a more satisfying account of the British situation, we must reconfigure the hypothesis that there is a fundamental link between corporate governance and bankruptcy. Section VII undertakes this task. It is here that we emphasize the role of debt finance, and its interaction with stock ownership and the relevant insolvency framework. By taking these "below the line" factors fully into account, rather than focusing solely on the ownership and control of firms' stock, the Article seeks to provide a better explanation of UK governance, as well as a richer account of the factors that distinction different corporate governance approaches. Section VIII then applies the reconfigured evolutionary theory to closely held corporations in the US and UK. Section IX is a brief conclusion.

I. Rival Corporate Governance Systems

As mentioned, share ownership in the US and the UK is generally characterized as being 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 (Moerland, 1995; Franks and Mayer, 1997). Moreover, 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 3 out of 10 of the country's publicly quoted companies have a shareholder that owns more than one-fifth of the shares (Faccio and Lang, 2000). Likewise, in major US companies large shareholdings, and especially majority ownership, are the exception rather than the rule (La Porta *et al*, 1999; Shleifer and Vishny, 1997).

The structure of ownership and control which exists in the UK and the US has been characterized as an "outsider/arm's-length" system

(Berglöf, 1997a; Goergen, 1998).[1] The "outsider" typology is used to describe the situation that exists because share ownership is dispersed among a large number of institutional and individual investors rather than being concentrated in the hands of "core" shareholders capable of exercising "inside" influence. The term "arm's-length" signifies the received wisdom that investors in the US 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.[2]

Matters are organized quite differently in continental Europe and in market-oriented economies in Asia. Publicly quoted companies do not play as nearly as important a role in the economy as they do in the US and the UK (La Porta *et al*, 1997). Also, with 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" (Berglöf, 1997a; Hoshi, 1998).

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.[3] The conventional wisdom is that in the US and the UK there is little interdependence between banks and larger industrial or commercial firms (see Charkham, 1994; Scott, 1997). This is logical enough since these are countries where the stock market is said to be the key allocator of capital (Economist, 2001a; *cf.* Demirguc-Kunt and Levine, 1999).

In insider/control-oriented jurisdictions, by contrast, the market capitalisation of the stock market constitutes a small percentage of GDP as compared with the US and the UK (La Porta *et al,* 1997; Wymeersch, 1997). By default, banking institutions should be at the forefront with respect to corporate finance.[4] Similarly, banks stand as leading candidates to exercise "inside" influence with respect to individual companies (Cunningham, 1999). Consistent with what might be expected in Japan, Germany and certain other continental European countries banks have developed and retained over time strong links with major industrial and commercial enterprises (Moerland, 1995; Scott, 1997). For instance, a German "universal bank" that lends money to a major corporate customer will also 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 (Charkham, 1994; Hopt, 2000). In Japan, it is common for an individual company to have an ongoing relationship with "main bank" where the bank owns a block of shares, supplies management resources and provides various financial services (Charkham, 1994; OECD, 1996).

In both Germany and Japan, during good times corporate managers are allowed ample latitude by banks since monitoring tends to be relaxed and informal. For instance, it has been said that a big German bank will act as an "owner, adviser, financier and benevolent uncle" (Barber, 1999; Hanazaki and Horiuchi, 2000). Things, however, are said to change if a company is performing poorly. The received wisdom is that, under such circumstances, control rights are swiftly transferred to the bank that is acting as the primary lender which then takes orchestrates an informal restructuring, an advantageous merger or an orderly liquidation (Charkham, 1994; Hanazaki and Horiuchi, 2000).

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, in both countries control of credit has been their primary means by which banking institutions have exerted influence (Charkham, 1994; Prowse, 1995; Skeel, 1998). While larger business enterprises that have a close relationship with a bank can achieve considerable autonomy by financing operations through retained earnings,[5] 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. This is because of a lack of alternative sources of finance. Again, equity markets in the two countries are also comparatively underdeveloped. Also, while in the United States larger corporations quite often issue publicly traded debt to raise fresh capital, this has traditionally not been the case in either Germany or Japan (Charkham, 1994: 99; Prigge, 1997: 1016-17; Corbett and Jenkinson, 1997; Saidenberg and Strahan, 1999: 1).

There has been extensive debate on the relative merits of a "bank-based" financial system as compared with its "market-based" counterpart (Levine, 2000). Nevertheless, it should not be taken for granted that banks are as pivotal as this intense dialogue implies.[6] Instead, classifying financial systems on the basis of whether they are "bank-based" or not is an exercise fraught with difficulties (La Porta *et al*, 2000). For instance, the role of the stock market in the US and the UK should not be unduly exaggerated. According to aggregate financial data, in these two "market-oriented" countries, debt is a more important source of corporate funding than is the issuance of shares (Prowse, 1995: Berglöf, 1997a).

Another reason that it can be unhelpful to focus unduly on banks when categorizing financial systems is that it cannot be taken for granted that, in a country with weak securities markets and concentrated share ownership, there will be substantial interdependence between banks and larger industrial or commercial firms. To illustrate, while Italy is an "insider/control-oriented" jurisdiction, the country's banks are not closely involved in corporate governance (La Porta *et al*, 2000; Melis, 2000; Carpenter and Rondi, 2000; Volpin, 2001). Even with Germany, often cited as the prototypical example of a bank-oriented financial system,[7] there is evidence to suggest that the influence of the banks has been exaggerated (Edwards and Fischer, 1994; Corbett and Jenkinson, 1997; Guianne, 2001).[8]

Moreover, 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 supplemental role to commercial bank lending, at least in Europe (McLaughlin, 2001). Also, banking institutions themselves are reconfiguring themselves in response to myriad financial pressures, with the result being that they are often content to abandon their "benevolent uncle" role (James, 2001).

In short, it is important to recognize that "insider governance" does not necessarily mean "bank governance." Although bank and other financial institutions are sometimes the principal shareholders in an insider system, family members and other individuals play a much more important role in many nations.

In recent years, there also have been increasing questions as to whether the distinction between outsider/arm's length and insiders systems will endure. Anecdotal evidence accumulating prior to the fall in global equity markets 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 (Van der Elst, 2000; Coffee, 2001). Similarly, Japan's IPO market was booming (Abrahams, 2000). Also, firms that had already issued shares to the public were actively seeking out broader markets for their equity, quite often by obtaining listings on US stock exchanges (Pagano *et al*, 1999; Hertig, 2000; Guha and Merchant, 2000). Furthermore, in insider/control-oriented countries those owning large blocks of equity in publicly quoted companies appeared to be unwinding their holdings to some degree (Coffee, 2001; Rhoads and Fuhrmans, 2001). At the same time, share ownership was becoming more popular on a societal level as the number of individuals owning equity directly or via collective investment vehicles (e.g. mutual funds) was growing significantly (Hansmann and Kraakman, 2001:

452). 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 (Targett, 2001).

The recent fall in global equity markets has led to, at the very least, a pause in the convergence trend. Global equity issuance, for instance, has declined significantly. Also, the pace at which concentrated shareholdings are being unwound might be slowing. Moreover, the stock market drop has sorely tested enthusiasm for shares in those countries where an incipient "equity culture" was emerging (Economist, 2001a; 2001b). 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". As a result, convergence along Anglo-American lines could still be very much on the cards.

II. The Foundations Of Corporate Governance: The UK as a "Problem Child"

A. Explaining Why Corporate Governance Arrangements Differ

In "the single most influential book ever written about corporations",[9] Berle and Means (1932) drew attention to the outsider/arms-length pattern of corporate governance that currently prevails in the US. 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 decision-making. The normative implications of this "separation of ownership and control" were keenly debated in the decades following the publication of Berle and Means book (see Mark, 1995; Gilson, 1996; Rock, 1996). Nevertheless, interested observers implicitly agreed on an important point: fragmented share ownership was inevitable in major business enterprises.

According to the prevailing orthodoxy, technology dictated that dominant firms must be large (Roe, 1994). 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 family connections with dominant shareholders. Therefore, the American version of the public corporation was the logical winner of a Darwinian struggle between different forms of corporate structure.

So long as the US public corporation was accepted as the evolutionary pinnacle, other systems with different institutional characteristics could be safely ignored: "neither laggards nor neanderthals (compel) significant academic attention" (Albert, 1993: 128). During the 1980s and early 1990s, however, Germany and Japan seemed to be enjoying greater economic success than the US (see Lipton and Rosenblum, 1991; Albert, 1993). This implied, contrary to the received wisdom concerning the "Berle-Means corporation",[10] that a different ownership and control framework was fully capable of delivering similar or even superior results (Gilson, 1996: 332). The possibility that there might be several equally efficient ways to organize large-scale industry raised, in turn, a question: why did the US system of corporate governance evolve in a manner different from its counterparts in Germany and Japan? (Roe, 1993).

As the 1990s began, the economic context changed but did so in a way that ensured that this question concerning the essential foundations of corporate governance systems remained topical. Throughout the decade, the United States enjoyed faster economic growth and lower unemployment than its chief economic rivals (Economist, 1999). 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 implies it should. 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 (Hansmann and Kraakman, 2001).

Since economic trends seemed to be demonstrating the relative efficiency of the US economic model, speculation grew as to why the apparently inferior insider/control-oriented system of corporate governance had persisted in so many countries (e.g. Wessel, 2001). 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 (Vives (ed.), 2000: 84-85; Economist, 2001a). This meant, in turn, that it was necessary to understand the recipe for US corporate success. Hence, while America’s economic surge changed the context, it remained pertinent to contemplate why the US system of corporate governance had evolved in a manner different from its counterparts in Germany and Japan.

Mark Roe has, in a wide range of published work, 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 US contributed significantly to the dominance of the Berle-Means corporation (Roe, 1990; 1994; 1997). Roe has argued that, at several points in the 20th 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, forced corporate ownership to remain fragmented and deterred 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 US history produced.

Roe has also drawn attention to an additional political contingency that may have had an influence on corporate governance patterns. He says there is 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 (Roe, 2000).

Roe's explanation for the correlation he has found is that social democracies favour employees over investors and correspondingly use regulation to increase the leverage workers possess (Roe, 2000). 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 increasing substantially the disadvantages associated with investing in a widely held public company. The upshot, according to Roe, 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 over discussion of the essential foundations of corporate governance arrangements in the United States and elsewhere. An alternate explanation for differences which exist that has quickly gained adherents is that the "law matters".[11] To elaborate, various economists and academic lawyers have hypothesized that corporate governance has not evolved along Anglo-American lines in other countries because the appropriate corporate law regime was not in place (e.g. Coffee, 1999b; Scott, 1999; La Porta *et al*, 2000; Johnson *et al*, 2000).

The essential insight which underlies the “law matters” thesis is that, in an unregulated environment, there is a real danger that a public company’s “insiders” (controlling shareholders and senior executives)[12] will cheat outside investors who own equity. According to the “law matters” story, minority shareholders feel “comfortable” in a “protective” environment where the legal system regulates quite closely opportunistic conduct by insiders.[13] 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 will largely preclude them from exploiting their position. The conditions therefore are well-suited for a widely dispersed pattern of share ownership (Coffee, 1999b; Black, 2000).

In a country where the law offers little protection against cheating by insiders, the outcome seemingly must be different (Scott, 1999; Johnson and Shleifer, 1999; Black, 2000). Potential investors, fearing exploitation, will steer clear of the stock market. Insiders, being aware of the 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 (Coffee, 1999b). 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.[14] 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 have been offered to account for the existence of divergent corporate governance regimes potentially accounts for developments occurring in the US. Roe developed his financial services regulation thesis specifically to address the American situation (Roe, 1994: vii). Moreover, in presenting his analysis of social democracy, he has reminded readers that while he might discuss other countries in some detail, he is in fact writing largely about the United States (Roe, 2000: 600). Moreover, consistent with the "law matters" hypothesis, the US has both dispersed share ownership and a legal system that regulates quite closely opportunistic conduct by insiders (e.g. Coffee, 1999b).[15]

As discussed in section I, the UK, like the US, has an "outsider/arm's length" system of ownership and control. The two countries have other features in common. For instance, they have a shared legal heritage encompassing the common law and principles of equity (DeMott, 1999). Moreover, Britain and the US both have a "shareholder economy" where private enterprise is about maximizing profits for those who invest and shareholders occupy the central position with respect to companies (Cunningham, 1999; Bolkestein, 1999).[16] 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 over-riding priority (Bolkestein, 1999; Allen and Gale, 2000a; Roe, 2001a).

Admittedly, the corporate economy is not organised in precisely the same fashion in the US and UK. Indeed, we will focus in sections V and VII respectively on two potentially significant distinctions, these being Britain's more concentrated share ownership structure and its comparatively underdeveloped market for corporate debt. Still, since the US and the UK have so much in common, ascertaining how matters developed in Britain is a good way to test the various theories that have been advanced to explain why the Berle-Means corporation is dominant in the US but not in various other major industrialised countries (Black and Coffee, 1994; Cheffins, 2001a). As we shall see, with each hypothesis we have considered thus far, the British experience casts doubt on their explanatory power. 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 UK is something of a "problem child".

Consider, for instance, Mark Roe's thesis that financial services regulation is important.[17] He has relied, in part, on developments in the American banking industry to support his argument that the Berle-Means corporation was an adaptation that arose to fit the kind of financial system US history produced rather than a product of market forces. He adopts the received wisdom on banks, saying that, while they developed and retained strong links with major industrial and commercial enterprises in Germany and Japan, they maintained their distance in the US (Roe, 1994). 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.[18]

In Britain, like the US, 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 (Thomas, 1978; Capie and Collins, 1992; Black and Coffee, 1994). Given what Roe has said, one would expect that in the UK there would have been laws in place that discouraged banks from stepping forward. In fact, however, the UK's commercial deposit-taking or "clearing" banks were never confronted with explicit restrictions on the activities they could undertake (Jacobs, 1923: 579; Bose, 1993; Allen and Gale, 2000b).[19] Instead, influenced by a strong bias in favour 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 (Capie and Collins, 1992; Fohlin, 1999b). The experience with UK banks correspondingly is 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.[20]

Turning from Roe's analysis of financial services regulation to his social democracy thesis, the experience in the United Kingdom again casts doubt on the arguments he has advanced.[21] Roe defines a social democracy as a nation with a government that is deeply concerned about distributional issues, favours employees over investors and plays a large role in the economy (Roe, 2000: 543). According to such criteria, the UK likely qualified as a social democracy from the end of World War II until Margaret Thatcher's rise to power in 1979 (Cheffins, 2002a). Still, despite this left-wing bias, there is evidence indicating that the UK's system of ownership and control was evolving towards the US model during the decades prior to Thatcher's election. Indeed, while the Berle-Means corporation was certainly not dominant in the UK before World War II, it may well have been by 1980 (Cheffins, 2002b).

In order to account for the British experience and bring it into line with his social democracy thesis, Roe has sought to argue that "neither stock markets nor ownership grew much" between 1945 and 1979 (Roe, 2002). There is plenty of secondary evidence which casts doubt on this "deep freeze" account of events. According to an 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." (Payne, 1978: 221) A distinguished British business historian subsequently offered a similar verdict, saying that

"…in 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." (Jones, 1997: 118)

Still, regardless of precisely what happened in the UK between 1945 and 1979, Roe has conceded that "(t)he United Kingdom would seem the hardest case for political theory" (Roe, 2002). He has therefore endorsed the notion that Britain is something of a "problem child" for his ideological account of corporate governance arrangements.

Roe, as well as acknowledging that events in Britain cause some difficulties for his social democracy thesis, has pointed out that "the UK also seems to fit badly with a law-driven theory" (Roe, 2002). 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". If law in fact is a pivotal factor, then the UK's legal regime should have favoured minority shareholders against corporate "insiders" as the country's outsider/arm's-length system of ownership and control was taking shape. The historical evidence, however, suggests this did not occur.

The publicly quoted company first became a well-established part of the British economy in the early years of the 20th century. At this point, however, it was standard for a business traded on the stock market to have the entrepreneurs who founded the firm and their heirs as "core" shareholders (Cheffins, 2001b; 2002b). This share ownership pattern ultimately unwound sufficiently for a separation of ownership and control to emerge, though 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 (Cheffins, 2001; 2002b). Throughout the relevant period, UK company law, by and large, offered minority shareholders little protection against opportunism by insiders. Admittedly, the regulation of UK financial markets was toughened considerably in the mid-1980s.[22] The country's current share ownership pattern was in place, however, by this time (Cheffins, 2001b). The upshot is that the Berle-Means corporation became dominant when lawmakers were not doing a great deal 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 UK, this did not mean that investors were left completely at the mercy of market forces. For instance, particularly during the first half of the 20th century, British companies sought to cultivate a loyal constituency of investors by offering regular and steady dividend payments (Samuel, 1933; Baskin and Miranti, 1997).[23] Moreover, from at least the 1920s onwards, the financial professionals who organized public offerings of shares in the UK were sufficiently motivated by reputational concerns to carry out significant "quality control" (Cheffins, 2001b). Finally, the London Stock Exchange, functioning without direct support from 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, pre-emptive rights, insider trading and other forms of self-dealing by directors and controlling shareholders) (*ibid*).

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 to be in place for widely dispersed share ownership to evolve (Coffee, 2001b).[24] Instead, the British experience indicates that institutional alternatives to corporate law can foster sufficient confidence on the part of investors to permit an outsider/arm's-length regime to take shape.[25] 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.

III. The Complementarity of Bankruptcy Regulation, Corporate Law and Corporate Governance

A. Debt as the Missing Piece of Corporate Governance Puzzle

One feature that links the various theories we have considered thus far is an equity bias. The primary question which each seeks to address is: why do share ownership patterns differ? To be sure, bank-oriented finance has attracted attention but this has been because it has been treated as the logical corollary of underdeveloped equity markets. The analytical bias in favour of shares means that in the comparative corporate governance literature, a potentially important piece of the puzzle is missing: a systematic appraisal of corporate borrowing. In other words, what might be happening "below the line" has been ignored at the expense of the configuration "above the line". This bias, it should be said, 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 (Triantis and Daniels, 1995).[26]

The analytical bias in favour of share ownership patterns seems odd when aggregate patterns of corporate finance are taken into account. The available data indicates that in major industrialised nations debt is a more important source of corporate funding than is the issuance of shares (Corbett and Jenkinson, 1997). As we have seen, this is even the case with the US and the UK, despite the fact that both have a "shareholder economy".

Regardless of the precise balance between equity and debt as a source of finance, ignoring the role of corporate borrowing is potentially misguided because corporate governance can be conceived of as an “interactive” process involving shareholders and creditors. 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 to constrain managerial misconduct. Moreover, a lender’s strong reaction to changing circumstances can provide signals for those owning equity to intervene (Triantis and Daniels, 1995).

The relationship between debt and equity can, however, also have its frictions. Consider, for instance, what can be termed the “agency costs of debt”. These arise 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” (Jensen and Meckling, 1976).

Conflicts of interest between shareholders and creditors can also run in the opposite direction. Take the case of a corporation that obtains finance primarily from one lender. Management may, in response to an implicit threat of exit, implement decisions benefiting that party at the expense of shareholders (Triantis and Daniels, 1995: 1096-1103). Biasing the borrower’s investment decisions in favour of projects with low risk would be one example of this type of “creditor rent extraction” (Buckley, 1992: 255; Morck and Nakamara, 2000). Others would include arranging fresh borrowing on terms highly favourable to the lender and charging excessive fees for the supply of additional services (e.g. management consulting or underwriting) (Mayer, 1998; Gorton and Schmid, 2000).

It should now be evident that a fully developed account of the configuration of the corporate economy in major industrialised nations needs to have due regard for what occurs “below the line”. One of us, in previous work, has in fact made this point and sought to add debt to the comparative corporate governance equation (Skeel, 1998). This was done by way of an "evolutionary theory" that posited a strong complementarity between a country's financial system and its bankruptcy law.[27]

We have just seen that Britain constitutes something of "problem child" for various explanations that have been offered to account for corporate governance structures in various countries. It transpires that the UK also causes some difficulties for the evolutionary theory as well. Still, the British experience does not displace the possibility that there is an integral link between bankruptcy rules and share ownership patterns. To understand the logic involved, it is necessary to be familiar with the intuition underlying the evolutionary theory. A summary follows, together with a description of how the theory applies in relation to "family capitalism".

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 favour of liquidation. The intuition which underlies the evolutionary theory is that corporate executives are aware of the bankruptcy law they face and adjust their behaviour 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 the 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 US 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. Corporate executives do not, however, have untrammelled discretion to do as they please. Instead, various factors make managers fearful of poor share price performance and give them incentives to boost earnings.[28]

One consideration will be the managerial labour market. Executives, mindful that other jobs might be more lucrative and challenging, will want to perform well in their current positions and this will require them to work effectively for their present 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, due partly to the growing influence and vigilance of independent directors on corporate boards (Neff and Ogden, 2001; Lublin and Murray, 2001; *cf.* Leonhardt, 2000). As the director of a large US publicly quoted company said in 2000 shortly after the dismissal of the CEO, "there is zero forgiveness. You screw up and you're dead." (Lublin and Murray, 2001).

Also pertinent will be executive compensation. During the past two decades, managerial remuneration has become much more strongly "incentivised" in the US. Between 1980 and the late 1990s, the percentage of chief executives of publicly quoted corporations that were awarded stock options increased from 30 per cent to more than 70 per cent (Hall and Liebman, 1998: 663; Conyon and Murphy, 2000: F647). 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%) (Conyon and Murphy, 2000: F646-47).

A distinctive feature of stock options is that they operate somewhat like a "one-way" bet for management. This is because 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 forego a potential profit opportunity (Cheffins, 1997: 657). Correspondingly, a management team that has a large number of options will tend to discount adverse outcomes when evaluating which business opportunities to exploit. With stock options now playing such an important part of CEO compensation, it follows that 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 (Plender, 2000).[29]

The market for corporate control is an additional factor that can influence managerial decision-making and thereby motivate executives to pursue strategies that could leave their corporation vulnerable in the event things go wrong. The theory involved is well-known (see Cheffins, 1997: 119). If there is a substantial disparity between a corporation's actual and potential performance, a bidder may calculate that it is worthwhile making a tender offer to the shareholders to buy their equity with a view to installing new managers. The bidder's assumption will be 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 being 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.

Kahan and Rock (2002) argue that in the US, the relative potency of the disciplinary mechanisms just described has been reconfigured over the past two decades. 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 precisely whether a takeover bid is hostile or friendly can be difficult (Schwert, 2000), the switch implies a shift away from acquisition activity that is explicitly disciplinary in orientation in favour of deals motivated by the desire to increase market share or generate synergies. This does not mean, however, that the disciplinary pressures US executives face have abated. Instead, the market for managerial talent and executive compensation have functioned as "equilibrating devices".[30] This is because, as we have seen, the incentives they create for managers to focus on shareholder value have become stronger in recent years.

Regardless of the relative importance of disciplinary mechanisms that influence executives of America's publicly quoted corporations, the fact that those in charge should be motivated to focus closely on share prices has potentially significant bankruptcy ramifications. Consider a scenario that the literature on financially distressed companies suggests is highly plausible (see Khanna and Poulsen, 1995; Andrade and Kaplan, 1998). 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 suggests that an outsider/arm's-length system of ownership and control will function more smoothly if there is a framework in place designed to preclude the outcome just described. What is contemplated is that those running a troubled but viable business will 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 offers from the managerial perspective. If bankruptcy meant immediate ouster, executives would face, *ex ante*, an unpleasant combination of possible results. On the one hand, if they adopted a "safety first" mentality they would 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 pursued promising but risky ventures that required substantial corporate borrowing, they would be out of a job if factors beyond their control led to the launch of bankruptcy proceedings.

For managers, this sort of "lose-lose" regime can be addressed in a couple of possible ways. One shift could be a reconfiguration of the pattern of ownership and control. The idea here would be that managers, fearful of a combination of market forces and harsh bankruptcy law, would seek out large, stable, "relational" shareholders. The presumption would be that those owning substantial blocks of equity would take a "hands on" role with firm, thus muting the need for discipline via incentive-oriented executive pay, aggressive outside directors and hostile takeover bids.

The other obvious move would be to attenuate the unforgiving nature of corporate bankruptcy. In this instance, reform would allow managers of financially distressed companies scope to remain at the controls so as to organize, where feasible, a restructuring. A widely held view is that in the US legal constraints deter the sort of "relationship investing" just described (see Frenchman, 1993: 170; Hawley and Williams, 2000: 147-65). Correspondingly, according to the evolutionary theory, it should not be surprising that a "manager-driven" bankruptcy law has emerged.[31]

Chapter 11 offers a distressed company the chance of rehabilitation. There is no requirement that a firm entering reorganization proceedings be insolvent, so managers are able to direct the timing of entry. Once there, the directors remain in control and continue to run the business. Creditors, secured and unsecured alike, are stayed from enforcing their claims. In due course, they must vote on a plan of reorganization. Their ability to vote against a proposal gives creditors some leverage against the debtor, but the leverage is limited in important respects. The creditors may not propose an alternative plan for at least the first 180 days,[32] so the consequence of non-acceptance would only be the further prolongation of proceedings. Besides, the debtor has control of the agenda, being able to determine the classes into which the creditors are placed for voting purposes. Provided that one impaired class can be persuaded to consent, non-consenting classes can be 'crammed down'.[33] This, though, would necessitate a costly cram-down hearing, which could be avoided simply by giving consent to the debtor's proposal. Chapter 11 further facilitates a debtor's ability to reorganize by giving the debtor extensive powers to arrange new, post-petition financing—including the power in some circumstances to "prime" existing security interests.[34]

Of course, executives are frequently fired during, or immediately before, Chapter 11 proceedings (Gilson *et al*, 1990). When this happens, it has a significant impact on their human capital, in that they are unlikely to hold senior positions again for a number of years, if ever (Gilson, 1989). Our point is not that this never happens, rather that managerial turnover is not *automatic*, which ensures that their risk of loss of human capital is minimised.[35]

Turn now to the insider/control-oriented approach to corporate governance. 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. With respect to corporate bankruptcy, neither country shares with the United States a manager-driven regime (Skeel, 1998: 1380-86). Instead, in both Germany and Japan the vast majority of firms are liquidated if there is a bankruptcy filing. Admittedly, the two countries do have procedures available under bankruptcy law for reorganizing a financially troubled company. Still, in Germany a "debtor in possession" rescue is not contemplated. In Japan this is a possible option 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 (Skeel, 1998: 1385; Alexander, 2000). The upshot is that in both countries executives of distressed companies cannot count on arranging a second chance under corporate bankruptcy law.

Let us now consider Germany and Japan within the context of the evolutionary theory. Assume for a moment that Germany and Japan offered a manager-driven bankruptcy regime like the U.S. This sort of arrangement would potentially undermine in a serious way 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 at bay a pivotal monitor of their corporation's affairs.

By contrast, a manager-displacing bankruptcy regime powerfully reinforces the leverage of lenders. If the executives of a financially troubled company know they will immediately lose their jobs if its "main" bank launches formal bankruptcy proceedings, they will listen closely to what representatives from the bank have to say. Manager-displacing bankruptcy is thus a natural component of insider governance, and this is what we see in Germany and Japan.[36]

As mentioned, insider/control-oriented financial systems have come under pressure in recent years. Since the evolutionary theory contemplates a feedback loop between corporate governance and bankruptcy law, it follows that the equilibrium which currently exists in Germany and Japan could be unstable. More precisely, the theory implies that a reconfiguration of bankruptcy law along manager-friendly lines could be on the cards.

Consistent with what the evolutionary theory implies, 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 US (Skeel, 1998: 1385). In Japan, steps are currently being taken to streamline the cumbersome "debtor in possession" reorganization option that already exists (Alexander, 2000). If outsider governance truly takes hold in these countries, the evolutionary theory predicts that further changes in favour of manager-friendly bankruptcy law are in prospect.

C. Evolutionary Theory and "Family Capitalism"

One additional point deserves consideration when thinking about the contours of the evolutionary theory. This is the relevance of its insights in circumstances where a country has an insider/control-oriented system of ownership and control but banks do not play the sort of role typically ascribed to them in Germany and Japan. The topic merits consideration because, as we have seen, classifying financial systems on the basis of whether they are "bank-based" or not is an exercise fraught with difficulties.

If banks do not dominate an insider/control-oriented corporate economy then who does? Family-owned companies are typically a strong contender. We are not concerned in this instance with small, closely-held business enterprises (which are considered in Section

VIII). Instead, we are interested in large business enterprises where family members own a large of block of shares and may well hold key managerial posts. Italy constitutes a classic example of a country where this sort of "family capitalism" is highly influential. 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 (Bianchi, 2002). 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 (Carpenter and Rondi, 2000).

Various industrialised 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.[37] Given this, it is worthwhile considering how "family capitalism" fits 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 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. This is because the dominant shareholder(s) should have a strong financial incentive to keep a careful watch on what is going on and should have sufficient influence to discipline and ultimately remove disloyal or ineffective managers (Cheffins, 2000).

Still, while unaccountable executives seem unlikely to pose a serious problem in companies with a dominant blockholder, a different danger exists. This is that core investors will collude with management to extract, via "rent-seeking", private benefits of control.[38] 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 (Cheffins, 2000; La Porta *et al* 2000).

Minority shareholders clearly may be vulnerable to expropriation in the manner just described (La Porta *et al*, 2000). They, however, are not the only potential victims; those lending money to the company also potentially qualify. We have already seen that there can be "agency costs of debt" when managers take actions that are calculated to benefit shareholders at the expense of lenders. When dominant shareholders collude with management, the dynamics will be somewhat different since the anticipated benefits will run directly to corporate "insiders"[39] rather than collectively to those owning equity. Still, the effect for 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 will presumably 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 serve as an effective counterweight to concentrated share ownership. Bankruptcy rules, however, can also serve as a beneficial corrective mechanism.

To understand the role which bankruptcy law can play, it is important to recognise that with a publicly quoted company dominated by a family, possible abuse of manager-friendly bankruptcy procedures is a serious possibility. One consideration is that executives who have the support of a family blockholder should be insulated from the sort of shareholder pressure that might otherwise arise with a financially distressed company. Moreover, the coalition of management and family owners will be well placed to control the agenda vis à vis creditors. This is because 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 the business is fundamentally sound and conclude that those in charge were capable and unlucky rather than lazy or dishonest, an option would be to save the existing business via a workout arranged outside bankruptcy. On the other hand, if serious doubts exist about 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 banks contribute fundamentally to corporate governance or not.

The reality of family-dominated governance often is much messier than this brief overview would suggest. In South Korea, for instance, the government has put heavy pressure on bank lenders to bail out troubled firms, rather than permitting them to fail (Milhaupt, 1998). 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 which 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 UK: The Hypothesis to be Tested

As we have seen, for theories that seek to account for the development of dispersed share ownership in particular countries on the basis of politics and law, the UK constitutes something of a "problem child". 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 UK is an "outsider/arm's length" system of corporate governance.[40] Also, Britain, like the United States, has a "shareholder economy" where private enterprise is about maximizing profits for those who invest. Moreover, as is the case in the US, a series of legal and institutional mechanisms serve to align managers' interests with those of shareholders. These include the market for managerial talent, performance-sensitive executive compensation schemes, and an active market for corporate control.[41]

Admittedly, with the factors that induce executives to take into shareholder interests, they do not operate with identical intensity in the US and the UK. For instance, managerial services contracts in the US are more highly "incentivised" than those in Britain (see Conyon and Murphy, 2000: F646-47). On the other hand, the market for corporate control potentially should have a stronger disciplinary aspect in Britain because UK companies have less scope to take defensive measures to fend off hostile takeover bids (Deakin and Slinger, 1997). Still, the key point for our purposes is that British executives operate under constraints that motivate them to maximize shareholder value. Concomitantly, like their US counterparts, they have incentives to implement strategies that offer a substantial potential "upside" but which also could threaten the viability of the company if things go wrong.

Given the manner in which the UK corporate economy is configured, the evolutionary theory of bankruptcy law would predict that the regime governing financially distressed companies would exhibit "manager-driven" characteristics. Otherwise, executives would face the unpalatable "lose-lose" scenario described in part III. Let us be a bit more precise with our prediction, however, by taking timing into account. The UK corporate economy evolved towards dispersed share ownership in the decades immediately following World War II. The posited complementarity between manager-friendly bankruptcy law and dispersed share ownership would suggest 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 where the UK qualifies as a "problem child"? As we will see now, a review of the evolution of English insolvency law—the terminological equivalent of US corporate bankruptcy law[42]—supports the latter view. Indeed, the evidence suggests that as share ownership was becoming more widely dispersed in the UK, the legal rules governing corporate financial distress went in the opposite direction the evolutionary theory would predict. 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.[43] Those available prior to the mid-1980s will be considered first. Reforms taking place at that time will then be analysed. The section will conclude by discussing possible future changes to the law.

B. Formal 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.[44] The consequent plethora of procedures is apt to confuse the uninitiated. So as to simplify our exposition, we will introduce the law by explaining how it would apply in a series of stylised 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-19th century.[45] The pivotal innovation Parliament made was introducing a procedure by which a court could order the winding up of a company that was unable to pay its debts, the descendant of which is today found in Part III of the Insolvency Act 1986.[46] Currently, when a court grants a winding up order, the judge will appoint a liquidator whose duty it is to ensure "that the assets of the company are got in, realised and distributed to the company's creditors".[47] This process, which is typically referred to as "liquidation", has similarities with proceedings launched under Chapter 7 of the US Bankruptcy Code.

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 authorising the seizure and sale of specified corporate assets. This is where winding up can come in. A creditor who anticipates receiving more of what is owing if there is an orderly liquidation as opposed to a piecemeal scramble for assets can respond by petitioning to court for a winding up order.

Assuming a judge grants a winding up order, this will have two principal effects. The first is that unsecured creditors will be precluded from proceeding further with enforcement actions.[48] 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 (Jackson, 1986: 7-19). The second is that the company's directors will be automatically removed from office,[49] thus leaving the liquidator free to wind up the company's affairs in the manner that will yield the best return for creditors.[50] 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.[51]

A crucial limitation of winding-up, as a means of realising value for creditors making a claim, is that it does not stay enforcement action by secured lenders.[52] 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 which exist to enforce the security (Fletcher, 1996: 633). The pivotal right a secured creditor has, once there has been default, is a licence to seize and sell the security to satisfy the amount owing (Goode, 1995: 689-91). Often, an enforcement agent known as a "receiver" will be appointed to exercise the rights in question (Goode, 1995: 692-93).

To illustrate, let us consider again our hypothetical. If our financially distressed company had used part of its assets as collateral for secured debt, the liquidator would have to hand over the relevant assets to the 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 (Fletcher, 1996: 633). Otherwise the liquidator—and the unsecured creditors on whose behalf the liquidator acts—would receive nothing.

The power which secured creditors have to seize and sell collateral can potentially create havoc for a financially troubled company. This is because it will be difficult for those in charge to conduct business in an orderly fashion if various parties are exercising claims against key assets on a piecemeal basis. 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 (Picker, 1992; Buckley, 1994; Armour and Frisby, 2001). In this case, only one receiver will need to be appointed to realise the security and marshalling the assets in one hand can facilitate an orderly response to the company's financial crisis.

English law ultimately evolved in a manner that was very favourable to the enforcement of security by one party. In the mid-19th century English lawyers began to draft for clients clauses granting security against all present and future property and in short order hospitable judges recognised the validity of such instruments.[53] Known as a "floating charge", this type of security interest did not have a direct counterpart in the US until the adoption of the Uniform Commercial Code in the various states. This is because US judges were unwilling to accept the idea of an all-encompassing floating lien until legislation implementing Article 9 of the U.C.C. specifically authorised the use of security encompassing all of a debtor's present and future property.[54] 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.[55]

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.[56] By virtue of changes made by the Insolvency Act 1986, a receiver appointed under a debenture containing a floating charge which gives the chargee priority to substantially the whole of the company's assets is deemed to be an "administrative receiver" and has certain powers and duties derived from statute.[57] Still, this private version of receivership remains very different from what was known in the US as an "equity receivership", where the courts never relinquished control over the appointment process (see Skeel, 2001: 56-60).

To see how 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.[58] Our company becomes financially distressed, thus entitling the bank to launch formal enforcement proceedings under the security agreement.[59] If the bank decided to exercise its rights, it likely would terminate the company's management powers by appointing an administrative receiver[60] who would take control of the collateral.[61] The receiver would then decide on a strategy to maximize the recovery of the secured creditor. This could involve shutting down operations immediately so as to sell individual assets on a break-up basis, continuing to trade with the intention of auctioning the business as a going concern or perhaps initiating a corporate rescue operation designed to restore the company to profitable trading.[62]

In theory, despite enforcement proceedings under a floating charge, one of the company's unsecured creditors could petition to have our company wound up.[63] The advent of winding up would not, however, terminate the administrative receivership. Instead, the receiver would remain free to exercise its powers in relation to the assets subject to the floating charge.[64] 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 the unsecured creditors.[65] Given that the company would probably 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 non-activity.[66]

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 for the duration of the process.[67] Still, the broad effect of the appointment of an administrative receiver is to divest a company's directors of their management powers during the currency of the receivership (Goode, 1997: 230). Since our company likely would be an "empty husk" once the receivership was concluded, appointment of the administrative receiver would correspondingly be the "end of the road" for the managers of our company.[68]

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 charge would almost certainly put them on the sidelines. The granting of a winding up order would have an 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. Throughout the opening decades of the 20th century, this sort of congruence was evident in the UK. 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 decision-making (Cheffins, 2001b: 466-68). With this sort of "insider" governance, the evolutionary theory would predict that bankruptcy law would be manager-displacing, and this is just what we see.

Later events, however, potentially create a paradox for the evolutionary theory. As time progressed, family control became less pervasive in larger UK companies and at some point between the 1950s and 1980s the divorce between ownership and control became sufficiently wide for the Britain to acquire its outsider/arm's-length governance regime (Cheffins, 2001b: 466-68). The evolutionary theory would predict that this trend should have been accompanied by a shift towards "manager-friendly" bankruptcy law. Comprehensive reform of corporate bankruptcy law did not occur, however, in tandem with the shift towards dispersed share ownership. Instead, the status quo prevailed until the middle of the 1980s.[69] At this point, significant changes were made. Did this yield the transition to "manager friendly" bankruptcy law which the evolutionary theory would predict? As we will see now, 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 (Fletcher, 1996: 14-15). Known as the "Cork Committee", after its chair, Sir Kenneth Cork, it published its report in 1982 (Insolvency Law Review Committee, 1982). The reform process culminated in the enactment of wide-ranging reforms in the Insolvency Act 1985.[70] This legislation, in turn, was quickly superseded by the Insolvency Act 1986, which continues to govern corporate bankruptcy today.[71]

In assessing the extent to which the reform of corporate bankruptcy law in the mid-1980s conformed with the manager-friendly transition the evolutionary theory would predict, two aspects are of direct relevance. The first is the introduction of a new "rescue" procedure, known as “administration”. There are some superficial similarities between this procedure and Chapter 11 of the US 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 (Franks and Torous, 1992: 70, 74, 78-79). For the purposes of the evolutionary theory, however, the differences are of greater importance.

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 one bank holding a floating charge, our company has now raised its debt finance from a wide range of lending institutions. A substantial fraction of the loans are unsecured and might well be syndicated, which means that dozens of banks will have taken a share of a given loan (Economist, 1997: 72). 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.[72]

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. This, in turn, will preclude the appointment of 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 organising a corporate rescue.[73] As we have seen, prior to 1985, the outcome in circumstances where there was no creditor with an all-encompassing security interest was either an inefficient piecemeal liquidation or a winding up order. 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 (Fletcher, 1996: 419-20; Carruthers and Halliday, 1998: 115-16).

For an administration order to be open to our company, a petition would have to made to court by the company itself, by its directors or by one of its creditors.[74] 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 realisation of the assets than in winding-up or a beneficial reorganisation of the company's debt structure.[75] If the court in fact granted the administration order,[76] this would impose a moratorium on the enforcement of creditors' rights and remedies, including those arising from security interests.[77] This freeze on creditor rights is roughly equivalent to the "automatic stay" under Chapter 11 of US bankruptcy law.[78] 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 (Carruthers and Halliday, 1998: 153, 178).

While proceedings conducted under chapter 11 and under administration orders do share an automatic stay in common, the resemblance between the two ends abruptly when consideration is paid to the treatment of directors (Goode, 1997: 274). 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.[79]

With respect to our hypothetical company, the absence of a "debtor in possession" feature akin to Chapter 11's means that, upon the granting of an administration order, the administrator would take control of the company and manage its affairs.[80] The company's incumbent directors and officers might well remain in post. They would be obliged, however, to co-operate 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.[81] Moreover, it would be the administrator's prerogative to remove the incumbent directors and appoint replacements.[82] The upshot is that, while the appointment of an administrator might facilitate the preservation or rehabilitation of the business conducted by our hypothetical company, the administration order would not offer to the executives the "manager-friendly" outcome chapter 11 provides.

A second aspect of the reform of English insolvency law which took place in the mid-1980s that is relevant for our analysis of the evolutionary theory involves the sanctioning of irresponsible or dishonest directors.[83] As part of the reform effort Parliament gave the judiciary new powers to punish directors for misconduct related to the running 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.[84] Also, Parliament expanded considerably the grounds upon which a court could order that an individual be disqualified from serving as a director.[85]

To illustrate the effects of these changes, consider again our hypothetical company. Assume our directors allowed the business to continue to operate when they ought to have known it had no reasonable prospect of survival. Unless they also took every reasonable step to avoid insolvent liquidation, they would have engaged in wrongful trading as defined by the Insolvency Act 1986.[86] 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.[87]

If there were a finding of wrongful trading, civil liability would not be the only potential sanction for the directors. Instead, 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.[88] There might, in addition, be other grounds for disqualification. Of greatest practical importance, the directors could also face a disqualification penalty if their company ended up insolvent and they had engaged in conduct rendering them "unfit" to serve as directors.[89]

A director's conduct does not have to be dishonest for there to be "unfitness" under the Company Directors Disqualification Act 1986. Instead, it will be sufficient if the individual has been lax in attending to accounting matters, has irresponsibly delegated managerial powers or has otherwise engaged in conduct which demonstrates recklessness.[90] 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 would be obliged to disqualify them for a period of between two and fifteen years.[91]

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 was the case 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. If the UK was poised to make corporate insolvency law more manager-driven, that would lend much credibility to this interpretation of events. Since bankruptcy reform is in fact currently on the agenda, it is appropriate to conclude this section by examining the relevant trends to see if the UK is in fact moving belatedly in the direction the evolutionary theory implies it should.

D. Recent Developments

In 2001, the UK government published a White Paper outlining reforms to bankruptcy law that it was intending to enact in the near future (DTI, 2001).[92] With respect to corporate bankruptcy,[93] the most important change outlined in the White Paper concerned the abolition of administrative receivership and its replacement with an expanded form of administration procedure (DTI, 2001: 9-12). The government's view is that banks are sometimes too quick to use their rights under floating charges to appoint receivers. Correspondingly, it wants to channel corporate financial distress through administration, on the assumption that this will serve to level the playing field for creditors and will give more scope for corporate rescues. For our purposes, though, the pivotal point is that implementation of the proposed reforms will have little effect on the position of managers. This is because those in charge will be sidelined by the appointment of an administrator just as surely as they currently are with an administrative receivership.

With the reform of bankruptcy law, a trend of greater relevance for the evolutionary theory is a possible shift towards explicitly authorised "debtor-in-possession" corporate rescues. A mechanism of this sort has in fact recently been enacted for "small" UK companies, defined on the basis of annual turnover, total assets and liabilities and the number of people employed.[94] Still, since our focus at this point 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. Instead, we will postpone discussion of the statutory changes affecting "small" companies until part VIII of the paper, which deals explicitly with closely held corporations.

With respect to larger companies, there has been some consideration of the introduction of a procedure that would allow a corporate restructuring to occur with the "debtor in possession", but the status of this proposal is unclear. In 2000, a review group that had been established to assess reform of the UK's corporate bankruptcy laws offered its views on the topic (Insolvency Service, 2000a). Apparently prompted by lobbying in favour of a mechanism akin to chapter 11, the review group considered whether a "debtor in possession" reorganization procedure should be made available for larger companies. 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 UK's companies legislation.[95] The steering group, however, declined the invitation to evaluate the case for reform, reasoning that bankruptcy policy was beyond its terms of reference (Company Law Review Steering Group, 2001: 279).

The White Paper published by the UK government in 2001 did not mention the "debtor in possession" issue so it seems unlikely that legislative reform is currently on the agenda. This does not mean, however, that changes to the law are out of the question entirely. Instead, it would seem that if the "debtor in possession" procedure that is now available to "small" companies is a success, the relevant procedures could ultimately be rolled out for larger business enterprises as well (Trade and Industry Select Committee, 1999: para 24). If this happened, or even if it seemed likely to happen, the shift would provide strong support for the evolutionary hypothesis. At this point, however, it is premature to say that English bankruptcy law is configured in the manner this theory would predict.

Let us summarise where things stand after considering the "law on the books". Throughout the early part of the 20th 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. 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 on the agenda but it is too early to predict the results. It follows that in order to reconcile the British experience with the evolutionary theory, one must go beyond the law "on the books" to achieve this. The next section of the paper seeks to do this by examining whether the received wisdom on UK share ownership is correct.

V. Does the UK have an "Insider/Control-Oriented" System of Ownership and Control?

On the basis of the received wisdom concerning the UK's system of ownership and control and its bankruptcy laws, 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 UK is a country with 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 UK than it is in the US (Black and Coffee: 1994: 2002; Cheffins, 1997: 638-39). Possibly, then, Britain has been miscast as an "outsider/arm's length" country. If this is in fact the case, then its manager-driven bankruptcy regime should align with its system of ownership and control in the manner which the evolutionary theory would predict.

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 UK corporate governance functions on an outsider/arm's length basis. In the United States, institutional shareholders own approximately 50 per cent of the shares of the country's publicly quoted companies, with the remainder being held directly by individual investors (Cheffins, 1998: 52). In the UK, in contrast, the equivalent figure is more than 70 per cent (Committee on Corporate Governance, 1998: para 5.1; Colby, 1999: 28). Correspondingly, with companies lacking a "core" shareholder, the potential for control by a group of institutions should be greater in Britain than it is in the US. Certainly, sociologist John Scott has cited institutional ownership to argue that in UK public companies where there is not a dominant owner, control exists by a "constellation of interests" (Scott, 1990: 354-55, 359-65; Scott, 1998: 48-50; 83-89). 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 UK…companies" (Stapledon, 1996: 10).[96]

Aside from the fact that institutional shareholders in the UK own a higher percentage of corporate equity than their counterparts in the US, in other ways the conditions in Britain are better suited for such investors to exercise control on a co-ordinated 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 US the same number of institutions will typically only own about 1/3 of the equity in a corporation (Cheffins, 1997: 638-39; Franks *et al*, 2001). This means it will be easier in Britain to form a coalition that has voting power sufficient to get management's attention (Coffee, 1994, 852-53; Cheffins, 1997: 638-39).

The legal environment is also potentially significant. In the US, securities law imposes certain constraints and restrictions on investors that impede the formation of institutional coalitions in relation to particular corporations.[97] In Britain, on the other hand, communication between financial institutions that own corporate equity is largely unregulated (Stapledon, 1996: 271-72).

While the differences between Britain and the US need to be acknowledged, it is one thing to point to the potential for control in the UK and another to say that this is turned into reality on any sort of consistent basis (Davies, 1993: 82). Admittedly, it does seem that institutional investors in the UK are more inclined to exercise influence on a joint basis than their American counterparts. An "activist" institutional investor in the US will typically pursue its own agenda and act as a "lone wolf" or "Lone Ranger" (Coffee, 1997: 1977-78; Black, 1998: 461). In contrast, in Britain, it is by no means extraordinary for institutional shareholders to co-ordinate their efforts and deal with corporate management on some sort of collective basis (Black and Coffee, 1994: 2050-52; Stapledon, 1996: 125-27; *cf.* Holland, 1995: 34-36). Also, if a UK 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 shares (Stapledon, 1996: 129-30; Franks *et al*, 2001). 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" (Stapledon, 1996: 129; Franks *et al*, 2001: 15).

Still, on balance, it remains fair to characterize the predominant approach to corporate governance in the UK as being "outsider/arm's-length".[98] For instance, the special case of poorly performing companies does not provide adequate grounds for disqualifying Britain from this category. This is because shareholder discipline also tightens in the US with such firms, albeit via the purchase of share blocks by potentially active investors rather than by way of conditions attached to the provision of new equity financing (Triantis and Daniels, 1995: 1086; Franks *et al*, 2001: 25-26).

More generally, a review of institutional investment commissioned by the UK government and conducted by Paul Myners provides strong evidence that an "outsider/arm's-length" verdict is appropriate for Britain. The acknowledged that in the previous few years there had been a considerable movement towards an activist stance by institutional investors (Myners, 2001: 89).[99] Still, 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" (Myners, 2001: 89).

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 (Myners, 2001: 91).[100] 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 (*ibid*).

The Myners Report's verdict on institutional passivity is consistent with views expressed by various other observers. Paul Davies (1991: 139), currently a professor at the London School of Economics, wrote that a "systematic and continuous relationship between institutional shareholders and management had yet to evolve." Jack Coffee and Bernard Black (1994: 2086), two US 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". According to a research report on institutional investors (Holland, 1995: 34-36, 43-46), there was some intervention on specific corporate governance issues (e.g. executive remuneration and the separation of the chairman of board and chief executive) but institutions only second-guessed managerial strategy formulation in the event of a crisis. A *Financial Times* survey of the financial directors of the UK's 100 biggest companies (Martinson, 1998: 21) indicated that while routine questioning of management by financial professionals was becoming more professional, "shareholders rarely…tried to use their muscle to make changes behind the scenes." Finally, two forthcoming 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 3% or more of a company's outstanding equity makes no difference to its financial performance (Faccio and Lasfer, 2002) and the other indicates that institutions owning large blocks of shares do not accelerate management turnover in poorly performing companies (Franks *et al*, 2001: 17, 19, 26).

Given the available evidence, the verdict on UK institutional investors offered by a newspaper columnist appears apt: "(a) certain very British reserve…unmistakably remains" (Financial Times, 1997: 10). 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 UK'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.

How can we move forward from here? There are two possibilities. One is to reassess Britain's bankruptcy regime to determine whether it is, in substance, manager-friendly despite having features commonly associated with a manager-displacing system. We will examine this possibility in the next section of the paper.

The other is to shift our focus from "above the line" to "below the line". The existing literature on corporate governance convergence concentrates on equity rather than debt, with the structure of share ownership being the pivotal concern. Thus far the discussion of the UK in this paper has, save for the analysis of bankruptcy laws offered in the previous section, conformed to this pattern. This has served thus far to conceal a potentially important difference between the US and the UK, this being that corporate debt has a considerably stronger market-oriented tinge in America than it does in Britain. In the UK, bank loans are the dominant form of corporate borrowing (Corbett and Jenkinson, 1997: 82-83). Issues of loan capital, comprising unsecured debt and debentures secured by means of a charge on corporate assets,[101] have not been a major source of external finance (*ibid*; Lister and Evans, 1988: 92).[102] In contrast, in the US the market for the equivalent form of debt, referred to as "bonds", is well-established and is important for larger corporations seeking to raise cash (Corbett and Jenkinson, 1997: 84-85; Saidenberg and Strahan, 1999: 1; McLaughlin, 2001). Sections VII and VIII of the paper shed light on the significance of this distinction between the US and the UK.

VI. Reassessing the UK's Corporate Bankruptcy Regime: Is it 'Manager-Friendly' In Practice?

As we have now seen, English corporate insolvency law is strongly manager-displacing and the UK's system of ownership and control is properly classified as "outsider-arm's length". It would be premature to conclude, however, that the evolutionary hypothesis is falsified with respect to Britain. This is because examining bankruptcy law "on the books" does not yield a full account of the way in which financial distress is addressed in UK companies. Instead, firms that actually end up bankrupt under the Insolvency Act 1986 are just the tip of the proverbial iceberg. For every company that ceases to function after financial distress, there will be others where a "workout" will be successfully negotiated, thus allowing profitable trading to resume.

Statistical evidence suggests that informal workouts are of particular importance in a British context. On average 3.65% of US corporations went into bankruptcy proceedings during any given year during the 1990s. The equivalent figure for Britain was only 0.67% (Klapper, 2001: 15, Table 2). It seems unlikely that a disparity of this sort occurred as a result of US companies encountering financial distress more often than their UK counterparts, particularly since American macroeconomic conditions were if anything, better than Britain's during the 1990s.[103] A more plausible explanation is that financially distressed companies in the US are more likely to enter formal bankruptcy proceedings than their British counterparts. Empirical evidence indicating that publicly quoted firms in the UK that suffer this fate are poorer performers—in terms of equity returns over the years preceding filing—than their US counterparts indicates this is probably the case (Armstrong and Riddick, 2000).

Why, all else being equal, are financially distressed companies in the UK less likely to end up in bankruptcy proceedings? One likely explanation for the disparity is that American law offers more scope for a corporate rescue than its English counterpart. Correspondingly, plausible turnaround candidates are dealt with under bankruptcy law much more frequently in the US than in Britain. To elaborate, in the US, with a corporation that enters chapter 11, some type of rehabilitation effort will typically be contemplated. In the UK, on the other hand, the invocation of corporate insolvency law has typically been treated as the end of the road for a company. Admittedly, the administration procedure discussed in Part IV is designed to assist in the rehabilitation of troubled companies that are worth saving. There has, however, been an "abnormally low incidence of usage" of this procedure (Fletcher, 1996: 479).[104]

Debt structure likely constitutes another factor that influences the disparity between the US and the UK. To understand why, a bit of background is required. All else being equal, the transaction costs associated with a private renegotiation 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 informal restructuring is more likely to be attempted where debt is concentrated in the hands of relatively few lenders (Gilson *et al*, 1990: 354; Chatterjee *et al*, 1996: 12-13; *cf.* Franks and Torous, 1994).

Let us turn now to the US and the UK. With the typical publicly quoted company, corporate debt is more diffuse in America than it is in Britain. To be more precise, the UK firm will be more likely to rely on bank loans than its American counterpart, which will be more inclined to incur debt by selling bonds to investors at large (Brierley & Vleighe, 1999: 175; Saidenberg and Strahan, 1999: 1; Bevan and Danbolt, 2001). It follows, in turn, that the transaction costs associated with organising an informal workout should be lower in Britain. All else being equal, then, formal bankruptcy proceedings should be less common in the UK than in the US.

One should not overestimate the extent to which debt is concentrated in Britain. Notably, UK public companies do not borrow primarily from a "main" bank. Instead, the loans in question will typically be syndicated, in part because regulatory requirements mean that banks need to diversify the default risk associated with lending very large sums. Still, even syndicated debt is unlikely to be as diffusely held as corporate bonds. Correspondingly, for the typical publicly quoted company, debt will be more concentrated in the UK than it is in the US.

Turning now to the informal processes invoked when financial distress compels large UK companies to carry out debt restructuring, one of us has done an empirical study on the topic (Armour and

Deakin, 2001).[105] One of the most interesting findings was that, whilst each restructuring does differ in certain respects, there is a striking degree of homogeneity in the way in which the negotiations are approached. More precisely, in most instances negotiations about debt "workouts" for large UK companies are structured in accordance with what is known in the banking community as the "London Approach".

The "London Approach" is worth investigating for our purposes because it may offer a "manager-friendly" substitute to formal bankruptcy law. To the extent it does so, the UK may begin to fall into line with what the evolutionary theory would predict. Again, the "law on the books" suggests that Britain is a "manager-displacing" jurisdiction, which does not "fit" with the theory because the country has a dispersed share ownership structure. On the other hand, if an informal process such as the London Approach is a pivotal "manager-friendly" 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 stylised example we referred to in section IV.[106] Recall that this involves a large company with widely dispersed share ownership. The firm has borrowed from banks by way of unsecured syndicated loans and also has some debt that is secured 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 organise a "London Approach" workout.

Invocation of the London Approach typically involves two distinct phases.[107] 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 be commenced.[108] On the other hand, if the accountants ascertain that key aspects of our 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[109]—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.[110] Assuming our company reaches the second stage of the London Approach, various outcomes might follow. One possibility is a financial reorganisation 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 programme of divestment designed to raise cash. Since invocation 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 until these sorts of activities were 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".[111] 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.[112] Furthermore, the banks will not undermine the distributional norm of *pro rata* allocation by engaging in "hold out" strategies designed to extract a larger slice of the pie. To the extent that they do squabble over who gets what, this will be disguised as disagreements about appropriate valuations or about legal priorities in insolvency. The result is that the lead bank should be well situated to negotiate with the financially troubled company as agent for all 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, with both the primary objective 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 end up receiving a lower return and/or will be 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 thereby invoke a judicially administered automatic stay. Management can therefore create breathing space for a rescue regardless of scepticism on the part of the creditors.

Under the London Approach, the situation is considerably different. With this procedure, it is the banks, not management, that take the initiative. Correspondingly, British executives cannot elect to keep creditors at arm's-length in the same way as their US counterparts. Also, once a London Approach rescue has been commenced, the banks that are participating can decide collectively to abandon the plan at any point and petition for administration or liquidation. The managers who end up sidelined as a result of such a choice have no effective recourse.[113]

It is worthwhile noting that banks who have launched a London Approach rescue will not reverse the choice lightly. The primary deterrent is that abandoning the privacy of a London Approach in favour 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.[114] Still, even though banks will hesitate before authorising a switch out of the London Approach, the fact remains that managers of a financially troubled company are more dependent on creditor goodwill under the London Approach than under chapter 11.[115]

The greater vulnerability of managers under the London Approach is made more acute by an additional factor. This is 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.[116] 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 UK, a potentially important source of funding in this context will be a rights issue, which involves a fresh issue of shares to existing investors. As we have seen in Section V, though, when a financially distressed company carries out a rights issue, institutional shareholders will quite often require a management shake-up before agreeing to participate. Correspondingly, executives who might otherwise be able to keep their jobs in a London Approach workout could end up out of work as a result of institutional activism.

To conclude this section, a holistic appraisal of the options facing a UK 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 which 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 UK, it would be going too far to label Britain as a “manager-driven” jurisdiction. This is because executives do not have sufficient control over the procedures that can be invoked in the event of financial distress to justify any such conclusion. As we saw in Part IV, managers of a financially troubled company are obliged to stand to one side if creditors choose to rely on an administrator, if an administrative receiver is appointed or if a successful petition for winding up is made. With the London Approach, while senior executives typically retain their posts, the banks that participate always do 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 UK, then, remains a “problem child”, which implies that the theory should be recast. Sections VII and VIII of the paper take up this task.

VII. Refining the Evolutionary Thesis in Light of the UK Experience

In the last three parts, we have explored British corporate governance through the lens of the evolutionary thesis. Once we move beyond the “black letter” account of British governance, and take a more in depth look at the way the governance mechanisms function in practice, some of the initial puzzles disappear. But not all. Britain remains a somewhat awkward fit even for the evolutionary theory.

To more fully reconcile the two, we must either adjust the theory or explain the UK away as an aberration.

In this part, we take the former approach. The discussion that follows will extend and adjust the evolutionary theory, and use the refined theory to try to make better sense of the governance patterns we observe in Britain. In its original incarnation, the evolutionary theory– like each of the other major theories-- focused principally on the role of equity in the overall governance framework.[117] The role of banks in out of court restructurings under 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 and related "below the line" considerations more fully into the analysis– that serves as the launching off point for the analysis that follows.

A. Adding Debt to the Evolutionary Theory

What should we make of the concentration or diffusion of a firm's equity and debt? To start, it seems likely that most firms whose stock is concentrated will also have one or a small number of debt holders. The reasoning is as follows. If a firm has a group of dominant shareholders, these shareholders will control the firm's management (see La Porta *et al*, 1999: 500). The coordination of ownership and control can reduce managerial agency costs, but it also may magnify the agency costs of debt– that is, the danger that shareholders will expropriate value from the firm's debtholders by increasing the riskiness of the firm or taking other actions that benefit equity at the expense of debt (see Klein and Coffee, 1996: 353-57).[118] If the firm's debtholders are scattered, collective action problems may interfere with their ability to control the agency costs of debt.[119] Scattered debtholders may fail to monitor because their stakes are too small or they would prefer to free ride on the efforts of others. In short, the combination of concentrated equity and diffuse debt creates a mismatch that can exacerbate the agency costs of debt (see Mahrt-Smith, 2000).

This does not mean that the agency costs of debt will go entirely unchecked if a firm with concentrated equity issues diffuse debt. At least two factors may reduce the seriousness of the problem. First, the agency costs of debt loom largest if the firm's fortunes are volatile or it is in financial distress.[120] The agency costs of debt are lower for healthy firms and firms that have limited debt in their capital structure.

Second, the agency costs of debt can be constrained to some extent by contractual terms in parties' debt agreement. Existing debentures include a variety of provisions that are designed to facilitate monitoring by, or on behalf of, scattered bondholders. Most debentures place substantial restrictions on a firm's right to make dividends to their shareholders, for instance, and require the firm to make sure that its cash flow significantly exceeds the firm's debt repayment obligations (McDaniel, 1986).

In practice, the debtholders themselves are generally not the ones who enforce the provisions. Instead, existing bond agreements contemplate that an indenture trustee will monitor on their behalf. By coordinating the monitoring function, the trustee thus replicates to some extent the monitoring capabilities of concentrated debtholders. The trustee is an imperfect substitute for bank loans or other forms of concentrated debt, however. In the U.S., for instance, the effectiveness of indenture trustees is limited in important respects.[121] Although trustees can be given more authority in the UK, even trustees with wide-ranging powers cannot renegotiate the terms of the debt agreement without obtaining the approval of a majority of the diffuse bondholders.

Overall, then, there will be a general pressure for firms with concentrated ownership to look to bank loans for their debt finance, rather than issuing public debt, due to the superior ongoing monitoring capabilities of concentrated debt. We should emphasize that this is a general tendency, rather than a fixed rule. One can easily think of counterexamples, such as the issuance of junk bonds to finance leveraged buyouts in the US in the 1980s.[122] The benefits of borrowing from banks rather than issuing public debt are likely to be more pronounced, moreover, for firms that are financially precarious or whose fortunes are volatile—that is, firms for which the agency costs of debt are a significant issue.

One additional caveat about the correlation between concentrated equity and concentrated debt (CE/CD) is in order. By emphasizing the importance of concentrated debt, we are not suggesting that the optimal number of lenders in a firm with concentrated stock is one. There may be good reasons for the firm to borrow from a group of banks, rather than a single lender. Recent empirical evidence suggests, for instance, that firms in many countries can borrow at more attractive interest rates if they borrow from more than one lender. Volpin (2001) speculates that this is because it is more difficult for a controlling shareholder to extract private benefits of control if there are multiple lenders. The lenders themselves may have additional reasons for syndicating. As noted earlier, the UK regulatory regime encourages banks to syndicate major loans; even in the absence of regulatory strictures, moreover, banks may wish to limit their exposure to any given borrower. Whatever the optimal number of lenders proves to be, however, the lenders will structure the loan so that they are well-positioned to actively monitor the debtor.

In contrast to insider-controlled firms, firms with diffuse stock are likely to rely less on bank lenders and more on publicly issued debt. (That is, there is a general tendency toward diffuse equity and diffuse stock, or DE/DD). The obvious reason for this is cost. The same qualities that make bank lending valuable for insider-controlled firms, such as banks' ability to provide active monitoring, make bank loans more costly in contexts where these services are less important

(Macey and Miller, 1995).[123] On balance, active monitoring is likely to be less critical for firms with diffuse stock, since the agency costs of debt are likely to be lower if there is no concentrated group of shareholders to influence the direction of the firm. In addition, the combination of diffuse equity and concentrated debt (DE/CD) may increase the risk of expropriation by the concentrated lenders. Like controlling shareholders in a firm with CE/DD, the concentrated lenders might be in a position to extract rents from the firm's diffuse shareholders. The lenders might strike an implicit bargain with managers, for instance, pursuant to which the lenders receive supracompetitive interest rates or provide other banking services at supracompetitive prices to the firm in return for favorable treatment of the firm's managers (see Gordon and Schmid, 2000: 46-47).[124]

Although the factors just described—most importantly, the cost of bank monitoring-- suggest there will be a general pressure toward disintermediation with firms that have diffuse stock, at least one countervailing consideration may check this tendency. Just as bank lenders or other concentrated debtholders are well-positioned to actively monitor a healthy firm, as discussed above, they also can coordinate more easily than diffuse debtholders in the event of financial distress. Their ability to coordinate may significantly reduce both the overall cost of financial distress and the risk that viable firms will be mistakenly liquidated or nonviable firms continued. As we have seen with the London Approach in Britain, if lenders can restructure firms outside of bankruptcy, there is no need for formal insolvency proceedings. These benefits suggest that the combination of diffuse equity and concentrated debt (DE/CD) may not be as undesirable as it appears at first glance, especially with firms that are financially unstable. On the other hand, the very possibility that a firm's reliance on bank lenders might be construed by the market as an adverse signal—that is, as an indication of instability—may provide an additional reason for firms with diffuse equity to issue public debt for their debt finance wherever possible.

The analysis of the relationship between concentration and diffusion in firms' stock and debt finance should not be taken to imply any particular developmental order as a historical matter. Although one might be tempted to assume that markets for publicly issued stock are likely to precede public markets for debt, this is not necessarily so. Indeed, the reverse often appears to be the case. In the United States, for instance, public markets for debt seem to have developed well before stock ownership became truly diffuse.[125] Similarly, the past decade has seen a dramatic increase in the issuance of public debt throughout Europe (McLaughlin, 2000; Hoffmann *et al*, 2001). Although there also has been a great deal of talk about the diffusion of European equity during this time, the growth in the European bond market does not seem to have been tied to the concentration or diffusion of firms' stock in any direct way. Each of these examples may lead to the combination of concentrated stock and diffuse debt (CE/DD). We would expect this combination to be transitory, because of the financial agency cost problems it creates. Diffuse stock and diffuse debt (DE/DD) is more likely to be the equilibrium state. During the interim, it obviously is crucially important either for firms to minimize their reliance on debt finance, or to develop an institutional mechanism for controlling the agency costs of debt.[126]

To summarize, then, firms' capital structure decisions will reflect a trade-off between the agency costs of debt, on the one hand, and the higher costs of bank lending, on the other. In firms with concentrated equity, the agency costs of debt will be a major concern, and this concern is most easily addressed with concentrated debt. Thus, CE/CD is a natural equilibrium. If a firm's equity is diffuse, on the other hand, there will be a general pressure to forego bank lending and issue public debt, due to its lower cost and the diminished importance of the agency costs of debt. If financial distress is a significant concern, the coordination advantages of concentrated debt may offset the tendency toward disintermediation. As a result, while DE/DD is likely to be the natural equilibrium, DE/CD may itself be a near equilibrium state. The shift to DE/DD may therefore be a rather gradual one.

To complete our initial discussion, we need only incorporate these distinctions into the evolutionary thesis as a whole. In an insider governance system, the revised thesis predicts that insider control (and thus concentrated equity) will be accompanied by concentrated debt. In such a regime, we are likely to find a manager-displacing approach to bankruptcy, which reinforces the debtholders' ability to monitor the controlling shareholders. Takeovers, incentive-based compensation, and other market-based governance devices will play a relatively limited role. Outsider/arm's length governance is characterized by diffuse stock, liquid markets, and a more market-oriented approach to corporate governance.

The diffuse equity of an outsider/arm's length regime fits more naturally with a reliance on bonds and other forms of publicly issued debt, rather than bank finance. Together with extensive use of bonds, we are likely to find a manager-driven, reorganization-based approach to bankruptcy. If firms issue large amounts of diffusely held debt, moreover, the formal bankruptcy rules will take on particular importance, due to the collective action problems faced by creditors in the event of financial distress.

Having sketched out the reconfigured evolutionary theory, we now turn to the question whether the theory offers a better explanation of UK governance.

B. UK Governance Through the Lens of the Refined Theory

What does the refined theory tell us about Britain? The first thing one notices is that UK governance raises precisely the issues discussed at the end of the last section. As we have seen, although equity ownership is more concentrated in the UK than in the US, British governance is best characterized as outsider/arm's length, with relatively diffused share ownership and increasingly market-based governance. An obvious equilibrium with diffuse stock is diffuse debt and a manager-friendly bankruptcy regime (DE/DD). But the debt in even the largest UK firms is generally quite concentrated (Brierley and Vleighe, 1999; Bevan and Danbolt, 2001). Rather than issuing public debt, most British firms rely on a relatively small consortium of banks and other lenders for their debt finance. Thus, UK governance consists of DE/CD, rather than either of the obvious equilibria of DE/DD or CE/CD.

To put the current parameters of British governance into perspective, recall that the diffusion of U.K. stock ownership is still recent and ongoing. As we have seen, British firms did not shift to the arm's length model until after World War II. During this period, the formal British insolvency procedures retained the distinctively manager-displacing character that we might have expected in the earlier, insider governance era – if anything, recent reforms such as the penalties for wrongful trading have underscored the manager displacing quality. Yet, as we saw in Part VI, British firms are often restructured outside of the formal insolvency process through the London Approach. In contrast to the severity of the formal procedures, the London Approach parallels U.S. Chapter 11 in some respects. Creditors have more control under the London Approach than in the U.S., for instance, but British corporate managers often initiate the process and they remain in their posts while the firm is examined in connection with the restructuring. For large UK firms, the bankruptcy regime might perhaps be characterized as intermediate, rather than either manager-driven or manager-displacing.

The London Approach vividly illustrates the most important benefit of a regime that combines diffuse equity with concentrated debt: concentrated debtholders can respond in coordinated fashion to financial distress. It is conceivable that UK governance will retain its current characteristics for precisely this reason. Yet bank financing is comparatively costly, as we have seen, which suggests that one can expect to see a general trend toward disintermediation wherever possible. Firms with diffuse equity may be able to borrow more cheaply from public markets than from banks. We suspect that this is what increasing numbers of UK firms will do.

Indeed, there is evidence that banks already are losing their near hegemony over debt finance for widely held UK firms. In recent years, British firms have increasingly turned to other institutional lenders, such as insurers and pension funds, for debt financing (Economist, 1997: 72). Although the market for public debt remains much smaller than in the U.S., it has significantly increased in recent years. It seems likely that this trend will continue, and perhaps accelerate, in the coming years.[127]

If we have correctly read the handwriting on the wall, and British firms look increasingly to public debt markets for capital, the diffusion will have important and obvious implications for the London Approach to corporate insolvency. Crucial to the London Approach is the relatively limited number of lenders, each of which has a substantial interest in the troubled firm's debt. As we have seen, these lenders can restructure the firm outside of the formal bankruptcy process because they do not face the kinds of collective action problems that make formal bankruptcy proceedings necessary in other contexts. The lenders have enough at stake to justify participating in the process, and each knows who the other players are. As a result, they can coordinate the decision whether to restructure the firm among themselves, without the need for judicial oversight or a formal automatic stay.

As debt finance becomes more diffuse, the London Approach could lose its effectiveness for many publicly held firms (Brierley and Vleighe, 1999; Armour and Deakin, 2001). Scattered bondholders cannot coordinate nearly as easily outside of bankruptcy as a syndicate of lenders can.[128] Rather than restructuring through the London Approach, firms with diffuse debt are therefore more likely to find themselves in one of the formal bankruptcy procedures if they encounter financial distress.

This does necessarily mean that we will see a relentless increase in formal UK insolvency proceedings, of course. If the London Approach becomes increasingly cumbersome for troubled firms, the parties can be expected to respond in a variety of ways. One possibility is that creditor groups and professionals may begin to insert new, workout friendly terms into bond indentures and other forms of debt to facilitate the restructuring process. Existing bonds already provide for a trustee to act on behalf of the scattered bondholders in a variety of contexts, such as issuing notices, declaring defaults, and filing proofs of claim in bankruptcy (see Kahan, 1995). Issuers also could include voting provisions that bound all of a group of debtholders to any restructuring agreed to by a majority of the class.[129] These provisions could preserve the parties' ability to restructure troubled companies outside of formal insolvency proceedings, and as a result could pave the way toward still more disintermediation.

Although workout-friendly terms might serve as a partial substitute for the London Approach in its current form, many of the limitations described above would remain. If a bond trustee coordinated the negotiations, for instance, rather than a syndicate of banks, it would be difficult to conduct the initial due diligence as quietly and unobtrusively as the parties do currently. 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. As a result, while some out-of-bankruptcy restructurings would be likely to succeed, it is likely that more firms with significant going concern value would land in formal insolvency proceedings than currently is the case.

One possible effect of the increased risk of formal insolvency proceedings might be to cause the managers of British firms to act more like managers in an insider governance regime. They might avoid ventures that created a risk of financial distress and follow through less aggressively on those projects that the firm did undertake. If the company did encounter financial distress, moreover, managers might take extraordinary risks in a last ditch effort to avoid Britain's manager-displacing formal insolvency proceedings. Although the existing penalties for wrongful trading would limit the later concern—that is, the concern with extraordinary risktaking – they magnify the concern that managers will be reluctant to follow through on appropriate business risks.

If more firms with significant going concern value wind up in formal bankruptcy proceedings, we may also see a second effect: increasing pressure on British lawmakers to adopt aspects of a U.S.-style, Chapter 11 approach. 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. 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. Not just managers, but creditors also, can be expected to press for a loosening of the bankruptcy framework.[130] As discussed earlier, there have already been rumblings along these lines. The INSOL lenders' group has called for a stay to be added to the 'scheme of arrangement' provisions, for instance, and we suspect that it is only a matter of time before UK lawmakers respond.

We should emphasise that each of the speculations we have engaged in—that UK debt finance may continue to diffuse, that we may see pressure to adopt U.S.-style bankruptcy rules—assumes that there are no dramatic, macro-economic shocks in the interim. Corporate governance obviously is only one factor in the overall corporate environment, and it may be swamped by larger events such as technological change or economic crisis. Indeed, it is plausible that precisely these kinds of considerations help explain why debt finance in the UK has remained so concentrated as compared to US debt finance. The rapidly rising interest rates of the 1970s made public debt comparatively unattractive as compared to bank lending (Bank of England, 1982); this and related considerations may have dampened the pressures toward diffusion in UK debt finance.

With these caveats in mind, let us summarise the insights of the revised evolutionary thesis for UK governance. The overall UK governance framework is outsider/arm's length in character. Although the equity of UK firms is more concentrated than in the US, it is quite diffuse by world standards and large UK shareholders tend to play only a passive role in corporate governance in most circumstances. Market devices figure more prominently than monitoring by corporate investors. Unlike the stock of UK firms, UK debt finance remains quite concentrated, particularly as compared to the US. It is plausible that these characteristics—outsider governance with diffuse stock and concentrated debt—will endure, but the reconfigured evolutionary thesis predicts that there will be general, continuing trend toward disintermediation, due principally to the cost of bank lending as compared to publicly issued debt. If debt finance does become more diffuse, this may have a feedback effect on the UK's formal insolvency rules; in particular, it may create pressure for lawmakers to adopt a more manager-driven, US style approach.

We have made several predictions about the likely direction of UK corporate governance, but these predictions are not our most important point. The most important point is that there is a predictable relationship among equity finance, debt finance, and bankruptcy in a nation's overall governance framework. Attending to all of these factors gives us a much richer understanding of comparative corporate governance in general, and U.K. governance in particular.

VIII. Applying the Reconfigured Evolutionary Theory to the Closely Held Company

The analysis thus far has given us additional insight both into British corporate governance and into the evolutionary thesis itself. To sharpen the focus of the evolutionary theory, we have needed to pay more explicit attention to the role of debt in corporate governance. We have pointed out that debt, like stock, will generally be more diffuse in an outsider/arm's length system. By contrast, both equity and debt tend to be more concentrated in insider governance.

The Article has focused almost exclusively on publicly held corporations, rather than smaller, closely held firms. There are obvious reasons for this emphasis. The vigorous debate over the conditions that make diffuse stock ownership possible is a debate about publicly held firms, and this Article has endeavoured to contribute to that debate. Similarly, the existing literature has tended to emphasise the agency cost issues that arise from the separation of ownership and control, and these issues are most apparent in publicly held firms.

Despite the crucial importance of publicly held companies, the vast majority of firms are closely held, not public, even in nations such as the U.K. and U.S. In this section, we apply the insights of the reconfigured evolutionary theory to closely held companies. The analysis begins by predicting the likely relationship between debt and equity and closely held firms, as well as the likely role of bankruptcy. We then turn to the actual governance of closely held firms in the U.K. and U.S. As we shall see, the capital structure and general governance of closely held firms closely fit the predictions of the theory. When we turn to the bankruptcy procedures for closely held firms in the U.K. and U.S., on the other hand, we encounter significant puzzles. In the U.K., recent legislative initiatives have moved in a much more manager-driven direction than the theory would predict. The U.S approach to bankruptcy for closely held firms, which has long had the same manager-driven quality, is puzzling for very similar reasons. Using the reconfigured evolutionary theory as a guide, this Part attempts to make sense of these puzzles, and to shed light on the governance of closely held firms.

Unlike publicly held firms, there is little or no separation of ownership and control in a closely held firm.[131] Closely held firms are characterized by a significant—and often complete – overlap between the firm's shareholders and its managers. Given the concentrated stock ownership, the evolutionary theory suggests that the debt finance of closely held firms is likely to be similarly concentrated in order to minimize the agency costs of debt. (Thus, CE/CD should be the equilibrium capital structure). With publicly held firms, as discussed in the last part, the combination of concentrated equity and concentrated debt calls for manager-displacing bankruptcy. One might therefore expect to see a manager-displacing framework for close corporation bankruptcy.

The first of these predictions, that closely held firms will have concentrated debt, turns out to be quite accurate. Close corporations often borrow from a single bank, and most of the remaining firms have a relatively small number of lenders (Scott, 1986; Armour and Frisby, 2001; *cf.* Mann, 1997). Because ownership is concentrated, and their stock is not actively traded, close corporations are insulated from the market for corporate control and market-based governance devices. The governance of close corporations thus seems to exhibit many of the characteristics we have attributed to insider systems in the publicly held firm context.

Turning to bankruptcy, however, we encounter striking anomalies in both the UK and the US. Start with the UK. In the UK, most closely held firms look to banks as their principal source of debt finance. These bank loans are often secured by a "floating charge" on all of the firm's assets (Armour and Frisby, 2001). As discussed earlier, the lending documents generally provide for the appointment of a private receiver if the firm defaults on its loan. Once appointed, the receiver is not subject to any automatic stay, and her task is to take control of the business and liquidate its assets.

Everything described thus far fits neatly within the predictions of the evolutionary theory. The U.K. process, with its manager displacement and lender control, has precisely the qualities one might expect, given the concentrated shareholdings and debt of closely held firms. Yet the winds of change seem, at least at first glance, to be blowing in a very different direction. Most importantly, the Insolvency Act 2000 has just introduced a new debtor-in-possession procedure for small firms.[132] The new provision will give the managers of small firms a more significant role in bankruptcy than ever before.[133]

In effect, these changes seem to suggest that the U.K. bankruptcy procedures for small firms may be evolving toward the U.S. approach, which has long had these same kinds of manager-driven provisions. Closely held U.S. firms use the same framework as their publicly held counterparts: Chapter 11, with its exclusivity period, automatic stay, and other manager protections.[134] Indeed, shortly after Chapter 11 was enacted, an empirical study of closely held debtors bemoaned that the debtors and their managers were now "in full control." (LoPucki, 1983). Thus, the U.S. approach seems to embody, and the U.K. rules seem to be edging toward, precisely the opposite framework as the reconfigured evolutionary theory would predict. Rather than a manager-displacing approach, one could construe these developments as a general convergence on manager-driven bankruptcy.

What can the evolutionary theory tell us about these puzzling developments? Before more fully unravelling the puzzle, we should begin by highlighting a crucial distinction between closely held and public firms. In closely held firms, the principal source of the firm's going concern value is usually the shareholder-owners—i.e., entrepreneurs – themselves. If the firm is to succeed, the entrepreneurs must retain their control rights; yet, in a close corporation, the control rights cannot be separated from the entrepreneurs' ownership rights. As a result, when a closely held firm that is worth preserving files for bankruptcy (that is, it encounters financial rather than economic distress), the reorganization process needs to ensure that the entrepreneur emerges from bankruptcy with both her ownership and control rights intact (Baird and Rasmussen, 2001; Ayotte, 2001; see also Armour and Frisby, 2001). The debtor-in-possession approach, which keeps the entrepreneurial managers in place and permits them to propose a reorganization plan, is of course one way to achieve this outcome.

Although the manager-driven, debtor-in-possession process helps to assure that entrepreneurs retain both ownership and control rights, a more creditor-oriented process like the traditional U.K. receivership could also achieve this effect. If the closely held firm is worth more as a going concern than in piece meal liquidation, the firm's creditors have an obvious incentive to bargain to that outcome under most circumstances.[135] This possibility leads us to a second, quite different explanation for the apparent anomalies in both U.K. and U.S bankruptcy law. Quite simply: appearances are misleading. If we take a closer look, we will see that neither the U.K. nor the U.S. has a truly manager-driven framework for closely corporation bankruptcy.

Turn first to the manager-driven Chapter 11 process that has long been in place for close corporations in the United States. For the owner-managers of a closely held corporation, the prognosis of a Chapter 11 filing is very different than for most publicly held firms. The managers of closely held corporations are nominally in control, but the vast majority of close corporation bankruptcies end in liquidation. Whereas roughly 95% of the largest, publicly held firms reorganize in Chapter 11, the number is closer to 10% for closely held firms (Jordan *et al*, 1999). For many of these firms, the principal lender ultimately is the one who determines whether there will be a reorganization, so the debtor's control turns out to be more circumscribed than might appear to be the case.[136] Moreover, in recent years, Congress has begun to rein in the Chapter 11 process as it applies to closely held firms.[137]

What about the trend toward more manager-driven close corporation provisions in the U.K.? Once again, there is less to this apparent trend than meets the eye. Although the debtor-in-possession provisions are explicitly limited to close corporations, they were not really enacted with close corporations in mind. The policy thinking behind the decision to apply the provisions to close corporations was that this would provide a 'road test' for the debtor-in-possession approach which, if successful, might then be rolled out to large firms as well. This history suggests that it would be a mistake to read too much into the recent adoption of a U.S.-style debtor-in-possession approach for small debtors in the U.K.

In fact, we suspect that close corporation bankruptcy in both nations is more likely to converge toward the traditional U.K. approach than toward a truly manager-driven process. Based on capital structure considerations alone—that is, the fact that both stock and debt are concentrated in closely held firms—the evolutionary theory would predict a manager-displacing bankruptcy regime. As discussed above, the analysis is complicated by the need for the owner-managers to retain both ownership and control rights if the firm is reorganized. But the vast majority of closely held firms appear to have little going concern value when they fail, and current Chapter 11 fraught with problems as a mechanism for restructuring the minority of closely held firms that are worth preserving.[138]

In short, we suspect that the U.S. approach to close corporation bankruptcy will continue to edge in a U.K. direction. Although the debtor-in-possession provisions are unlikely to disappear,[139] creditor control makes more sense than giving wide-ranging discretion to the firm's manager-owners. Increasingly, this is what one finds in the U.S., and we doubt that U.K. lawmakers will make significant, additional departures from the traditional U.K. approach, which has long reflected the view that creditors should be the ones who decide how to resolve a closely held firm's financial distress.

IX. Conclusion

The UK poses a great puzzle for each of the major new theories of comparative corporate governance. Mark Roe has argued that outsider/arm's length governance is unlikely to develop in a social democracy, yet the shift in Britain from insider to outsider/arm's length governance appears to have occurred during a long period of labour– that is, social democratic– control. For their part, advocates of the "law matters" thesis predict that outsider/arm's length governance can not emerge until shareholder protections are fully in place, yet the diffusion of share ownership in U.K. came before, not after U.K. lawmakers adopted important protections for minority shareholders.

The evolutionary theory is not immune from the U.K. puzzle, either. The evolutionary theory predicts that outsider/arm's length governance will be accompanied by manager-driven bankruptcy, yet British governance mixes diffuse stock ownership with manager-*displacing* bankruptcy provisions. On closer inspection the puzzle partially disappears. Although the formal U.K. bankruptcy procedures are manager-displacing, many publicly held U.K. firms are reorganized through a norm-driven, out-of-bankruptcy process insolvency experts refer to as the London Approach. The London Approach is initiated by managers, and managers remain in place at the outset of the restructuring process.

To more fully make sense of U.K. governance, 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. U.K. governance appears to be in a state of transition in this respect. Although U.K. stock is diffuse, debt finance remains quite concentrated. Based on the analysis of this Article, we speculate that U.K. debt markets are likely to become more diffuse in the future, and that this will lead to a more self-evidently outsider/arm's length governance framework. Most importantly, we believe that British bankruptcy will become increasingly manager-driven as debt becomes too diffuse for the London Approach to continue to play the role it plays now.

In the last part, the Article shifted from publicly held corporations to the governance of closely held firms. In this context, both U.K. and U.S. governance prove puzzling for the revised evolutionary theory. Given the characteristic concentration of both equity and debt in closely held firms, one would expect to find a manager-displacing approach to bankruptcy. Yet the U.S. has long had manager-driven rules for close corporation bankruptcy, and the U.K. has recently adopted a debtor-in-possession provision for small firms. In part, this puzzle can be explained as a response to the distinctive bundling of ownership in control and closely held firms. But the manager-friendly appearance of the rules also is somewhat misleading. In contrast to the governance of publicly held firms, where the UK seems to be evolving in a U.S. direction, our analysis suggests that the trend is precisely the opposite for close corporation bankruptcy. In practice, U.S. close corporation has become more like the manager-displacing U.K. approach in recent years, and we expect this trend to continue.

Notes

[1] See also Mayer (1998) and Berndt (2000), which focus solely on an "insider/outsider" dichotomy, with the latter also reviewing the terminology used in the literature.

[2] The position in the UK will be discussed *infra* section V. On the US, see Black (1998).

[3] On the parallel, see Mayer (1997); Cunningham (1999); Hopt (2000).

[4] This assumes that the country in question has a fully industrialised economy. A country that is "underdeveloped" may lack strong securities markets and a small banking sector. (Demirguc-Kunt and Levine, 1999).

[5] This, indeed, is particularly common in Germany. See Prowse (1995: 24); Prigge (1997: 1016-17).

[6] Marco Becht and Colin Mayer, *Corporate Control in Europe*, unpublished working paper (2000) at 4, 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, for example, Demirguc-Kunt and Levine (1999).

[7] See, for example, Charkham (1994: 35); Scott (1997: 150); Rubach and Sebora (1998).

[8] Fohlin (1999a) advances similar arguments from an historical perspective. Furthermore, Miwa and Ramseyer (2001) cast doubt upon the role which banks play in Japan.

[9] Hessen (1979: 1329).

[10] The "Berle-Means corporation" shorthand is borrowed from Roe (1994: 93).

[11] On the popularity of this explanation, see Wessel (2001). The phrase "law matters" is borrowed from Coffee (1999b: 644).

[12] La Porta *et al,* (2000: 4).

[13] The terminology is borrowed from Roe (2000: 586).

[14] For an overview of the literature, see La Porta *et al* (2000: 14-16). The research methodology has, however, come in for some criticism (e.g. Partnoy, 2000; Roe, 2001b).

[15] Note, though, that Coffee now doubts whether the experience in the US conforms with the "strong version" of the "law matters" story, which is that the law must provide investors with substantial legal protection in order for share ownership to become widely dispersed. See Coffee (2001).

[16] Others have used somewhat different terminology to make the same point. See, for example, Berglöf (1997b); Bradley *et al*, (1999) ("contractarian").

[17] One of the authors has developed the arguments made here in more detail elsewhere. See Cheffins (2002a).

[18] An important example was the Glass Stegall Act of 1933, a federal law repealed in 1999 which prohibited bank affiliates from owning and dealing in corporate securities: Act of June 16, 1933, ch. 89, 48 Stat. 162.

[19] Current Bank of England guidelines may, however, discourage the acquisition of large blocks of corporate equity.

[20] The situation is the same with other UK financial institutions. See Allen and Gale (2000a); Cheffins (2002b).

[21] For a more detailed analysis, see Cheffins (2002a). For additional criticism of Roe's social democracy thesis, see Coffee (2001).

[22] The most important change was the enactment of the Financial Services Act 1986, c. 60.

[23] From the 1940s to the 1960s, dividends were suppressed by a combination of tax policy and "voluntary restraint" urged by government: Thomas (1978: 237-43).

[24] Note, though, that Coffee argues that legal regulation may be required for securities markets to persist and attain their fullest development.

[25] Black (2000) makes the same point without referring specifically to the UK experience.

[26] This bias has been widely criticised. See, for example, Jackson (2000).

[27] See also Skeel (1999), applying the theory to bank and insurance firm governance.

[28] For an overview, see Cheffins (1997: 117-19).

[29] On whether the empirical evidence in fact demonstrates that incentivised pay improves performance, see Core *et al.* (2001).

[30] The terminology is borrowed from Kahan and Rock (2002).

[31] In their study of creditor rights, share ownership and other variables in different nations' corporate governance framework, LaPorta *et al* (1997) do not find a significant relationship between creditor rights and concentration of equity ownership concentration. Although our Article predicts that a nation will having manager-driven bankruptcy if firms' equity is dispersed, the La Porta *et al* findings cannot be seen as either confirming or raising questions about our theory. First, the La Porta *et al* creditor rights variables are extremely crude, and seem to be based on the bankruptcy rules as written, rather than as they function. Japan, for instance, qualifies as having relatively weak creditor rights (scoring 2 out of 4), despite the fact that during the period studied Japanese bankruptcy was extremely harsh in practice, and almost never resulted in reorganization. Second, weak creditor rights under the La Porta *et al* analysis loosely correlate with manager-driven bankruptcy, but the overlap is far from complete. Of the four variables La Porta *et al* consider, for instance, whether "management stays in reorganization" is far more important than the others ("no automatic stay," "secured creditors get paid first," and "restrictions for going into reorganization").

[32] 11 U.S.C. section 1121.

[33] 11 U.S.C. section 1129(b)(setting forth requirements).

[34] 11 U.S.C. 364 (post-petition financing). Creditors do retain the ability to petition for the removal of the managers and the appointment of a trustee pursuant to 11 U.S.C. section 1104, in cases of fraud or gross mismanagement: a high hurdle to clear, making this no more than a longstop protection. In recent years,

creditors have sought to counteract managers' ability to delay the Chapter 11 proceedings by negotiating "pay to stay" arrangements with key managers. These arrangements reward managers if the firm emerges from Chapter 11 within a specified time.

[35] Of course, it is not possible to remove the risk that the manager's human capital will be lost because the firm becomes economically distressed for reasons beyond her control (e.g. a shock to demand in her industry). This can be addressed, *inter alia*, through executive compensation arrangements.

[36] As noted above, note 31, the La Porta *et al* (1998) study dealing with creditor rights and share ownership dispersion neither supports nor refutes this thesis.

[37] On ownership and control patterns in continental Europe, see Faccio and Lang (2001). On banking, see Charkham 1994: 145-46); Fridenson (1997) (discussing France). On ownership and control patterns in East Asia, see Claessens (2000). On banks, see Amsden (1999) (discussing Korea and Taiwan).

[38] On the terminology, see Bebchuk and Roe (1999: 130, 142).

[39] On the terminology, see La Porta *et al.* (2000: 4).

[40] This proposition will be scrutinised more closely in section V.

[41] For an overview of how these function in a UK context, see Cheffins (1997: 112-14, 117-22).

[42] Under English law, 'bankruptcy' refers solely to individual insolvency proceedings, whereas corporate proceedings are

referred to as ‘corporate insolvency’. In keeping with much of the literature, the American terminology is used throughout this paper.

[43] The survey offered here is not comprehensive. Some additional procedures are discussed briefly in the endnotes.

[44] For this reason, all statutory references to specific provisions are to the latest consolidating legislation.

[45] On the evolution of general incorporation legislation in England, see Davies (1997: 38-46). On the origins of English corporate bankruptcy law, see Lester (1995: 222-28); Fletcher (1996: 10-13).

[46] See now Insolvency Act 1986, s 122(1)(f). See also ss 124, 125. 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 is usually consequent on a threat by creditor to petition for winding-up unless the vote is taken. See generally Davies (1997: 838-43).

[47] Insolvency Act 1986, s 143(1).

[48] Insolvency Act 1986, ss 128, 130(2), 183, 184.

[49] See *Measures Bros Ltd v Measures* [1910] 2 Ch 248. In a voluntary liquidation, discussed above note 46, the employment of those acting as directors is not terminated automatically, but the appointment of a liquidator means that all their powers cease: Insolvency Act 1986, s 103.

[50] The liquidator might, if desirable, continue the firm’s operations and auction its business as a going concern. He has 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 (Insolvency Act 1986, s 167; Sch. 4 para. 5).

[51] Again, a "creditors' voluntary winding-up" (above note 46) is an alternative to the court-supervised winding-up procedure described in the 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 court is typically sufficient to deter putative enforcement actions. Moreover, the outcome of a creditors' voluntary winding-up is functionally equivalent to court-supervised winding-up for both the company (liquidation) and for the directors (cessation of their powers in favour of a liquidator appointed by creditors). Correspondingly, the procedure is not examined in detail in the text.

[52] *Re David Lloyd & Co*, (1877) 6 Ch D 339.

[53] *Re Panama, New Zealand and Australia Royal Mail Co*, (1870) 5 Ch App 318.

[54] See, e.g.*, Zartman v First National Bank of Waterloo* 189 NY 267, 82 NE 127 (NYCA, 1907); *Benedict v Ratner* 268 US 353, 359-361 (1925).

[55] U.C.C. §§ 9-204, and comment 2; 9-205.

[56] Holders of a floating charge had the option of applying to court for the appointment of a receiver, but there were few advantages to doing so : Gower (1954: 419-20).

[57] See Insolvency Act 1986, ss 29(2), 42-49. These statutory powers and duties do not apply to receivers appointed under

security agreements that do not cover such a wide range of collateral. See Goode (1997: 212-15).

[58] As a practical matter, the bank would typically 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 as compared with other security interests a debtor grants. See Campbell and Underdown (1991: 111).

[59] For more detail on when the holder of a floating charge will be entitled to take enforcement proceedings under the security agreement, see Campbell and Underdown (1991: 114-15).

[60] On this and other types of intervention, see Goode (1995: 738).

[61] 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 (1995: 736-41).

[62] On the powers of an administrative receiver, see Goode (1997: 234-37). On the possibility of a receiver organising a corporate rescue, see Fletcher (1996: 420).

[63] A court cannot refuse to make a winding up order on the grounds that the company's assets have been mortgaged up to the hilt: Insolvency Act 1986, s 125(1); Goode (1997: 106 n 42).

[64] *Re Northern Garage Ltd* [1946] 1 Ch 188; *Sowman v David Samuel Trust Ltd* [1978] 1 All ER 616; *Re Potters Oils Ltd* [1986] 1 WLR 201.

[65] On the outcome in the unlikely event of a surplus, see Goode (1997: 263-64).

[66] Companies Act 1985, ss 652, 652A. It is a precondition of such removal that the company's creditors be informed and do not object. Where there are no assets, then there is no reason to object. Furthermore, no one will be willing to act as liquidator with no assets to pay them.

[67] A supervening winding-up order would, however, result in the automatic removal of the company's directors. See above note 49 and accompanying text.

[68] An exception to this could be 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 unpaid unsecured creditors of the original company, see Fletcher (1996: 489, 664-67).

[69] On the absence of major legislative initiatives until this point in time, see Fletcher (1996: 13-14).

[70] On the motives underlying the enactment of the legislation, see Carruthers and Halliday (1998: 112-123).

[71] On the transition from the Insolvency Act 1985 to the Insolvency Act 1986, see Fletcher (1996: 19-20).

[72] On why larger UK companies tend not to grant all-encompassing security interests, see Carruthers and Halliday (1998, 163, 195).

[73] See above, text to notes 53-62; Insolvency Act 1986, s 29(2) (definition of "administrative receiver" as receiver appointed by creditor with security encompassing the whole, or substantially the whole, of the debtor company's property).

[74] Insolvency Act 1986, s 9(1). Note that a creditor whose security covers all, or substantially all, of the debtor's assets can oppose to 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 *ibid.* ss 9, 10 (discussing a creditor entitled to appoint an "administrative receiver").

[75] Insolvency Act 1986, s 8(3).

[76] The chances of success will be high: Rajak (1994: 204, Table 8.4).

[77] Insolvency Act 1986, s 11(3). For instance, there will be an absolute bar on the appointment of an administrative receiver and a winding up petition cannot be brought.

[78] 11 U.S.C. § 362.

[79] Insolvency Act 1986, ss 13, 388, 389.

[80] *Ibid*, ss 14(1), 17, sch. 1.

[81] *Ibid*, s 14(4).

[82] *Ibid*, s 14(2)(a).

[83] For background on the development of the legislation, see Carruthers and Halliday (1998: 269-83).

[84] See Insolvency Act 1985, s 45.

[85] The grounds for disqualification were expanded under the Insolvency Act 1985.

[86] Insolvency Act 1986, ss 214(2), (3). On when a director "ought to know" that a company will not avoid insolvent liquidation, see s 214(4).

[87] *Ibid,* s 214(1). In practice, applications for wrongful trading declarations are rare. On why this is the case, see Cheffins (1997: 545-46).

[88] Company Directors Disqualification Act 1986, s 10.

[89] *Ibid*, ss 6-9. On the practical importance of this ground for disqualification, see Farrar and Hannigan (1998: 345, 348)

[90] *Re Sevenoaks Stationers (Retail) Ltd* [1991] BCLC 325, 330, 337; *Re Linvale Ltd* [1993] BCLC 654; *Re Hitco 2000 Ltd* [1995] 2 BCLC 63; *Re Continental Assurance Co. of London plc* [1997] 1 BCLC 48; *Re Barings plc* [2000] 1 BCLC 523.

[91] Company Directors Disqualification Act 1986, s 6.

[92] The recommendations were based on primarily on a prior study: Insolvency Service (2000a). See also the earlier consultation document: Insolvency Service (1999).

[93] A shake-up of the personal bankruptcy regime was also proposed, with the declared objective being to allow entrepreneurs who have become bankrupt through "bad luck" rather than their "fault" to enjoy a speeded-up discharge: DTI (2001: 1-8). See also the earlier consultation document on

personal insolvency: Insolvency Service (2000b). The change, it is hoped, will encourage entrepreneurship. Nevertheless, reform will not offer much for managers of publicly quoted companies. This is because they are unlikely to be asked to give personal guarantees of business debts and thus are not at risk of personal bankruptcy if the firm fails.

[94] Insolvency Act 2000, s 1 and Sch 1. 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 that £2.8m; (ii) its balance sheet total is not more than £1.4m; and (iii) it does not employ more than 50 persons.

[95] The new proposal builds on a different existing mechanism to the new DIP procedure introduced by the Insolvency Act 2000 (above note 94 and text thereto). The Insolvency Act 2000 extends the CVA mechanism, which is located in the Insolvency Act 1986. The new proposal seeks to develop a similar "cram-down" mechanism known as the "scheme of arrangement". It is thought of as preferable as a means of securing a reorganization for large firms because it binds creditors who are "unknown" at the time of the vote and who therefore have not been informed. The Committee conducting the Review of Business Rescue Mechanisms considered that the Insolvency Service should liaise with the ongoing Review of Company Law over the desirability of this proposal, apparently because the schemes of arrangement provisions are located in Part XIII of the Companies Act 1985, as opposed to the Insolvency Act 1986 (Insolvency Service, 2001).

[96] See also Holland (1998: 27); Davies (2001: 12-13).

[97] See generally section III above, as well as Black (1998: 461) (expressing doubts, however, on the importance of law); Coffee (1994: 877-82).

[98] See, e.g., Stapledon (1996: 231, 253, 279), questioning whether the Berle-Means corporation is dominant in the UK but concluding that the ultimate controllers of UK companies are arm's-length shareholders.

[99] On this trend, see also Parkinson (2000); Pye (2001).

[100] For more on the institutional investment "culture", see Clements (1995). For further background on why UK institutional investors are reluctant to intervene, see Short and Keasey (1997: 26-38); Parkinson (2000: 239-40).

[101] On the terminology, see Adams (1989: 67-68).

[102] Loan capital was, however, an important source of finance during the 1960s. On why the situation changed, see Bank of England (1981).

[103] One consideration might be that British companies are less highly leveraged than those in America (Rajan and Zingales, 1995: 1428-1430, 1438), but the difference seems small compared to the disparity in corporate bankruptcy rates.

[104] This is also the case with company voluntary arrangements, another potential rescue alternative available under the Insolvency Act 1986. See Goode (1997: 335).

[105] The study was based primarily on interviews with lawyers, bankers and accountants who specialised in debt restructuring work in London during the 1990s to build up a picture of what

was involved. This was backed up, wherever possible, by reference to other empirical studies and to descriptions in the practitioner literature.

[106] Above, text to notes 72ff. Even more so than in earlier examples, it should be borne in mind that actual practice in any given instance may vary widely from the highly stylised facts set out in the text.

[107] This paragraph and the next draw on Armour and Deakin (2001: 34-35).

[108] 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.

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

[110] The terminology is drawn 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 institution performing this function is referred to as the 'lead' bank (see Wood, 1995).

[111] Various explanations for participants' adherence to the London Approach norms are considered in Armour and Deakin (2001: 40-46). Also important is the implicit threat of regulatory sanctions by the Bank of England (although this has ceased to be so credible since the removal in 1998 of the Bank's responsibility for the prudential regulation of banks).

[112] 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 the creditor cannot enforce its security, which will restrict its ability to realise the optimum value for its collateral.

[113] An administrative receivership is unlikely to occur, as publicly quoted companies rarely grant floating charges. See above, note 72.

[114] It is difficult to quantify the extent of the so-called 'indirect' costs of bankruptcy. For evidence drawn from one case study suggesting they are of a very high order of magnitude, see Cutler and Summers (1988). See also Chen and Merville (1999).

[115] Companies in Chapter 11 are, to some extent, also dependent on creditor goodwill, in particular for obtaining fresh financing.

[116] In a London Approach workout, old equity may retain up to 15% of the firm's value (Armour and Deakin, 2001: 36).

[117] La Porta *et al* (1997) arguably take debt into account most fully, as they consider creditor rights and several measures of debt levels in their analysis of the legal determinants of external finance. As noted, above note 31, their findings do not shed light on the analysis of this Article.

[118] As discussed in Part III above, controlling shareholders may also expropriate value from minority shareholders through private benefits of control.

[119] 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 Kahan (1995: 583-86), noting that institutional investors hold most corporate bonds.

[120] This is because the principal risk—often referred to as an overinvestment problem—is that shareholders will take risks that provide a possible benefit to shareholders but whose downside will be borne partially or completely by debtholders. If the firm will remain solvent in both the good and bad states of the world, shareholders the overinvestment problem disappears, since shareholders bear the costs of their decision making.

[121] The source of these limitations in the US is the Trust Indenture Act of 1939. But British law does not hamstring trustees in the same way, and it is possible to imagine trustees who would play a far more active role even in U.S. debt governance than the passive existing trustees. The "supertrustee" proposed by Amihud *et al* (1999) is just such an imagining. The obvious downside of an active trustee is that vigorous monitoring is more costly than passive investment. We discuss the tradeoff between the benefits of reducing financial agency costs and the costs of monitoring below.

[122] Interestingly, LBOs may be the exception that proves the rule in some respects. The LBOs of the 1980s proved to be a transitional state. Despite the predictions of some prominent commentators (e.g. Jensen, 1989: 61), most were taken public again within a few years. Moreover, LBOs often included a significant amount of (concentrated) bank finance along with the junk bond financing.

[123] The rise of the commercial paper market in the United States in the 1960s and 1970s was an illustration of this phenomenon. Unable to compete with traditional bank loans, banks lobbied

for changes to the banking laws that would enable them to enter the commercial paper market (Litt *et al*, 1990).

[124] Diffuse stock and diffuse debt may go in tandem for other reasons as well. Markets for publicly issued, unsecured debt may, for instance, provide valuable information to scattered shareholders about the prospects of the firm (Adler, 1993).

[125] In the U.S., investment bankers who cut their teeth selling U.S. war bonds to the American public played a central role in developing a market for railroad bonds thereafter. The railroads, which were the first major U.S. corporations, first raised capital through the bond markets and only later began to raise significant amounts of capital from the equity markets (Coffee, 2001: 26-27; Skeel, 2001: 48-52).

[126] In the United States, as has often been noted, J.P. Morgan solved this problem by developing a reputation for protecting the European investors who were a crucial source of financing for the American railroads. By the early 1900s, J.P. Morgan and its peers held both stock and debt interests in numerous American corporations (DeLong, 1991).

[127] 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 issue.

[128] Even if bondholders were represented by a trustee, the need to obtain bondholders approval for any significant restructuring would complicate the parties' ability to maintain the level of secrecy that current characterizes the London Approach.

[129] In the United States, investment banks began to include precisely these kinds of provisions in bond indentures in the 1930s, but voting provisions were subsequently prohibited by the Trust Indenture Act of 1939. The voting prohibition has significantly complicated out-of-bankruptcy workouts in the U.S. Although firms with publicly issued debt do restructure through out-of-bankruptcy solicitations, the right of dissenters to insist on full payment makes restructuring impractical unless nearly all of the bondholders consent. The classic discussion is Roe (1987).

[130] The pressure from managers is likely to come in actual cases, rather than through the legislative process. Historically, managers have not been major lobbyists on bankruptcy issues even in the manager-friendly U.S. context. Skeel (2001: 81-82) explains that managers tend 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 conclusions about the most recent US and UK reforms, see Carruthers and Halliday (1998).

[131] There is no single, accepted definition of a closely held corporation. Existing definitions tend to focus on the number of shareholders: for example, the American Law Institute's (1994) Principles of Corporate Governance define a 'close corporation' as one with a small number of shareholders and no active trading market for its shares.

[132] A small company is defined as satisfying two or more of the following three criteria: (i) its annual turnover is not greater that £2.8m; (ii) its balance sheet total is not more than £1.4m; and (iii) it does not employ more than 50 persons (above, note 94).

[133] Another imminent reform is a shake-up of the personal bankruptcy regime to allow entrepreneurs who have become bankrupt through 'bad luck' rather than their 'fault' to enjoy a speeded up discharge (DTI, 2001). The relationship between entrepreneurship and close corporation insolvency is discussed below.

[134] Although Congress has added a number of "small debtor" specific provisions in recent years, as we discussed below, Chapter 11 is available to all corporate debtors, without reference to size or ownership composition. See 11 U.S.C. 109.

[135] For a model showing that, under some conditions, a lender may not have an incentive to renegotiate to an efficient allocation of control and ownership rights to the entrepreneur, see Ayotte (2001). To the extent creditors do not have appropriate incentives, the best solution may be to couple creditor control with a pre-determined carve-out for the owner-entrepreneur.

[136] The principal lender often has a security interest in all of the debtor's significant assets, and it frequently has a large unsecured deficiency claim as well. The classification of the deficiency claim has been one of the most controversial issues involving close corporation debtors, in large part because it often determines whether the lender has complete veto power over any proposed reorganization plan. Some courts have forbidden debtors from classifying deficiency claims separately to increase the likelihood of confirming a reorganization plan—see, e.g., *Matter of Greystone Joint Venture*, 995 F.2d 1274 (5th Cir. 1991)—while at least one has gone so far as to *require* separate classification: *Matter of Woodbrook Associates*, 19 F.3d 312 (7th Cir. 1994).

[137] See e.g., 11 U.S.C. section 362(d)(3) (limiting the automatic stay in "single asset real estate" cases). The proposed legislation that passed both the House and Senate in 2001 would have limited the exclusivity period to 100 days for small business debtors.

[138] The most obvious problem is that closely held companies are unlikely to be reorganized unless the shareholder retain their interest, yet Chapter 11 requires adherence to the absolute priority rule (which eliminates shareholders' interest) in order to confirm a "cramdown" plan over the objections of a dissenting class. Debtors have tried to resolve this tension by proposing to contribute new value. . For an analysis of the new value issue, in the context of the Supreme Court's most recent attempt to resolve it, see Baird and Rasmussen (1999).

[139] For a discussion of the political factors that are likely to preserve the general status quo, see Skeel (2001: 233-35).

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