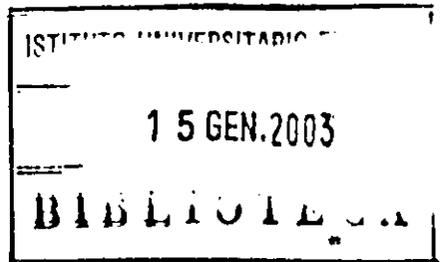




European University Institute
Department of Law



**THEORIES OF THE COMPANY,
EMPLOYEES AND TAKEOVER
REGULATION**

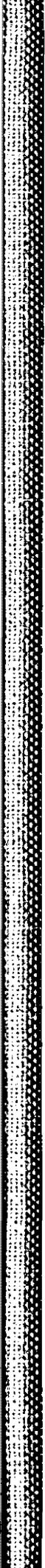
ANDREW JOHNSTON

under the supervision of

Professor Silvana Sciarra
Professor Simon Deakin

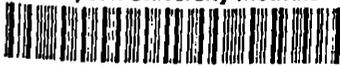
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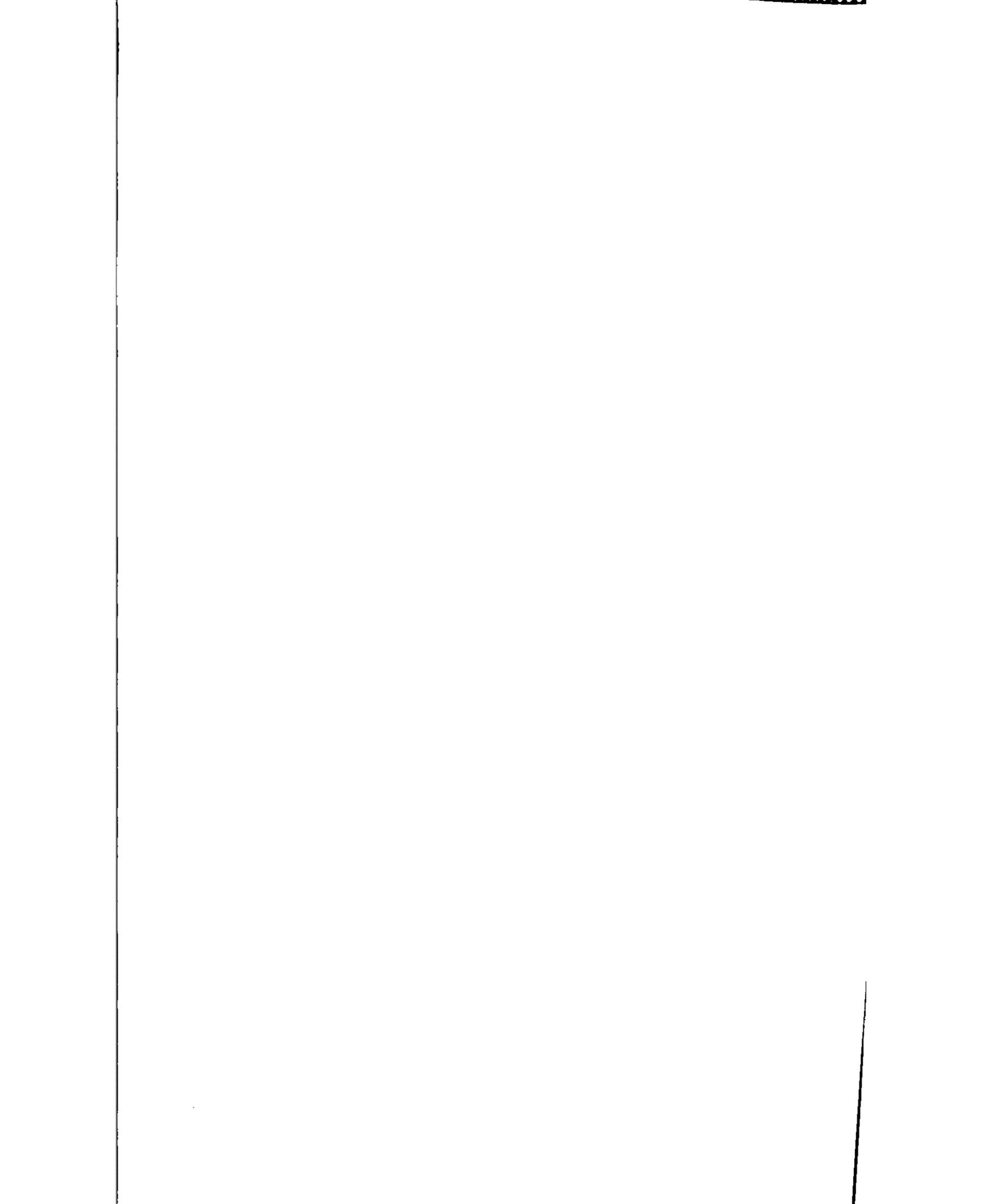
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Theories of the Company, Employees and Takeover Regulation

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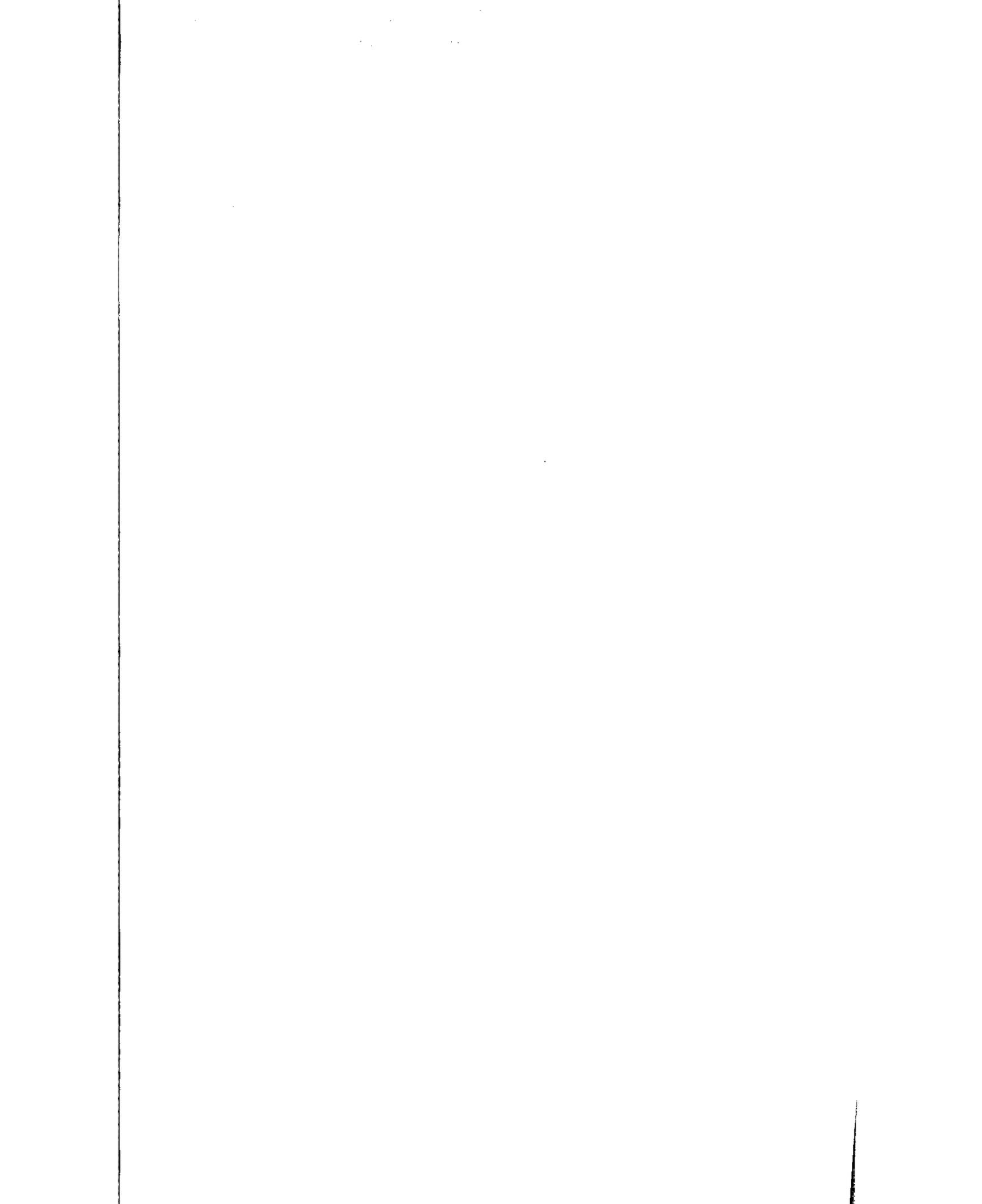
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Theories of the Company, Employees and Takeover Regulation

"Company law does not set out to recognise the interests of the employee. Its *dramatis personae* are directors, shareholders, creditors, auditors, but not the company's workers. With trivial exceptions they find no mention in the Companies Act."¹

Introduction and Methodology

Part One: The Three Models

"The managerial firm may not be dead, but it is under intense pressure."²

General company law in the UK and the US is at present based on a managerialist model in which management owes its duties to the corporate entity rather than any particular corporate constituency. In recent years, this model has been under sustained challenge from the doctrine of shareholder value, which asserts that management should exercise their discretion solely in order to produce value for shareholders. While company law itself does not (yet) reflect shareholder value as the sole purpose of the company, hostile takeovers and adaptive market mechanisms provide management with strong incentives to pursue that aim.

The first part of this thesis draws on a range of theoretical material, taken from law, economics and political science to develop and critique three alternative heuristic models of the corporation against which to judge the contents of company law, and, in particular, takeover regulation. This modelling is given manageable scope through a focus on the

¹ Wedderburn, Lord, *Company Law Reform* (1965) at 14; see also Deakin, S and Hughes, A, "Comparative Corporate Governance: An Interdisciplinary Agenda" (1997) 24 *Journal of Law and Society* 1 who note at 2 that "In the common-law world, internal company structures are largely designed to deal with the relationship between the board of directors and the principal corporate constituents - and these are, above all, the shareholders...Employees are not the subject of special treatment; their contractual rights are supplemented by certain statutory protections for the individual worker, and by collective rights of bargaining and consultation. However, it is significant that many of these labour law rights do not necessarily operate at the level of the *company*..."

relationship between the company and its employees. Each model offers a different rationale for employee involvement or representation of their interests (or the absence thereof) in corporate decision-making, and accordingly their treatment by company law. The way in which each model answers this "delicate and politically sensitive question"³ rests on an analysis of employees' relationship with the company and their contribution to the productive process.

It is important to note at the outset that the thesis deals with the large, publicly-held corporation whose shares are listed on a public exchange, rather than the small privately-owned corporation. Companies falling into these two broad categories raise very different issues of governance. In the small private company, shareholders, board and employees are often the same people, with the result that there are fewer "agency" and representation problems. By contrast, the shareholders of the large public corporation are normally dispersed and have little or no contact with the business of the corporation or the board, meaning that there is normally little or no monitoring of management by shareholders.⁴

The "agency" or "neoclassical" model deconstructs the corporate entity to reveal a "nexus of contracts". Its central assumption is that employees are protected from risk by fully "presentiated"⁵ or express contracts, and that as long as there are liquid labour markets, then an employee who loses his job will generally suffer minimal losses. Employment contracts are dealt with either individually or collectively under labour law and are generally of no concern for Anglo-American company law. On the basis of these assumptions, it is asserted that the only constituency with a "residual" or variable claim

² Osterman, P, *Securing Prosperity* (1999) at 150

³ Becht, M, Bolton, P, and Rowell, A, "Corporate Governance and Control" (*ECGI Finance Paper No2, October 2002* at 15 fn 21)

⁴ Although hopes that institutional investors may be willing to play a more active role in monitoring and containing management are periodically raised and dashed. A good recent example of raised hopes was the successful pressure exerted by institutional shareholders for Michael Green to step down as chairman of the newly-merged ITV company (see *The Economist*, "The Shareholder's Revolt", 23rd October 2003). The limits to such interventions became clear shortly afterwards as institutional investors failed to prevent the appointment of James Murdoch as chief executive of BskyB, on the insistence of his father, the chairman of BskyB and its main shareholder through Newscorp (see further, *The Economist*, 8th November 2003).

⁵ This term originated with Macneil who analyses contracts in relational terms; see for example Macneil, I, *The Relational Theory of Contract: Selected Works of Ian Macneil* (2001) ; Macneil, IR, "Economic

against the company are the shareholders, and that if their returns are maximised, then the wealth of society as a whole will be too. The precise way in which the maximisation of shareholder value should be ensured remains at the heart of mainstream debate about corporate governance, which concentrates on the "agency" problem of making management more accountable to shareholders.

The traditional challenger to the neoclassical contractual model, the "political stakeholder" model, sees the employees as the "governed" of the enterprise and argues that they should have some input into decision-making, either on the basis of the democratic imperative, or on the basis that companies, as an integral but differentiated part of society, should be socially responsible. A reform programme along these lines, assert its advocates, would not only be a good in itself, but could be instrumentalised to improve the motivation and productivity of the company's employees. Ideally, such joint governance should be established voluntarily, but if those in control of corporations are reluctant to share decision-making power, the law should compel them to do so.

Finally, the "productive coalition" model attempts to steer a middle course between these two opposing paradigms. It makes an *economic* argument that employee interests often require articulation within the company, and that this should occur either by strengthening managerial autonomy from interference from other constituencies, or by reforming decision-making structures to make them more pluralistic. While this model adopts the same contractual methodology as the "agency" model, the key difference lies in its recognition that corporations are a framework of both "explicit" and "implicit" (or unenforceable) contracts. While this latter category may seem counter-intuitive to lawyers, sociological (and increasingly socio-legal) research into the practical operation of contracts demonstrates a low level of reliance on strict legal rights and a greater use of "understandings" or "conventions" which reduce transaction costs.⁶ Implicit promises

Analysis of Contractual Relations: Its Shortfalls and the Need for a "Rich Classificatory Apparatus" (1980) 75 *Northwestern University Law Review* 1018.

⁶ The ground-breaking article is Macaulay, S, "Non-Contractual Relations in Business" (1963) 28 *American Sociological Review* 55; see also Macneil, I (2001) (*supra* note xx); Campbell, D and Harris, D, "Flexibility in Long-term Contractual Relationships: The Role of Co-operation" (1993) 20 *Journal of Law and Society* 166; Collins, H, *Regulating Contracts* (1999); Campbell, D, "Reflexivity and Welfarism in the Modern

about the treatment they can expect in the future may encourage employees to make investments in firm-specific skills (or "human capital") which will be of less value in other employment contexts. Of course, in the absence of legal protection, these investments may become vulnerable to opportunism in certain exceptional situations (like takeovers). This means that, contrary to the assertions of the agency model, employees may also be "residual claimants", in the sense that they also bear some risk in the event of the firm failing or the termination of their relationship with the firm. Since such specialised skills are essential to many companies' competitive advantage, and therefore form a part society's wealth-generating capacity, appropriate governance structures should be put in place to encourage and protect them. In the light of these arguments, reasons for and against legal intervention on the grounds of improving allocative efficiency are then discussed.

Within the wide body of literature surveyed in the first part of this thesis, it is often made clear that the perspective being advanced is either descriptive of the legal system or a normative statement aimed at, for example, improving efficiency or social justice. However, at other times, the nature of the arguments being advanced is glossed over or ignored altogether. Often, their advocates, coming from a non-legal perspective appear not to consider the extent to which their theoretical approach is reflected in the law's provisions. Therefore, wherever possible during the first part of the thesis, the nature of the claims being made for each of the theories will be clarified by reference to legal provisions.

Law of Contract" (2000) 20 *OJLS* 477. Reliance on strict legal rights is only likely to occur where there is no relational context (and therefore no operational reputation mechanism) or where the relationship has broken down: see Campbell, D (2000) (*supra* this note) at 485 and Collins, H (1999) (*supra* this note) at 102.

Part Two: Application of the Models to Takeover Regulation

The second part of the thesis analyses various regimes of takeover regulation with particular reference to these models, and attempts to identify their underlying theoretical assumptions. Particular attention is paid to the ability of the board to take defensive measures, and to the rights (if any) which are granted to employees. Takeovers are an appropriate area for analysis because the conflicts between the various corporate constituencies and between the various models of the firm developed in the first part are highly visible. It is also notable that, as a capital market measure, takeover regulation clashes with the dominant norm of company law, namely managerialism.

First, the dominant theory of the market for corporate control is discussed, and critiques of it are offered. UK and US systems of takeover regulation are then analysed, and measured against agency and productive coalition models of takeover regulation. These jurisdictions were chosen because of the striking differences in their systems of takeover regulation despite the shared theoretical orientation of their systems of company law and corporate governance. While the UK system of takeover regulation clearly rests on the agency model and underpins a market for corporate control, analysis of US takeover laws elicits a more cautious response as managerialism remains a significant influence. However, it is suggested that the effect of these differences is lessened by the widespread use of adaptive mechanisms which align the interests of management and shareholders, and leave the hostile takeover as a mechanism of last resort.

Next, the newly-introduced German takeover regulation, and the extent to which it reflects that country's very different system of corporate governance, is briefly considered. Finally, the recently adopted European takeover directive is considered. First, its evolution and the various rationales which have been advanced during its lengthy gestation period are considered. The various drafts and the reports which accompanied them are analysed by reference to the theories of the company developed in part one. It is concluded that market integration (the creation of a "level playing field") was not in itself

a sufficient rationale to explain the legislative choices made in the various drafts of the directive: those drafts, which treated the takeover directive as a pure capital market measure, were centred on an agency model conception of the company. Various EC labour law measures on the information and consultation of employees were cited in response to fears expressed by the European Parliament that the interests of employees were not adequately protected by the various drafts of the directive. These measures are briefly analysed in terms of the level of protection they would provide in the takeover context. It is concluded that the recently reached compromise is understandable in the light of the persistence of different varieties of capitalism within the EU. This state of affairs necessarily led to opposition to capital market measures being taken in isolation from other issues of corporate governance. Broader harmonisation of corporate governance structures would be a Herculean task and is very unlikely. In the absence of some strong employee participation provisions, an outright ban on defensive measures by the board was wholly acceptable to the Member States (in particular, Germany) whose systems of corporate governance are influenced by considerations from the second or third models. Accordingly, the compromise reached, which allows Member States some flexibility in the way they apply the directive, makes sense because it respects the evolved diversity of European systems of productive organisation and therefore allows Member States to retain their competitive advantage.

It is concluded that most financial market regulation is based on an agency model of the corporation; social issues, including the treatment of employees, which are highlighted by the political stakeholder model are dealt with both by voluntary measures such as the Commission's exhortation to CSR and by weak-form *ex post* participation measures like information and consultation. This compartmentalisation of the economic and the social appears to be largely unchallenged in the legislative agenda of the Commission. Any "social externalities" arising from financial market regulation are dealt with by remedial social legislation which does not impinge upon the operation of capital markets and the pursuit of a solution to the agency problem. The "productive coalition" model puts forward a challenge to the current conventional division between economic and social matters by producing arguments based on economic methodology for greater

representation of employee interests within corporate governance. It is suggested that this model, while more challenging to implement, offers a more realistic basis on which to deal with corporations at the supranational level, and, if adopted, will provide European enterprises with sustained competitive advantage in international markets.

Methodology

Much of this thesis is concerned with an analysis of the company in contractual terms. Accordingly, neither the shareholders nor anyone else are treated as the "owners" of the company. Instead, the rationale for the allocation of rights in company law is sought in the nature of the relationship in question.

Rejection of the Property Rights Model

An important strand of contractual analysis of the firm has been in terms of property rights.⁷ Where the regular supply of a factor of production is essential for the success of an enterprise, the firm must decide whether to hire or own it. Since owning an asset gives the owner residual rights to decide what to do with that asset where it is not contractually committed, ownership will eliminate the risk of "hold-up" (opportunistic hard bargaining) where the factor has become essential to the future of the business (for example, because it has become co-specialised with an asset which the firm owns). However, there is a trade-off. Ownership by the firm also imposes costs in the form of reduced incentives on the part of those using the factor in the course of the business to take proper care of it.⁸ The decision whether to rent or own the asset in question is a balancing exercise between these two sets of costs.

The property rights theory is very important in broader contractual analysis of the firm, in particular because it considers an important consequence of ownership to be the right to fill gaps in incomplete contracts. However, the theory either excludes labour from consideration altogether, on the basis that it cannot be owned,⁹ or suggests that the

⁷ Hart, O, "An Economist's Perspective on the Theory of the Firm" (1989) 89 *Columbia Law Review* 1757; see also Bratton, WW, "Enron and the Dark Side of Shareholder Value" (*George Washington University Public Law and Legal Theory Working Paper No 35 of 2002* available at <http://papers.ssrn.com/abstract=301475> at 18 fn 68.

⁸ These costs are characterised as agency costs by Jensen, M and Meckling WH, "Rights and Production Functions: An Application to Labor-Managed Firms and Codetermination" (1979) 52 *Journal of Business* at 15-16

⁹ Vertical integration of labour is impossible since it would amount to slavery. According to some contractualist perspectives, the specialisation of labour creates extensive opportunities for "hold up" by both parties to the "contract". This risk is exacerbated where labour and other assets of the business become

suppliers of labour should, in appropriate circumstances, also be the owners of the enterprise.¹⁰ This latter suggestion is not considered further in this thesis, which concentrates on the position of employees in company law *qua* employees, not *qua* shareholders.¹¹

For the same reason, and for reasons of space, employee share ownership schemes are also excluded. Many theorists contemplate a role for employees in corporate governance through the mechanism of share ownership.¹² They suggest that employees are free, and should be encouraged, to become shareholders in the shareholder-value orientated corporations which employ them, and in this way exercise influence over corporate decision-making. Employee share ownership certainly raises intriguing possibilities and important difficulties as regards the articulation of stakeholder interests within the corporate governance structure.¹³ However, this thesis is confined to considering justifications for the provision of governance rights to employees in their capacity as employees rather than as shareholders.

In contrast to the property rights approach, agency perspectives on corporate governance tend to exclude labour from their scope on the basis that it is a static, uniform (commodity) input, rather than one of a number of factors of production in dynamic

co-specialised or "complementary". As we shall see in Chapter 3, this is one of the prime concerns of "productive coalition" theorists.

¹⁰ For a detailed discussion of the difficulties which arise when labour is the "owner" of a business, see Hansmann, H, *The Ownership of Enterprise* (1996).

¹¹ For an attempt to model the labour input's interaction with the firm in terms of "access" precisely to get around the inability of firm's to own the labour input, see Rajan, R and Zingales, L, "Power in a Theory of the Firm" (1998) 113 *Quarterly Journal of Economics* 387.

¹² See for example, Parkinson, J, *Corporate Power and Responsibility: Issues in the Theory of Company Law* (1993) at 423-6 and the sources cited there.

¹³ For example, while employees would certainly obtain valuable rights as shareholders which could conceivably complement their position as stakeholders of the company, they would necessarily also have to face the shareholders' collective action problem, which is discussed in detail in chapter one. Their influence on management as one of a number of dispersed shareholders is likely to be small. Their interests as shareholding employees are also likely to diverge from those of purely financial investors, both as regards the time frame for return on their investment and the division of rents. In addition, and more importantly, as the aftermath of Enron demonstrates, where employees invest a large proportion of their savings in their employer as opposed to the market as a whole, this exposes them to an unacceptable degree of risk, as the insolvency of their employer leads to loss of both employment and savings for retirement. For a more detailed discussion of some of the problems raised, see Hirsch, JM, "Labor Law Obstacles to the Collective

evolution. With this assumption, the question never arises of maintaining labour *in situ*, because any alternative supply purchased on the market at a moment's notice will be equivalent. The role of the firm as a governance structure does not extend to creating incentives for investments in firm-specific skills, or to keeping specialised labour in place within the firm by maintaining trust among corporate participants. The political stakeholding and productive coalition models challenge these assumptions rather than those of the property rights model.

Systems Theory

Interdisciplinary research poses complex problems for a thesis in law, and in particular for attempts to understand how elements of economic and political analysis provide the rationale for legal rules and enter into legal discourse. I have attempted to get around some of the apparent conflicts between economic or political research and the provisions of the law by adopting a systems theoretical approach which treats the law as one of a number of autopoietic systems.¹⁴

Teubner explains that we do not have to attempt to reconcile the irreconcilable, and that we should understand inter-systemic conflicts between, for example, law and economics, as an inevitable by-product of the differentiation of society, understood as a system of communication, into such functional and specialised subsystems. With the passage of time, these social subsystems evolve and become so functionally specialised that they gain limited autonomy from the underlying social system. This process is known as autopoiesis and goes beyond simple self-referentiality: their internal communications are self-generating and they "produce their own elements, structures, processes and boundaries. They construct their own environment, and define their own identity."¹⁵ These elements are mutually reinforcing, depending on each other for their validity, and

Negotiation and Implementation of Employee Stock Ownership Plans" (1998) 67 Fordham L Rev 957, in particular at 967-84.

¹⁴ Which broadly means "self-referential", although Teubner uses the term in a technical sense to describe cognitively open but operatively closed systems: see Teubner, G, *Law As an Autopoietic System* (1993) at 32-3.

¹⁵ *ibid* at 69-70

feed into each other, a process explained by systems theory in terms of a "hypercycle". As the subsystem follows its own logic and seeks internal consistency, so the communications which constitute it become increasingly differentiated both from society and other social subsystems. While each subsystem, as part of society, may observe other systems (it is "cognitively open" to "its environment"), its differentiated method of internal communication means that it cannot interact with those other systems directly (it is "operatively closed"). This means, for example, that the legal subsystem generates "legal reality" only indirectly, by observing the operation of the social or economic systems and then reconstructing them within its own internal communications and according to its own systemic logic.

Systems theory suggests that the conflicts between legal and economic analysis of the same underlying productive relationships should be understood as arising from the distinctive binary functions that those sub-systems have to fulfil in relation to the underlying main societal system. In the case of the law, it is the legal/illegal distinction. In the case of economics, it is the efficient/inefficient distinction. In the case of political science, it is the exit/voice distinction. This functional conflict is likely to lead to differences in the characterisation of corporate relationships and the normative demands which accompany them.

Despite these methodological difficulties, an interdisciplinary approach may generate considerable insight through an analysis of company law in its economic and social context. The collision between politics, economics and law is nowhere more evident than in the system of corporate governance. If, as systems theory insists, the law is cognitively open to its environment, then its content should reflect broader society's perceptions of its main subject matter, and the relationships which are embedded in it. If the model of the company used by the law is a richer one which draws on theoretical perspectives from a whole range of disciplines, its regulation of the underlying enterprise is likely to be more appropriate. For example, Dore has argued that the way in which intra-corporate

relationships are governed reflects broader social expectations of the firm.¹⁶ As one aspect of the corporate governance system, the law cannot ignore social expectations in reconstructing the corporation within its legal reality. The direction of causality may also be reversed, the form taken by the firm within the legal system exercising an influence over popular perceptions of the firm. This process of mutual reinforcement demonstrates not only that law is not independent from society, but also that these systems interact in a dynamic way. For example, where the contractual model is influential, the corporation is considered "popularly, as the place where for the moment, one earns one's living, where one might also have an active and enjoyable social life and the satisfaction of interesting work; as a legal entity to which one owes obligations which are time bound by the period of notice specified in the employment contract." This popular perception of the firm appears in economic theory as "a web of contracts, the nature of which is constrained only by law and convention; all such contracts, even those which have legal entities as contractors (the firm, a trade union) being ultimately dissolvable into the contracts of individuals."¹⁷

The use of systems theory to by-pass difficult conflicts in this way inevitably led me to undertake a functionalist analysis of the law.¹⁸ Systems theory suggests that company law responds to changes in its environment (and in particular to changes in corporate governance systems) by reconstructing them in its immanent model of the firm. Changes in company law should therefore generally be referable to changes at the level of productive organisations or corporate governance.¹⁹ For example, as this thesis suggests, changes in the productive relationships which constitute the firm, such as the increasing importance of employees' firm-specific skills to the firm's competitive advantage, might be expected to lead to changes within the legal system, assuming, of course, that the legal system accepts both that its role is to encourage efficiency and the particular notion of efficiency at the heart of the productive coalition model.

¹⁶ Dore, R, *Stock Market Capitalism: Welfare Capitalism - Japan and Germany Versus the Anglo-Saxons* (2000) at 28

¹⁷ *ibid*

¹⁸ According to Weinrib, E, *The Idea of Private Law* (1995) at 6, the functionalist view insists that the "law provides only the authoritative form into which the conclusions of nonlegal thinking are translated."

¹⁹ See Teubner, G (1993) (*supra* note 14) at 125.

Systems theory is neither purely normative nor purely descriptive of the content of law: it simply describes a process according to which their common roots in society mean that aspects of economic or sociological thinking inevitably make their way indirectly into the law, and vice versa. This thesis takes three important theories of the company and considers which of them has been reconstructed within the legal system to provide the theoretical underpinnings for takeover regulation, and asks whether the other models would offer improvements if translated into law.²⁰

The changes at the level of theory discussed in chapter three pose serious difficulties for traditional legal methods, in particular mandatory regulation. A theory which insists on the differentiation of productive systems may, of course, be criticised for indeterminacy, for example, where it emphasises that the importance of firm-specific investments may differ radically from firm to firm, or even within firms over time. However, we might expect the law to respond to these developments at the level of theory by refining its methods and assigning an increasing role to reflexive (or self-) regulation, as it reconstructs in legal reality the increasing differentiation of productive relationships in the social sphere. To some extent this is a constitutive process as increasing reliance by the legal system on procedural regulation and default rules simultaneously reflects and enhances the ability of social actors to articulate their interests within differentiated processes for the governance of individual corporations.

The adoption of this systems theoretical methodology required the assumptions and goals of the law to be judged against the insights contained in the economic and political science literature. When specifically applied to the position of employees within takeover regulation, this required description and contextual analysis before the legal position could be measured against the theoretical part of the thesis and the law's immanent assumptions identified. The outcome of this analysis inevitably raised suggestions about

²⁰ As Teubner, G (1993) (*supra* note 14) says at 126, "The real business of theory is not to come up with specific proposals for regulation, but to construct legal reality in another way...to develop a new perspective on what constitutes a corporation... And if practice accepts what theory has to offer, then there

the ways in which legal regulation could become more responsive to the theoretical perspectives developed in part one, bearing in mind, of course, that this interdisciplinary translation must be done indirectly.

Inter-systemic conflicts

As systems theory predicts, inter-systemic conflicts come to the surface at various stages of the theoretical analysis in part one. A few examples will suffice at this stage; I will indicate others in the main body of the text.

i) Ontology

"Whether you take a doughnut hole as a blank space or as an entity unto itself is a purely metaphysical question and does not affect the taste of the doughnut one bit."²¹

First, and most perhaps most importantly as an introductory matter, I had to deal with the great ontological question: what is the nature of the company? Is it an entity, a moral person,²² which transcends the individuals who make it up, or no more than the sum of its parts? Unfortunately, but unsurprisingly, an answer to this question will not be found in this thesis. Indeed, it may be, as Hart suggests, that seeking to define what the "corporation" corresponds to in social reality is an erroneous enquiry. Rather the initial enquiry should place the corporation in a specific context.²³ Then, depending on that context, the corporation may be "simultaneously the creature of the state, a complex of contracts among the associated parties, and an institution with a real life of its own, distinct from its members."²⁴ Where we are analysing the rights and duties in law of the

is the possibility that these insights will lead to the development of a different and perhaps better law of corporate governance."

²¹ Murakami, H, *A Wild Sheep Chase* (London: Harvill: 1989) at 61

²² Note Ripert's discussion of the long-standing idea that "La personne morale est vivante et agissante. Elle est créée par les associés, mais la créature est plus forte que le créateur." (Ripert, G, *Aspects Juridiques Du Capitalisme Moderne* (1951)at 52)

²³ Hart, "Definition and Theory in Jurisprudence" in Hart, *HLA Essays in Jurisprudence and Philosophy* (1983), at 31; at 23 he notes that "words like 'corporation'...do not have the straightforward connection with counterparts in the world of fact which most ordinary words have and to which we appeal in our definition of ordinary words."

²⁴ Blumberg, P, "The Corporate Entity in an Era of Multinational Corporations" (1990) 15 *Del. J. Corp. L.* 283 at 373

legal person, there is no alternative to indulging in a spot of reification. While perplexing for non-lawyers, to do otherwise is nonsensical. When, however, we are looking at contractual arguments about the reasons for the allocation of decision-making power within the corporation (as even lawyers recognise that their "entity" must act through human agents), to assert simply that the corporation is a separate entity does not advance matters. This thesis considers the most important recent arguments about the rationale for the allocation of these decision-making rights.

Since ontology does not distinguish the models developed in the first part of this thesis, the much-debated ontological issue²⁵ can be set aside for the purposes of this thesis. The divide between the models considered here is not whether the corporation exists as a separate entity, but whether its internal arrangements should be considered in contractual or hierarchical terms. While it should be admitted at this early stage that this puzzle too may ultimately be incapable of a meta-solution which satisfies the demands of all disciplines,²⁶ it remains of fundamental importance because normative arguments about regulation turn on this characterisation.²⁷

ii) Terminology

Translating key concepts between economic and legal analysis is problematic. To what extent should the law's corporate actor be equated with the "firm" of economics? Does the meaning of "contract" differ between legal and economic writing? If we are to consider corporate constituencies as linked by "contracts", what is the precise scope and meaning of that phrase? Does it mean that a legal obligation has been assumed? Or does

²⁵ As Galbraith, JK, *The New Industrial State* (1972) says at 73: "Few subjects of solemn inquiry have been more unproductive than study of the modern large corporation. The reasons are clear. A vivid image of what *should* exist acts as a surrogate for reality. Pursuit of the image then prevents pursuit of the reality."

²⁶ Note the comment of Eisenberg, MA, "The Conception that the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm" (1999) 24 *Delaware Journal of Corporate Law* 819 at 820 that "the corporation has a dual nature: In one aspect, it consists of reciprocal arrangements; in another, it is a bureaucratic hierarchy."

²⁷ The argument between neoclassical contractarians and political stakeholders has superseded but largely retreads earlier ontological arguments between concession theorists, who considered the corporation as a creation of the state, and early contractarians, who considered it a purely private arrangement. The real concern of both debates is (and always was) less about answering a philosophical conundrum and more about grounding pro- or anti-regulatory arguments.

it simply indicate that an exchange has taken place? Similarly, if economists label one individual as the agent of another, what legal consequences does this have?

Of course, as with the ontological debate, clear answers to these questions do not exist. One may attempt to delineate the concepts within their respective subsystems - a difficult task for the lawyer faced with economic terminology and vice versa - and to suggest ways in which the various disciplines may attempt to take account of the insights provided by their differentiated rivals for the claim of most useful heuristic.

Another important point about terminology should be made here. While employees and shareholders appear fairly consistently across legal, economic and political analysis, the main corporate decision-makers tend to appear as "management" in the economic literature and as the board in legal literature.²⁸ Because of this, when I am discussing economic theories, I normally refer to those who take decisions about the running of the company as "management", understood in legal terms to include the board and those to whom the board has delegated authority. I assume (perhaps rather rashly given recent spectacular corporate governance failures such as Enron) that the board holds management to account in accordance with lines of command, and therefore that management and the board may be lumped together within the homogeneous "management" category. By contrast, when considering whether a theoretical argument from another discipline is descriptive of the legal position or normative, a more "legal" terminology is appropriate and the term "board" is used, because the law does not recognise an intermediate category between board and employee. It is in the board that legal responsibility arises. This issue is particularly salient when considering the duties imposed on the board in the event of a takeover. Finally, where the issue concerns the legal role of the board, I refer to it as such.²⁹

²⁸ And, of course, executive members of the board and their delegates will also be employees.

²⁹ It should also be noted that while an ever-growing number of "soft law" corporate governance codes make a functional distinction between executive directors, who are involved in management, and non-executive directors, who are not, the law does not reflect this distinction. In fact, English company law is increasingly insisting on objective minimum standards of care from all directors, regardless of whether they exercise any management function. While these minimum standards may be raised where individual directors in fact have a higher degree of experience or managerial responsibility (see *Re D'Jan of London Ltd* (1994) 1 BCLC 561), all directors are obliged to supervise the management of the company. As Lord

The reason for this conflict of terms in the literature is fairly clear. The law looks at corporate actors for the purpose of imposing fiduciary and common law duties, and so whether an actor is classified as a director or as a manager has important legal consequences for that individual. Economic analysis on the other hand is looking at the firm in terms of resource allocation (and occasionally production), and therefore does not need to draw a strict distinction between those who do and do not bear legal responsibility. Rather it draws a line between those who "manage" in the sense of allocating resources to uses and monitoring their performance, and those who "work" in the sense of performing the tasks allocated to them by contract or by command.

A Warning: The Limited Role of the Law in Corporate Governance

Systems theory counsels that law can only have a limited effect on the underlying social system,³⁰ and that its interventions may function as "irritants" to the social system and to various other sub-systems.³¹ However well-intentioned, piece-meal legal intervention is likely to have wider consequences than first anticipated. This insight is of particular salience as regards corporate governance systems, which are supposed to be sensitive to the needs of the underlying productive economy.³² They encompass not only law, but also economics, politics and social interactions, including, but not necessarily limited to, market contracting and management.

One's view of the role which the law should play in establishing the corporate governance framework cannot be separated from the way in which one defines corporate governance.³³ The scope and aims of any corporate governance system³⁴ will depend on

Woolf, MR, put it in *Re Westmid Packing Services Ltd* (1998) 2 BCLC 646 at 653, "[E]ach individual director owes duties to the company to inform himself about its affairs and to join with his co-directors in supervising and controlling them."

³⁰ Teubner, G (1993) (*supra* note 14) at 125 refers to its "modest role in the dynamics of the processes of evolution of industrial organisation".

³¹ Teubner, G, "Legal Irritants: How Unifying Law Ends up in New Divergences" in Hall, PA and Soskice, D (eds), *Varieties of Capitalism* (2001), 417

³² This is discussed at the end of chapter 6.

³³ As Romano, R, "Corporate Law and Corporate Governance" (1996) 5 *Industrial and Corporate Change* 277 says, "Corporate law and corporate governance are flip sides of the same coin."

the model of the company which underlies it. The contours of various definitions of corporate governance may be mapped closely against the models of the firm developed in the first part of this thesis. For example, Shleifer and Vishny set out a definition of corporate governance within the neoclassical perspective:

"Corporate governance deals with the way in which suppliers of finance to corporations assure themselves of getting a return on their investment...Our perspective on corporate governance is a straightforward agency perspective, sometimes referred to as separation of ownership and control. We want to know how investors get the managers to give them back their money."³⁵

This "agency" definition of corporate governance has come to dominate the financial economics literature. In contrast to this, Lipton and Rosenblum argue that

"the ultimate goal of corporate governance is the creation of a healthy economy through the development of business operations that operate for the long term and compete successfully in the world economy. Corporate governance is a means of ordering the relationships and interests of the corporation's constituents: stockholders, management, employees, customers, suppliers, other stakeholders and the public. The legal rules that constitute a corporate governance system provide the framework for this ordering."³⁶

Building on this broader definition, Margaret Blair seeks to develop a fuller notion of corporate governance, "one that refers to the whole set of legal, cultural, and institutional

³⁴ As Lipton, M and Rosenblum, SA, "A New System of Corporate Governance: The Quinquennial Election of Directors" (1991) 58 *University of Chicago Law Review* 187 point out at 187, "Corporate governance is a means, not an end. Before we can speak intelligently about corporate governance, we must define its goals. In much of the recent academic literature on corporate governance, however, the goals are either ill-defined or assumed without examination." This explains the lengthy treatment of models of the company in the first part of the thesis.

³⁵ Shleifer, A and Vishny, RW, "A Survey of Corporate Governance" (1997) 52 *Journal of Finance* 737 at 737-8

³⁶ Lipton, M and Rosenblum, SA (1991) (*supra* note 28) at 189; in broader terms, Teubner, "Corporate Fiduciary Duties and their Beneficiaries: A Functional Approach to the Legal Institutionalization of Corporate Responsibility" in Hopt, KJ and Teubner, G (eds), *Corporate Governance and Directors' Liabilities* (1985), 149 suggests at 162 that "the social function of the economy", of which companies form an important part, should be defined in terms of "ensuring the satisfaction of future social needs".

arrangements that determine what publicly traded corporations can do, who controls them, how that control is exercised, and how the risks and returns from the activities they undertake are allocated."³⁷ Within non-agency economic analyses of the firm, Zingales' famous definition approaches corporate governance in terms of "the complex set of constraints that shape the ex post bargaining over the quasi-rents generated by the firm."³⁸ Similarly, Deakin and Hughes have argued that a "broader conception of stakeholder relationships addresses the economic effectiveness of the relationship between stakeholders and directors."³⁹

Moving on to consider political stakeholding approaches to corporate governance, it might be suggested that, broadly speaking, it encompasses "the rules under which managers run the company and are held accountable for their stewardship."⁴⁰ Streeck elaborates that "Good corporate governance in the Continental-European sense is one that ensures an equitable and socially beneficial balance between the interests of the various stakeholders in the corporation, protecting social peace and enabling the firm to function in harmony with its social environment."⁴¹ Similarly, Robert Dahl has argued that the "large corporation should be thought of as a *political system*, as an entity whose leaders exercise great power, influence and control over other human beings...If, however, the large corporation is a social enterprise and a public political system, the government of the corporation should be very much a public matter."⁴²

³⁷ Blair, MM, *Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century* (1995) at 3

³⁸ Zingales, "Corporate Governance" in Newman, P (ed), *The New Palgrave Dictionary of Economics and the Law* (1998), 495

³⁹ Deakin, S and Hughes, A (1997) (*supra* note 1) at 5

⁴⁰ Plender, J, *A Stake in the Future: The Stakeholding Solution* (1997) at 18

⁴¹ Streeck, W, "The Transformation of Corporate Organization in Europe: An Overview" (2001) *MPIfG Working Paper 01/8, December 2001*

⁴² Dahl, RA, "A Prelude to Corporate Reform" (1972) *Business and Society Review* 17 at 18; at 19-20 he refers to the "usually unexamined assumption that investors, whether individuals or firms, have some special right to govern the firms in which they invest. I can discover absolutely no moral or philosophical basis for such a right. Why investors and not consumers, workers, or, for that matter, the general public?" Of course, as Chapter 1 shows, the assumption of investor control has been rationalised on an economic basis. Chapters 2 and 3 set out political and economic challenges to that rationalisation.

An appreciation that company law is only one among many influences⁴³ on corporate governance means that legal prescriptions should be made with some care. With this limitation in mind, any discussion of the way in which company law allocates rights to the various corporate constituencies must begin with the various models of the company which provide rationales for the default terms provided by the law. Company law simply "serves both to facilitate and to regulate the conduct of the corporate enterprise."⁴⁴ According to the contractual approach, company law is nothing more than a standardised (and enabling⁴⁵) framework produced as a public good with the aim of reducing transaction costs, and within which decisions about the allocation of corporate resources may be made. By facilitating contracting in this way, it arguably contributes to its regulatory goal of efficiency. Models which look beyond conventional preoccupation with the agency relationship between management and shareholders advocate, *inter alia*, reforms of company law, since this is one of sources of norms controlling corporate decision-making and so has a role to play in ensuring better governance. Advocates of the agency perspective treat the board of directors as a special-purpose governance mechanism for the exclusive benefit of shareholders. They argue that the law should reflect this evolution and "the background term should be the one that is either picked by contract expressly or is the operational assumption of successful firms."⁴⁶

By contrast to the limited role which the law plays in corporate governance systems, the models of the company do exercise a strong pull on doctrinal understanding of law. While the neoclassical model of the company may not be as pre-eminent in the UK as it is in the US, its "legacy can be seen in the preoccupation of many UK scholars with internal governance and accountability issues within the corporation to the detriment of a

⁴³ Blair, MM (1995) (*supra* note 31) at 3 lists some of the other influences: "aspects of corporate finance, securities and bankruptcy law, laws governing the behavior of financial institutions, labor relations practices, contract law and theory, property rights, compensation systems, internal information and control systems."

⁴⁴ Eisenberg, MA, "Corporate Law and Social Norms" (1999) 99 *Columbia Law Journal* 1253 at 1253

⁴⁵ Meaning that it can be adapted to fit the needs of a given corporation: see the discussion of Easterbrook, F and Fischel, D, *The Economic Structure of Company Law* (1991) in chapter 4.

⁴⁶ Easterbrook, F and Fischel, D (1991) (*supra* note xx) at 36

wider view of the corporate role in society."⁴⁷ By contrast, countries such as Germany which have a less contractualist, more stakeholder-orientated corporate theory have a more fluid division and interaction between company and labour law.

The challenge for lawyers who advocate legal reform on the basis of the second and third models of the company is to find reasons why company law is both an appropriate and necessary tool to implement and support their model. This thesis is a small step along that difficult journey.

⁴⁷ Wheeler, S, *Corporations and the Third Way* (2002) at 5. Its influence may also be seen in the normal understanding that "the interests of the company" should be equated with the interests of the shareholders, the interests of employees being instrumentalised to that end.

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Part One:
The Three Models
of the Company

Chapter One: The Neoclassical or Agency Model

Introduction

In this thesis, I refer to the dominant paradigm of the firm within the economic literature as the "neoclassical"¹ or "agency" model.² It is of great academic and practical interest as it forms the basis of much economic analysis of company law and corporate governance. It deconstructs the corporate entity to reveal a collection of interdependent contracts, a considerable departure from orthodox economic analysis, according to which the firm embodied a fixed production function overseen by a manager.³ The "neoclassical" label refers to the particular conception of contract at the heart of this model. With the exception of the contract between shareholders and management, the corporation's constituent contracts are assumed to make detailed provision for all future contingencies, or to be fully "presentiated"⁴ and enforceable. The "agency" label refers to the normative conclusions drawn by advocates of this model: the law should take steps to reduce or minimise the "agency costs" which arise when the entrepreneurial function (consisting of risk-taking and decision-making) is divided between management and shareholders of the company.

This chapter looks at the development of the agency model, considers its normative implications, and critiques it from the perspective of hierarchy. In line with the focus of this thesis, particular attention is focused on the model's treatment of employees. However, since its central concern is with the relationship between shareholders and management, much of the theoretical literature advancing this perspective does not deal

¹ This is Bratton's terminology: see Bratton, WW, "The New Economic Theory of the Firm: Critical Perspectives from History" (1989) 41 *Stanford Law Review* 1471 at 1478-80

² The reason for describing it in this way rather than using the more common "nexus of contracts" is because the "productive coalition" model developed in Chapter 3 also deconstructs the corporate entity and analyses the relationships and allocation of rights within corporations in contractual terms. Thus both models may be subsumed within the umbrella term "nexus of contracts".

³ Chandler, AD, "Organizational Capabilities and the Economic History of the Industrial Enterprise" (1992) 6 *Journal of Economic Perspectives* 79-100 at 85; also Hart, O, "An Economist's Perspective on the Theory of the Firm" (1989) 89 *Columbia Law Review* 1757. Of course, this orthodox economic view largely coincides with the legal "entity" view of the corporation.

⁴ See Macneil, IR, "Economic Analysis of Contractual Relations: Its Shortfalls and the Need for a "Rich Classificatory Apparatus"" (1980) 75 *Northwestern University Law Review* 1018

directly with the position of employees. Accordingly, the analysis is carried out indirectly by identifying the model's underlying assumptions.

The Contractual Analysis of Corporations

The firm is often described as a "nexus of contracts".⁵ This modern economic ontology of the firm has certain analytical advantages when compared with the law's traditional "entity" approach to the company. One advantage is that it avoids the mystification (to non-lawyers) of granting separate personality to a company. The starting point for contractual analysis is that the "'personhood' of a corporation is a matter of convenience rather than reality."⁶ While the "entity" ontology continues to be useful in considering the corporation's external relations, e.g., with suppliers of goods, deconstruction of the corporation into its constituent contracts offers analytical advantages as regards internal relationships. It focuses on the agreed terms of participation of each group, and the protection they receive from the law. This approach is very influential both in economics, which has come to recognise that internal relationships have a strong bearing on the efficiency with which the production function is carried out, and in law, which focuses on the rights and obligations of corporate participants.

Whether company law should treat employees like any other "outsider" contractor, on the basis that they have an external, market-governed relationship with the corporate entity, or as affected by and forming an integral part of the corporation's internal governance structure is a central question for this thesis.⁷ The contractual approach to the firm has much to add to this debate. In its agency incarnation, it firmly suggests that employees should be located outside, while the model discussed in chapter three suggests that, in many cases at least, employees should be brought inside. It refuses to treat the law's distribution of control rights as given or written in stone. Instead it insists that "ownership

⁵ Originating with Jensen, MC and Meckling, WH, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3 *Journal of Financial Economics* 305.

⁶ Easterbrook, F and Fischel, D, *The Economic Structure of Company Law* (1991) at 12

⁷ On this question generally, see Wedderburn, Lord, "Employees, Partnership and Company Law" (2002) 31 *Industrial Law Journal* 99-111.

of the firm is an irrelevant concept"⁸ and seeks contractual explanations for the allocation of control or "management rights", including "the right to make decisions not contractually predetermined."⁹

In contrast to the model developed in Chapter Two, which looks at companies and company law in terms of democracy and social citizenship, contractual analysis sets itself the task of providing guidance to company law about how its provisions might support economic efficiency. Neoclassical contractualists argue that economic efficiency requires that rights in corporate governance should only be granted to management and shareholders: this chapter traces the rationale for that proposal.¹⁰

The Meaning of "Contract"

Here we find our first inter-systemic conflict. "Contract" is a descriptive term used in both legal and economic subsystems. Economists, who lead the field in advancing the "nexus" perspective, and lawyers use the term very differently. Descriptively, lawyers employ the term contract to label a situation in which there has been an exchange of (at least two) promises, or a "present communication of a commitment to engage in a reciprocal measured exchange."¹¹ By contrast, economists use the term in a looser sense than lawyers, referring to "relationships characterized by reciprocal expectations and

⁸ Fama, EF, "Agency Problems and the Theory of the Firm" (1980) 88 *J Pol Econ* 288-306 at 290. He adds that "Each factor in a firm is owned by somebody. The firm is just the set of contracts covering the way inputs are joined to create outputs and the way receipts from outputs are shared among inputs." Similarly, Alchian, AA and Demsetz, H, "Production, Information Costs, and Economic Organization" (1972) 62 *American Economic Review* 777 at 784 and 787 that shareholders should not be thought of as owners, but as optimistic investors who contract for the residual. All contractors choose the form of their return in accordance with their view of the prospects of the venture. Employees and bondholders, who contract for a fixed return, should be considered pessimistic or risk-averse investors.

⁹ Dow and Putterman, "Why Capital (Usually) Hires Labor: An Assessment of Proposed Explanations" in Blair, MM and Roe, MJ (eds), *Employees & Corporate Governance* (1999), at 19

¹⁰ A detailed critique of the reasoning and conclusions reached by this model is offered by Chapter 3 which also uses contractual methodology but reaches rather different conclusions about the position of employees. By contrast, Chapter Two discusses the extent to which concerns other than economic efficiency might give rise to normative arguments that company law should look after the interests of employees as well as shareholders and other investors in companies.

¹¹ Macneil, I, *The Relational Theory of Contract: Selected Works of Ian Macneil* (2001) at 131, extracted from *The New Social Contract* (1980)

behavior."¹² Faced with this conflict of description, Eisenberg suggests that we should understand the term "nexus of contracts" in the economic literature as referring to the wider concept of a "nexus of reciprocal arrangements" which are not necessarily legally enforceable.¹³ This differentiation of such a central term greatly hinders discourse between law and economics, and of course, causes problems where one of the parties seeks to rely on their legal rights under the "contract".

The normative implications of the term also differ. The economist's "contract" is a "reciprocal arrangement" for exchange arranged on the market, and so is accompanied by a normative argument that it should not be interfered with, on the basis that it is presumptively *pareto* efficient (in the absence of some evidence of market failure). Since both parties have voluntarily chosen to enter into the arrangement in question, they must be made better off by the exchange, in the sense that they value what they receive more highly than what they trade. Repeated exchanges lead to the progressive allocation of society's resources to their most highly valued uses.¹⁴ Where the "contract" is complex and its continuation is projected into the future, one or both of the parties may be granted considerable discretion in order to deal with change.¹⁵

By contrast, in a lawyer's mind, the term "contract" carries implies that the promises in question are legally binding by reference to certain tests of recognition (including that all terms have been settled in advance), and capable of enforcement from the moment the

¹² Hart, O (1989) (*supra* note 3) at 1764 fn 30; also Eisenberg, MA, "The Conception that the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm" (1999) 24 *Delaware Journal of Corporate Law* 819 at 822-3

¹³ Eisenberg, MA (1999) (*supra*) ; the economist's broader notion of contract incorporates implicit contracts and social norms, discussed further in Chapter 3. Rock, EB and Wachter, ML, "Symposium on Norms and Corporate Law: Introduction" (2001) 149 *University of Pennsylvania Law Review* 1607 at 7 argue that the economist's assumption that many corporate contracts would be "self-enforcing" or "self-governing" through the actions of the parties themselves (for example, through reputation), meant that "the economics literature did not need to differentiate between privately and judicially enforced agreements...a legal system is simply not included in the model."

¹⁴ See for example, Epstein, R, "In Defense of the Contract at Will" (1984) 51 *University of Chicago Law Review* 947 at 956-7

¹⁵ In the context of a socio-legal analysis of contract's "planning and co-ordinating role", Vincent-Jones, P, "Contractual Governance: Institutional and Organizational Analysis" (2000) 20 *OJLS* 317 points out at 326 that "hierarchical elements built into complex contracts overcome problems associated with difficulties of specification, high uncertainty, and asset specificity." However, he emphasises that the "hierarchical dimensions of contract should not be identified or confused with legal obligations and sanctions."

contract is concluded;¹⁶ if it arises at all, the question of whether the arrangement is efficient is a secondary one. The lawyer's enforceable contract is far narrower than the economist's efficient contract.

Opening up the Corporate Entity: Ronald Coase and the Theory of the Firm

All contractual analysis of company law draws to some extent on Coase's seminal 1937 article, "The Nature of the Firm".¹⁷ Coase contradicted the conventional zero transaction cost approach, insisting that in some cases efficient market allocations would be precluded by the "cost of using the price mechanism."¹⁸ Firms are a voluntary response of rational actors to the existence of transaction costs and "represent a more efficient method of organizing production"¹⁹

Before Coase, orthodox economic theory closely resembled the legal "entity" approach, treating the firm as a "black box" or a "monad".²⁰ In both law and economics, the "firm" was a metaphysical market actor, which simply responded to market signals, and was assumed to have a fixed production function. The manager's role was to choose the most appropriate option from a fixed set of feasible production plans, and then buy and sell inputs and outputs on competitive markets in accordance with that plan.²¹ No cognitive or other limitations on the part of the manager were taken into account, so the success or failure of the firm depended upon its response to its market environment rather than its internal organisation.

¹⁶ Ripert, G, *Aspects Juridiques Du Capitalisme Moderne* (1951) at 95 discusses the logical and legal difficulties which arise if one attempts to view the corporation as a "contract" in the narrow legal sense: under corporate law, even the most fundamental parts of the contract may be rewritten without the consent of all.

¹⁷ (1937) ns 4 *Economica* 386; reprinted in Coase, "The Nature of the Firm" in Coase, Ronald H *The Firm, the Market, and the Law* (1988), 33. Generally in this thesis, the corporation is treated as one example of a firm, albeit by far the most prevalent in modern economic organisation.

¹⁸ *ibid* at 38

¹⁹ *ibid* at 37, fn 14. Coase claims at 14 that "in the absence of transaction costs, there is no economic basis for the existence of the firm." He rules out division of labour, risk and co-ordination of production as rationales for the firm.

²⁰ Williamson, "The Firm as a Nexus of Treaties: An Introduction" in Aoki, M, Gustafsson, B, and Williamson, OE (eds), *The Firm As a Nexus of Treaties* (1990), at 8

²¹ See Hart, O (1989) (*supra* note 3)

Coase broke new ground by arguing that the firm has a variable production function which "depends on the contracting and property-rights system within which the firm operates."²² The "visible hand"²³ of the entrepreneur supersedes the price mechanism of the market as co-ordinating mechanism for the productive activity in question wherever internal organisation is more cost-effective than decentralised market contracting.²⁴ Since both methods involve transaction costs, the choice is made on a comparative transaction cost basis. The entrepreneur makes decisions to allocate resources to what he considers their most appropriate use.²⁵ Co-ordination through an entrepreneur replaces a series of explicit contracts setting out the rights and obligations of the parties at great length. Under this single "contract", the owner of the input grants the entrepreneur²⁶ a limited power of direction in exchange for a fixed or floating remuneration.²⁷ This simplification allows the same productive result to be achieved while economising on the costs of specifying each contract in detail. It is the entrepreneur's power of direction which marks the firm off from the market:

²² Jensen, M and Meckling WH, "Rights and Production Functions: An Application to Labor-Managed Firms and Codetermination" (1979) 52 *Journal of Business* 469

²³ Chandler, AD, *The Visible Hand: The Managerial Revolution in American Business* (1977)

²⁴ Coase, (1988) (*supra* note 17) at 7. The development of the theory of transaction costs may even be traced back to Kaldor, N, "The Equilibrium of the Firm" (1934) 44 *Economic Journal* 60-76, who noted in Part VI that "...the existing organization of the economic system, the division of the productive organization into a great number of independent units under a single control, is essentially one adapted to the existence of dynamic change and imperfect foresight...."

²⁵ Coase, (1988) (*supra* note 7) at 35 contrasts the operation of the price mechanism with the entrepreneur's power of direction: "The price of factor A becomes higher in X than in Y. As a result, A moves from Y to X until the difference between the prices in X and Y, except in so far as it compensates for other differential advantages, disappears. Yet in the real world we find that there are many areas where this does not apply. If a workman moves from department Y to department X, he does not go because of a change in relative prices, but because he is ordered to do so." Of course, as Coase recognises, the cognitive limitations of the entrepreneur will be one of the costs which fixes limits on the firm's size.

²⁶ Or, in the case of a company, the management: see the discussion of Berle and Means below.

²⁷ While traditionally the labour input was provided for a fixed return, the providers of share capital are considered to contract for a floating or "residual" return. In both cases, management can, within certain bounds, determine the use which will be made of the input. Fama, EG and Jensen, MC, suggest in "Separation of Ownership and Control" (1983) 26 *Journal of Law and Economics* 301 at 303 that "the contracts of most agents contain the implicit or explicit provision that, in exchange for the specified payoff, the agent agrees that the resources he provides can be used to satisfy the interests of residual claimants." The fixed remuneration employment contract also contributes to efficiency by eliminating future disputes about the price and the distribution of the "co-operative surplus". See for example, Cheffins, BR, *Company Law: Theory, Structure, Operation* (1997) at 33.

"When the direction of resources (within the limits of the contract) becomes dependent on the buyer in this way, that relationship which I term a "firm" may be obtained."²⁸

The economic concept of the power of direction is translated into law in the form of managerial prerogative and is one of the key tests for the identification of an employment relationship.²⁹ For Coase, the employment relationship was the archetypal relationship for which the firm was particularly likely to emerge, precisely because a "very short term contract would be unsatisfactory."³⁰

Splitting the Atom of Entrepreneurship: Berle and Means' *The Modern Corporation and Private Property*

The application of Coase's theory of the firm to the large public corporation requires the identification of the functional equivalent of the entrepreneur. In their seminal analysis of the modern corporation, *The Modern Corporation and Private Property*³¹ (which preceded Coase's theory of the firm by five years), Berle and Means argued that the risk-bearing and managerial (or decision-making) functions, which had previously been united in the person of the entrepreneur, had, during the evolution of the modern corporate form, been split between shareholders and management respectively. They referred to this as the "separation of ownership and control" or "managerialism".

Berle and Means' analysis of the corporation forms the blueprint for the agency model, leading its advocates to argue that systems of corporate governance, including company

²⁸ Coase (1988) (*supra* note 17) at 40, although he notes that the extent to which direction is permitted by the contract may vary, which suggests a continuum between market and "firm" relationships rather than a straight dichotomy.

²⁹ In fact, Coase tested his model against the "real world" in the form of the employment relationship, noting that "The legal concept of 'employer and employee' and the economic concept of the firm are not identical, in that the firm may imply control over another person's property as well as over their labour. But the identities of these two concepts are sufficiently close for an examination of the legal concept to be of value in appraising the worth of the economic concept." Coase (1988) (*supra* note 17) at 53-4 fn 48

³⁰ Coase (1988) (*supra* note 17) at 40. This may be contrasted with a commodity contract where "the main items can be stated in advance and the details which will be decided later will be of minor significance" (*ibid*). Coase does not elaborate on why short term contracts are unsatisfactory for labour supply. In Chapter 3 it will be suggested that longer term arrangements are necessary for key factors of production in order to provide both flexibility and continuity of input. While Coase concentrates on flexibility to respond to the environment, assured continuity is also essential where labour evolves with the firm and is not readily substitutable with alternatives available on the market.

law, should focus on resolving the conflicts between management and shareholders to which this division of labour gives rise. Managerialism seriously weakened shareholders' capacity to exercise control over management, because increasing geographical dispersal³² and diversification of their shareholdings led to shareholders becoming "rationally apathetic" about monitoring management,³³ which by default increased the degree of latitude available to management.

Berle and Means drew a parallel between the factory labourer after the industrial revolution and the shareholder in this type of corporation. Just as the labourer had surrendered his right to control over his labour to his master in return for wages, so the shareholder in the large corporation had ceased to be a "quasi-partner, manager and entrepreneur",³⁴ becoming instead a "passive property owner".³⁵ This "equally revolutionary" change in the nature of the corporation "placed the wealth of innumerable individuals under the same central control...The property owner who invests in a modern corporation so far surrenders his wealth to those in control of the corporation that he has exchanged the position of independent owner for one in which he may become merely recipient of the wages of capital."³⁶ This had "destroyed the unity that we commonly call property...and divided ownership into nominal ownership and the power formerly joined to it."³⁷ Shareholders who had "exchanged control for liquidity"³⁸ now looked to the market in order to realise their expectations.³⁹ Although "the law still maintains the

³¹ Berle, AA and Means, G, *The Modern Corporation and Private Property* (1932)

³² This dispersal became international with the huge demands for capital made by railway construction: see Chandler, AD (1977) (*supra* note 23) at 90-2

³³ This is the famous "collective action problem" which permeates inter-shareholder relations. Where a shareholder incurs costs monitoring management, he will not receive commensurate private benefit, as less diligent shareholders "free ride" on his efforts wherever there is an improvement in the standard of management of the company: see further, for example, Parkinson, J, *Corporate Power and Responsibility: Issues in the Theory of Company Law* (1993) at 54-6; Easterbrook, F and Fischel, D (1991) (*supra* note 6) at 66-7; Cheffins, BR (1997) (*supra* note 27) at 62-4.

³⁴ Berle, AA and Means, G (1932) (*supra* note 31) at 245

³⁵ *ibid* at 311, emphasis in original

³⁶ *ibid* at 5; this development is also described by Kennedy, AA, *The End of Shareholder Value: The Real Effects of the Shareholder Value Phenomenon and the Crisis It Is Bringing to Business* (2000), who draws a distinction between "investors who had established companies to commercialize a promising technology... [and those] in the business to make a buck by delivering value to their customers" (29) and finally those who aimed to "make as much money as fast as possible" (38)

³⁷ *ibid* at 7

³⁸ *ibid* at 250

³⁹ *ibid* at 247-250

conception of a sharp dividing line recognizing the bondholder as a lender of capital and the stockholder as a quasi-partner in the enterprise", in reality the shareholder had become "simply a supplier of capital on terms less definite than those customarily given or demanded by bondholders."⁴⁰ However, the law did not reflect this change and continued to insist on insider status for shareholders.

With the passing of the power of direction to the group Berle and Means described as "control", fundamental questions arose about the role of management under the new paradigm. Berle and Means argued that the formerly private corporation had become "quasi-public",⁴¹ and that "Neither the claims of ownership nor those of control can stand against the paramount interests of the community."⁴² Accordingly, it was "conceivable - indeed it seems almost essential if the corporate system is to survive - that the 'control' of the great corporations should develop into a purely neutral technocracy, balancing a great variety of claims by various groups in the community and assigning to each a portion of the income stream on the basis of public policy rather than private cupidity."⁴³

While agency theorists share Berle and Means' fear of an unconstrained "control" group constituting a "corporate oligarchy coupled with the probability of an era of corporate plundering",⁴⁴ the technocratic solution favoured by Berle and Means is anathema to them. Agency theorists argue that "ownership" and "control" should be reunited, or at least have their divergent interests aligned, on the grounds that the corporation must be run in *someone's* interests. Failing this, management will be rendered unaccountable and free to pursue their own self interest. Accordingly, agency theory favours Berle and Means "possible" solution, whereby "the group in control of a corporation would be placed in a position of trusteeship in which it would be called on to operate or arrange for

⁴⁰ *ibid* at 245

⁴¹ *ibid* at 5, defining it as "a corporation in which a large measure of separation of ownership and control has taken place through the multiplication of owners"

⁴² *ibid* at 312

⁴³ *ibid* at 312-3. Berle's agency theory-tinged arguments in favour of managerial accountability to shareholders in his 1932 debate with Dodd (discussed in Chapter 2) suggest that he did not consider this outcome very likely.

⁴⁴ *ibid* at 311; they considered this different from the "quasi-public" option discussed above, according to which the corporation would be run according to some (unspecified) notion of public policy.

the operation of the corporation for the sole benefit of the security owners despite the fact that the latter have ceased to have power over or to accept responsibility for the *active* property in which they have an interest."⁴⁵

By arguing that the law should treat the directors as fiduciaries for the shareholders specifically, rather than the company as a whole, the agency model seeks to implement the economic concept of an "agent" into the legal system, thereby turning back the clock to an era when shareholder partners occupied centre stage in company law.⁴⁶ The widely-perceived failings of the conglomerate era⁴⁷ transformed the economic view of managerialism from a (r)evolution in business form into a problem of management accountability. While Berle and Means considered the consequences of splitting the atom of property, agency theorists consider that some semblance of accountability can only be achieved by putting it back together again.

The Meaning of "Agency"

This division of entrepreneurial labour between shareholders and management lies at the heart of the "agency" model, which treats management as the "agents" (or "employees") of the shareholders. While the dangers of managerial unaccountability are very widely discussed, the agency relationship between management and shareholders is also praised for giving rise to greater efficiency, in particular by allowing a division of labour and specialisation of the two groups, with one bearing risk and the other skilled in decision-

⁴⁵ *ibid* at 311. It is notable that Berle and Means did not favour this possibility, commenting that "Were this course followed, the bulk of American industry might soon be operated by trustees for the sole benefit of inactive and irresponsible security owners."

⁴⁶ While this might not make sense from a historical perspective (see for example, Ireland, P, "Company Law and the Myth of Shareholder Ownership" (1999) 62 *Modern Law Review* 32), these normative arguments from economic theory are having an increasing influence over conceptions of the scope and function of company law: the outcome of the Company Law Review in England and Wales (see the Government White Paper on *Modernising Company Law*), and in particular the reformulation of directors' duties, appears far closer to an agency conception of the corporation than to managerialism or any of the forms of stakeholding discussed in this thesis. Schedule 2 states that the directors should only take into account "the company's need to foster its business relationships, including those with its employees and suppliers and the customers for its products or services" as a means to promoting "the success of the company for the benefit of its members as a whole." For criticism of this, see Wedderburn (2002) (*supra* note 7).

⁴⁷ See further Chapter 4.

making.⁴⁸ Since the shareholders cannot specify in detail *ex ante* the precise way in which management will advance their interests, management must be given sufficient discretion to enable them to respond to changes in the firm's environment. While discretion allows management to make best use of their skills, it also rules out the most usual means of control, namely express contract (in the legal sense), leading agency theorists to seek other methods for ensuring management serves the interests of shareholders. Accordingly, within the neoclassical perspective, this incomplete contract is simultaneously the defining efficiency-enhancing characteristic of the modern corporation and the key problem with which corporate governance and the law must deal.

The use of the term "agency" here gives rise to another systemic conflict as it has different meanings in law and economics. Cheffins describes the economic relationship of agency in terms of factual dependency.⁴⁹ Jensen and Meckling define "an agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent."⁵⁰ The economic notion of agency focuses on the problem of vulnerability to opportunism which arises where one economic actor is dependent on another. Like all economic actors, agents tend to put their own interests first, giving rise to "agency costs", which are "composed of the value of the output lost from the agent's self-serving conduct together with the costs the principal incurs in attempting to regulate such behaviour."⁵¹ The precise cause of these costs may be incompetence, opportunism or "empire-building" (enlarging the business for motives of prestige rather than for the benefit of the shareholders) on the part of the agent. The agency model's prime concern is the identification and implementation of methods which may be used to minimise - it is recognised that they will never be eradicated completely -

⁴⁸ See, e.g., Fama, EF (1980) (*supra* note 8) at 291 who argues that "The major loss in retaining the concept of the entrepreneur is that one is prevented from developing a perspective on management and risk bearing as separate factors of production, each faced with a market for its services that provides alternative opportunities, and, in the case of management, motivation towards performance."

⁴⁹ Cheffins, BR (1997) (*supra* note 27) at 45

⁵⁰ Jensen, MC and Meckling, WH (1976) (*supra* note 5) at 308

⁵¹ Cheffins, BR (1997) (*supra* note 27) at 45; Cheung, SNS, "The Contractual Nature of the Firm" (1983) 26 *Journal of Law and Economics* 1 at 10 argues that agency costs should be considered as transaction costs. In this sense, the agency model follows in the Coasean tradition, albeit that transaction costs arise beyond this central relationship (particularly as developed by Williamson, see Chapter 3).

these costs, such as improved incentives to the agent to serve the principal's interests, or the design of (more) effective market-based monitoring mechanisms.⁵² Such measures will be put in place where they have the effect of conferring a net benefit on the principal, i.e., the costs of operating the mechanism are lower than the amount which is saved in agency costs. Gilson describes the much sought after solution to the agency problem as the "organizational Holy Grail"⁵³ which has occupied American corporate governance theory since Berle and Means.

In comparison, the legal notion of agency is much narrower, describing a "relationship...where the agent has authority to alter the principal's legal position."⁵⁴ The law imposes obligations on those actors who are caught within a formal category. Not all economic agents will be categorised by the law as agents, although many will. Thus, when economic literature refers to management as agents of the shareholders, it does not purport to be descriptive of the legal position, in the sense that they are legally bound to serve the interests of the shareholders as such. Instead, it argues that this is what the law, along with the other mechanisms of corporate governance, should aim for in order to enhance the wealth of society.

Davies confirms that in the pre-managerialist company of the nineteenth century, the law in fact treated management as the agents of the shareholders, but notes the "more modern view of the directors as the agents of the company but receiving their powers by virtue of the company's constitution, which is controlled by the shareholders."⁵⁵ If one mistakenly interprets the term "agency" in its technical legal sense, the model appears to be an attempt to return to the situation before the emergence of the Berle and Means

⁵² The market for corporate control and other adaptive mechanisms are discussed in part two, in particular in Chapter 4.

⁵³ Gilson, RJ, "Corporate Governance and Economic Efficiency: When do Institutions Matter?" (1996) 74 *Wash. U. L. Q.* 327 at 331

⁵⁴ Davies, P, *Introduction to Company Law* (2002) at 118; the narrower concept may be explained on the basis that the law's task is to decide when to impose liability on the agent and/or the principal.

⁵⁵ *ibid*; see also Ireland, P (1999) (*supra* note 46) who traces the evolution of the corporation from its roots in partnership, via a partnership with separate legal personality, to (at 42) its eventual reification and depersonification leading to the "radical economic separation" of companies and their shareholders. Ireland notes the strong pull those partnership roots have on company law, and in particular in maintaining shareholders at the centre of the model.

corporation and separate legal personality. By contrast, the economic concept embodies the irreconcilable conflict between the two groups, and the argument about whether management should be made more accountable to shareholders, as the agency model suggests, or be allowed more autonomy to balance the needs of various constituencies, as the productive coalition model suggests.

The Agency Model and Complete Contracts

While it insists that the contract between shareholders and management is incomplete, the agency model assumes that the other productive inputs are provided pursuant to complete contracts, which are discrete and fully presentiated. Therefore, contracts of employment are dealt with entirely adequately by the rules of classical contract law and of no concern to the agency model. Employees are in no sense dependent on management (that is, they are not in an "economic" agency relationship with them).⁵⁶

The application of the agency model to employees received its classic exposition from Alchian and Demsetz in 1972.⁵⁷ They wrote that

"[i]t is common to see the firm characterized by the power to settle issues by fiat, by authority, or by disciplinary action superior to that available in the conventional market. This is delusion. The firm does not own all its inputs. It has no power of fiat, no authority, no disciplinary action any different in the slightest degree from ordinary market contracting between any two people...To speak of managing, directing, or assigning workers to various tasks is a deceptive way of noting that the employer is involved in renegotiation of contracts on terms that must be acceptable to both parties...Long-term contracts between employer and employee are not the essence of the organization we call a firm."⁵⁸

⁵⁶ This point is important because the model developed in Chapter 3 revolves around the idea that employees may be dependent on management because of the same kind of contracting problems which beset the management-shareholder relationship.

⁵⁷ Alchian, AA and Demsetz, H, "Production, Information Costs, and Economic Organization" (1972) 62 *American Economic Review* 777

⁵⁸ *ibid*; Williamson, OE, *The Economic Institutions of Capitalism* (1985) notes at 53 fn 11 that Alchian has since rejected this position. Bearing in mind the difficulties of applying economic theory directly to the law, arguments could nevertheless arise as to whether or not Alchian and Demsetz's model of the

Although it might be argued that Alchian and Demsetz are using the term "contract" in its economic sense, this statement does appear to contradict Coase's notion of the firm to the extent that he saw the entrepreneur's power of direction as its defining feature, and employment as the paradigmatic case where a short-term contract would be unsatisfactory.⁵⁹ Their analysis excludes both transaction costs and guaranteeing continuity of factor supply as explanations for the firm.⁶⁰ Contracts are assumed to be renegotiable wherever necessary at negligible cost and replacement productive inputs to be freely available on the market, allowing the firm to expand and contract costlessly in response to changes in its environment as it pursues the shareholders' interests. There is no clear distinction between allocations by the firm and allocations by the market.⁶¹ Alchian and Demsetz even argue that no distinction should be drawn between the grocer-customer relationship and the grocer-employee relationship on the basis that both customer and employee are free to leave the grocer ("exit") and contract elsewhere

employment relationship is descriptive of the way in which the law deals with it. It might be argued that US law, with its doctrinal assumption of employment at will, which construes the employment contract as a series of contracts lasting a moment, each fully executed before a new one is entered into, comes close to implementing this model into legal reality: see for example Summers, "Employment at Will in the United States: the Divine Right of Employers" in *Scritti in Onore Di Gino Giugni* (1999) at 1603. This is confirmed by Selznick, P, *The Moral Commonwealth* (1992) at 308: "The 'contract at will' is not much of a contract. No continuing relationship is established or even contemplated, and one cannot readily sue for breach of an agreement that may be terminated without notice. The idea of contract is so attenuated here that, it could be said, 'the labor contract is not a contract, it is a continuing renewal of a contract at every successive moment, implied simply from the fact that the laborer keeps at work and the employer accepts his product.'" (citing JR Commons, *Legal Foundations of Capitalism* (1924), 285). See also Epstein, R (1984) (*supra* note 14) at 948 whose evolutionary approach suggests that the "survival of the contract at will, and the frequency of its use in private markets, might well be taken as a sign of its suitability for employment relations." Epstein argues at 951 that the contract at will is a rule of construction which provides an efficient solution to the problem of filling in gaps in incomplete contracts. It allows the decision-maker to respond to unforeseeable changes in the firm's environment by altering the firm's contractual commitments.

⁵⁹ However, Alchian, AA and Demsetz, H (1972) (*supra* note 57) argue at 783 that their "view of the firm is not necessarily inconsistent with Coase's" and that their model goes further than his in that it explains the position of the monitors and the residual claimant. They also disagree with his interpretation of the contractual position of employees: "...it is not true that employees are generally employed on the basis of long-term contractual relationships any more than on a series of short-term or indefinite length contracts." (784)

⁶⁰ They consider the firm to be no more than a monitoring mechanism which reduces "shirking" in team production situations. The "agency" problem discussed in this chapter only arises when the group of functions associated with ownership is split. They therefore treat the board as monitoring management on behalf of the shareholders, and so the task of corporate governance systems should be to ensure that the agent acts for the benefit of the principal.

(assuming competitive markets).⁶² The identity of his employees or customers makes no difference to the grocer: he considers them fully interchangeable and generic.⁶³

In another seminal article,⁶⁴ Jensen and Meckling further developed the contractual approach, arguing that

"The private corporation or firm is simply one form of *legal fiction which serves as a nexus for contracting relationships and which is also characterized by the existence of divisible residual claims on the assets and cash flows of the organization which can generally be sold without permission of the other contracting individuals*. While this definition of the firm has little substantive content, emphasizing the essential contractual nature of firms and other organizations focuses attention on a crucial set of questions - why particular sets of contractual relations arise for various types of organization, what the consequences of these contractual relations are, and how they are affected by changes exogenous to the organization. Viewed in this way, it makes little or no sense to try to distinguish those things which are "inside" the firm (or any other organization) from those things that are "outside" of it. There is in a very real sense only a multitude of complex relationships (i.e., contracts) between the legal fiction (the firm) and the owners of labor, material and capital inputs and the consumers of output."⁶⁵

This statement has been very influential and is rightly famous for its contribution to the ontological debate, that it is an error to personify the corporation, given that "we seldom fall into the trap of characterizing the wheat or stock market as an individual...."⁶⁶ Corporate personality is an "artificial construct under the law which allows certain

⁶¹ In this regard, note the comment of Jensen, MC and Meckling, WH (1976) (*supra* note 5) at 311: "The "behavior" of the firm is like the behavior of a market, i.e., the outcome of a complex equilibrium process."

⁶² Alchian, AA and Demsetz, H (1972) (*supra* note 57) at 777.

⁶³ Hart, O (1989) (*supra* note 3) at 2.3 has elaborated on Alchian and Demsetz's rather elliptical dismissal of Coase's dichotomy between the firm and market, explaining that the employment relationship does not differ from market contracting in the sense that the employee who disobeys instructions will be fired rather than sued, which is "typically the sanction that one independent contractor will impose on another whose performance he does not like."

⁶⁴ Jensen, MC and Meckling, WH (1976) (*supra* note 5)

⁶⁵ *ibid* at 311

⁶⁶ *ibid* at 311

organizations to be treated as individuals."⁶⁷ Lawyers are (or should be) aware that their corporations are not real in a physical sense: rather they are simply devices of attribution.⁶⁸ Neoclassical contractualists consider this deconstruction fatal for arguments that corporations should be socially responsible.⁶⁹ As a collection of contracts, all participation in "the corporation" is voluntary and participants are protected by the terms of their agreement. If contracts give rise to externalities (effects on non-parties), compensation should be agreed by bargaining in the first place (in order to reach wealth-maximising solutions), or if transaction costs are too high and preclude this, by legal regulation.⁷⁰ In the absence of externalities, the neoclassical model opposes legal intervention in voluntary arrangements.

Deconstructing the company in this way does give rise to difficulties when one moves beyond management-shareholder relationships and attempts to identify the other party to the employment contract, a matter of great legal importance. Presumably the "employer" is the shareholders, clothed in limited liability⁷¹ and negotiating through their manager agents. Yet, analysis in these terms is normative: it is not consistent with the law as it stands, since it involves equating the company with the shareholders, something that the law has consistently refused to do. It also begs the fundamental question of why, in economic terms, the employees should be considered "outsiders" in company law.⁷²

⁶⁷ *ibid* at 310 fn 12

⁶⁸ See in particular, Teubner, G, "Enterprise Corporatism: New Industrial Policy and the "Essence" of the Legal Person" (1988) 36 *American Journal of Comparative Law* 130.

⁶⁹ Jensen, MC and Meckling, WH (1976) (*supra* note 5) at 311. Of course, within the legal system, the corporation itself may be held liable in tort. Within a contractual model, this could be explained as imposing liability for externalities on the parties to the contract through the legal mechanism of the corporate entity. The thrust of their argument appears to be that in the wider social system there is no responsibility of the corporation as distinct from the parties to the contracts which constitute it. Jensen and Meckling, somewhat perplexingly, however, conclude at 357 that "[t]he publicly held business corporation is an awesome social invention."

⁷⁰ Coase, "The Problem of Social Cost", reprinted in Coase, RH *The Firm, the Market, and the Law* (1988) at 95. A full discussion of this lies outside the scope of this thesis.

⁷¹ Wedderburn, Lord, *Company Law Reform* (1965)

⁷² In another article, Jensen, M and Meckling WH (1979) (*supra* note 22) argue at 2 that "Suppliers of inputs (labor, raw materials, capital, etc.) along with consumers of the product implicitly or explicitly enter into a set of contracts which delineate the rights and obligations of the respective participants in the activities of the organization." This suggests that the reason for treating employees as outsiders lies in the terms of their contracts, but the precise reason is not set out. The answer must be that they do not have residual claims, and so their interest begins and ends with their contracts.

Easterbrook and Fischel and Company Law as Contract

The most important study of the application of economic theories of the firm to company law is *The Economic Structure of Corporate Law* by Easterbrook and Fischel.⁷³ They assess the provisions of US company law against a model in which the "corporation is a complex set of explicit and implicit contracts".⁷⁴ In this section it will be demonstrated that their analysis rests on neoclassical model assumptions because it is primarily concerned with the implicit contract between management and shareholders, treating all other contracts as explicit and making complete provision for the future.

Translating the economist's firm into the legal system does not pose particular methodological difficulties for Easterbrook and Fischel: "Corporations are a subset of firms. The corporation is a financing device and is not otherwise distinctive."⁷⁵ Company law accordingly plays a rather limited role: it provides an "off the peg" corporate contract, eliminating the costs of producing a new one from scratch every time a business is incorporated.⁷⁶ Facilitating corporate participants' exercise of their freedom of contract is the only logical role for the law to play: its "comparative advantage" is that it "need not answer questions unless they occur", allowing considerable cost savings compared with *ex ante* private bargaining.⁷⁷ Easterbrook and Fischel argue that their "company law as contract" thesis is largely descriptive of US company law as it stands, and make the normative claim that where the law does not conform, it should. The almost total absence of provisions relating to employees in US⁷⁸ and English⁷⁹ company law appears to underpin their argument that employees are adequately protected elsewhere - otherwise

⁷³ Easterbrook, F and Fischel, D (1991) (*supra* note 6)

⁷⁴ Easterbrook, F and Fischel, D, "Contractual Freedom in Corporate Law: Articles and Comments; The Corporate Contract" (1989) 89 *Columbia Law Review* 1416 at 1418

⁷⁵ Easterbrook, F and Fischel, D (1991) (*supra* note 6) at 10; they continue that "A corporation is characterized by a statement of capital contributions as formal claims against the firm's income that are distinct from participation in the firm's productive activities."

⁷⁶ *ibid* at 34-5; they set out the rationale for company law: "The short but not entirely satisfactory answer is that corporate law is a set of terms...that almost everyone will want to adopt. Corporate codes and existing judicial decisions supply these terms 'for free' to every corporation..."

⁷⁷ Easterbrook, F and Fischel, D (1991) (*supra* note 6) at 35

⁷⁸ With the exception of the constituency statutes (discussed in Chapter 4) adopted in around 40 states which allow management to consider the interests of constituencies other than the shareholders.

⁷⁹ s309 of the Companies Act 1985 is a much discussed but apparently ineffectual exception.

they would be allocated rights⁸⁰ - and that, as a consequence, company law is (and should remain) solely aimed at resolving the agency problems at the heart of the firm. Legal intervention to ensure efficiency is only necessary with regard to this incomplete contract, because in all other cases, it results automatically from the free interplay of market actors.

Determination of the Content of Company Law by Hypothetical Bargaining

Easterbrook and Fischel use a hypothetical bargaining process to determine (or rather, justify) the content of company law. This methodology corresponds to their normative thesis that "corporate law should contain the terms people would have negotiated, were the costs of negotiating at arm's length for every contingency sufficiently low."⁸¹ This focus on transaction costs has clear parallels with the work of Coase. A term is inserted into the corporate contract if the parties (assuming costless contracting) would have bargained and paid for it. It may then be described as "contractual", since all terms generated by the hypothetical bargaining process would have been negotiated, were it not for the desire to save costs.⁸²

They submit that this hypothetical bargaining process yields a unique outcome: corporate governance rights and protections should be (and are) granted to shareholders alone, because they value them the most highly, and therefore, in any actual negotiation over allocation, would have bargained and paid for them.⁸³ The reason shareholders value the

⁸⁰ Overall, "what should be worked out and supplied by corporate law is the rule that, if uniformly applied, will maximize the value of corporate endeavor as a whole." (Easterbrook, F and Fischel, D (1991) (*supra* note 6) at 35)

⁸¹ *ibid* at 15

⁸² For criticism that the hypothetical bargaining approach simply entrenches existing distributive outcomes, see Millon, D, "Communitarians, Contractarians, and the Crisis in Corporate Law" (1993) 50 *Washington and Lee Law Review* 1373

⁸³ At another point in their work, Easterbrook, F and Fischel, D (1991) (*supra* note 6) at 36 place less emphasis on this hypothetical approach and say that the default term should be "the one that is either picked by contract expressly or is the operational assumption of successful firms." This rests on the evolutionary assumption that since most successful firms only grant rights to shareholders, so firms should continue to do so. It does not appear to take into account that available business forms may be constrained by path dependency, i.e., that based on the evolution of the corporate form out of partnership, the law granted rights to shareholders in the first place in most businesses, and this became the norm. Selection then took place largely among firms which conformed to this pattern. For more discussion of this see Roe, MJ, "Chaos and Evolution in Law and Economics" (1996) 109 *Harvard Law Review* 641. The role of

rights most highly lies in "the special nature of the claim held by equity investors - a claim to 'what is left over' rather than to a definable return such as a wage or a payment of interest."⁸⁴ The shareholders are considered to have contracted with management "for a promise to maximise long-run profits of the firm, which in turn maximises the value of their stock."⁸⁵ In this context, control rights are of no value to the other constituencies who have fixed (and enforceable) contractual claims.⁸⁶ By default, therefore, the shareholders, as the only group that can use control to increase the value of their claim, value control rights more highly than anyone else, and, by allocating control rights to them, it is argued, the law maximises the wealth of society as a whole.

The proposed allocation of governance rights exclusively to shareholders must answer the objection that in practice they are seldom willing to exercise the rights they hypothetically value and are prepared to pay for. Easterbrook and Fischel recognise this, describing as a "puzzle" and "one of the oddities of markets" the fact that "when shares are widely traded, no one has the right incentive to gather information and make optimal decisions."⁸⁷ This presumably means that the valuation which shareholders hypothetically

network externalities in constraining choice among possible business forms is discussed below - see note 112 below.

⁸⁴ Easterbrook, F and Fischel, D (1991) (*supra* note 6) at 25

⁸⁵ *ibid* at 36; for discussion of the status of this argument post-Enron, see Blair, MM, "Directors' Duties in a Post-Enron World: Why Language Matters" (2003) 38 *Wake Forest Law Review* (*forthcoming*), part I. She notes the retreat from an insistence on short-term value maximisation on the part of, *inter alia*, Michael Jensen. Easterbrook and Fischel's insistence that the board should maximise "long-run" profits is somewhat perplexing: it must be based on the argument that lower returns to shareholders in the short term (perhaps to the benefit of the company's employees) will be considered by efficient markets to be referable to an improved income stream in the future. Yet the authors do not explain why the market would not value more highly profit maximisation in the short term within the constraints imposed by the nexus of explicit contracts. For a discussion of the driving forces behind short-term stock price mechanism, see Millon, D, "Why is Corporate Management Obsessed with Quarterly Earnings and What Should Be Done About It?" (2002) 70 *George Washington Law Review* 890.

⁸⁶ Easterbrook and Fischel (1991) (*supra* note 6) at 36 identify risk bearing solely with holding a variable or residual claim: "Risk bearers get a residual claim to profit; those who do not bear risk on the margin get fixed terms of trade." The absence of a residual claim means that all other contracts are complete and risk-free, and this is confirmed by the law's grant of control rights to shareholders. As Deakin, S and Slinger, G, "Hostile Takeovers, Corporate Law, and the Theory of the Firm" (1997) 24 *Journal of Law and Society* 124 point out at 129, "this argument is essentially circular...It is necessary to go further, and show that shareholders are inherently more exposed to risk than other owners of inputs, before the structure of the corporation can be adequately explained on economic efficiency grounds." The arguments in favour of employees' contracts being complete, such as they are, are set out below.

⁸⁷ Easterbrook, F and Fischel, D (1991) (*supra* note 6) at 25

place on the rights⁸⁸ should be considered separately from their willingness to exercise them once they have been allocated, which might be affected by the collective action problem.⁸⁹ Alternatively one might suggest that, although shareholders value them more highly than any other constituency, even they do not value them particularly highly.

The Position of Employees in Neoclassical Contractual Analysis of Company Law

Employees do not bargain hypothetically for decision-making rights because they are able to achieve full contractual protection against any risks they face and so place no value on governance rights:

"Employees... are voluntary creditors. The compensation they demand will be a function of the risk they face...As long as these risks are known, the firm pays for the freedom to engage in risky activities...risks created by a firm's activities may be understood by a...union if not by individual...workers. If the risk premium is correctly set, it is irrelevant whether each voluntary creditor is informed. Each is protected by the market price."⁹⁰

⁸⁸ Hansmann, H, *The Ownership of Enterprise* (1996) suggests at 48 that allocation of rights to shareholders might be considered the best available allocation option because "by virtue of their ownership, the patrons are assured that there is no other group of owners to which management is responsive." Were another option more efficient, this initial allocation would be contracted around.

⁸⁹ The question of exercise is one which has led to a large body of literature on the (potential) role of institutional investors in corporate governance (see for example, Davies, "Institutional Investors in the United Kingdom" in Prentice, DD and Holland, PRJ (eds), *Contemporary Issues in Corporate Governance* (1993), 69). Hawley, J and Williams, A, "The Emergence of Universal Owners: Some Implications of Institutional Equity Ownership" (2000) *Challenge* July-August 43 suggest that institutional investors who are properly diversified should be considered "universal owners" who care about the performance of the economy as a whole, rather than narrowly defined issues of corporate governance in particular firms. Firms which externalise in order to maximise their private benefit impose costs on those investors who "own" the whole economy. They argue that this might encourage investors to take an interest in issues such as training, education and public health issues. The barrier to the emergence of more public policy orientated institutional investor activism is, of course, the collective action problem, which means funds will only act where they expect others to do similarly. This requires some form of (costly) co-ordination. For the time being, the market for corporate control (and associated corporate governance mechanisms) is widely considered to compensate for shareholder apathy in monitoring and is discussed in detail in Chapter 4.

⁹⁰ Easterbrook, F and Fischel, D (1991) (*supra* note 6) at 50-1

Easterbrook and Fischel emphasise that, assuming costless negotiations and perfect information,⁹¹ the allocation of governance rights exclusively to shareholders should not have distributional consequences because, as contractual terms, "they are fully priced in transactions among the interested parties."⁹² The shareholders pay for the governance rights they receive (but rarely exercise) through higher prices for the supply of labour where the allocation of control rights to shareholders exposes the employees to risk.⁹³ While stopping some way short of accepting that "bounded rationality" may prevent the drafting of contracts which make full provision for all contingencies, they do recognise that individual workers may face cognitive difficulties in assessing the degree of risk they face in a given contracting situation. However, they suggest that "employees work at terms negotiated by unions (and nonunion employees can observe the terms offered at other firms, which supply much information)."⁹⁴ One might also suggest, although this is little discussed by agency theorists, that legal requirements imposed on companies to inform and consult employees on a regular basis about changes which affect their interests also assist with the assessment of risk before contracts are concluded. Procedural obligations of this kind should be relatively uncontroversial because, in reducing information asymmetry, they may allow contracts to reflect risks more accurately, and therefore be more complete.⁹⁵

Arguments have been made, and are considered at length in chapter 3, that employees, who have invested in idiosyncratic or "firm-specific" skills which are not fully redeployable via the labour market, bear risk like shareholders. If they change job, they are likely to suffer a reduction in income to reflect the lower level of skills they bring to their new position. Further, transaction costs (in particular, uncertainty about the future)

⁹¹ These are fairly major assumptions to make in the light of the development of transaction cost and informational economics.

⁹² Easterbrook, F and Fischel, D (1991) (*supra* note 6) at 17

⁹³ Of course, as will be discussed below, the difficulty with this approach is that it will not be possible at the time of entering the contract to accurately estimate the likely risk borne by employees by virtue of not holding any control rights.

⁹⁴ Easterbrook, F and Fischel, D (1991) (*supra* note 6) at 24. Whatever virtues unions have in representing their members collectively, it is difficult to see how they are equipped to predict the future.

⁹⁵ The danger from an agency perspective is that such reforms open up a Pandora's box of debate about the informational and transaction cost difficulties faced by employees in making their contracts fully explicit. This is touched on below and forms the subject of much of the third chapter.

prevent them from protecting themselves fully by legally binding contract. Easterbrook and Fischel do address these arguments in a cursory manner, but do not reconsider their central assumption that employees are always "protected by the market price". They recognise that:

"Employees may be investors in the sense that portions of their human capital are firm-specific - that is, are adapted to the corporation's business and are worth less in some other job...The question is not whether employees and other 'constituencies' of the firm have entitlements or expectations - they do - but what those entitlements are. If employees negotiate for or accept a system of severance payments to protect their firm-specific human capital, they ought not to grumble if they are held to their bargains when business goes bad. Each investor must live with the risks built into the firm. Equity claimants lose out to debt claimants when times are bad and are not thereby entitled to some additional compensation. It is all a matter of enforcing the contracts. And for any employee or investor other than the residual claimant, that means the explicit, negotiated contract."⁹⁶

As we saw above, Easterbrook and Fischel assume that employees who will make firm-specific investment are able *ex ante* to accurately assess the risk they will face and to bargain for an appropriate "fixed payout" to reflect it.⁹⁷ If employees' contracts did not provide adequate protection against risk, then employees would not have concluded them on those terms. Accordingly, employees who choose, or are forced, to exit from the firm, suffer no loss (apart from certain relocation costs⁹⁸) as long as liquid labour markets operate swiftly to re-employ them elsewhere. Company law (understood as a hypothetical bargain) confirms that employees generally do not face risk by not allocating them any governance rights since to do so would serve no purpose. If the law were to provide

⁹⁶ Easterbrook, F and Fischel, D (1991) (*supra* note 6) at 37

⁹⁷ The idea that employees bear no risk seems to contradict the idea that they make investments in firm-specific capital: see further Chapter 3.

⁹⁸ Fischel, DR, "Labor Markets and Labor Law Compared with Capital Markets and Corporate Law" (1984) 51 *University of Chicago Law Review* 1061-1077 at 1067

rights by default to employees, the costs of negotiating them away would be wasted in each case.⁹⁹

Writing on his own, Fischel recognises that their firm-specific investments may make employees dependent on the firm and expose them to risk in the form of opportunism on the part of management.¹⁰⁰ As in his writings with Easterbrook, he suggests that the primary rational response on the part of employees to this vulnerability is to make *ex ante* demands for increased (i.e., above-market) compensation on the basis of their putative future firm-specific investments and corresponding assumption of risk.¹⁰¹ This premium could be justified on the basis of the "relative inability of participants in labor markets to diversify risk."¹⁰² Employers should meet these demands by "such risk-shifting devices as long-term contracts or severance-pay provisions - in order to minimize the risk borne by workers."¹⁰³

An insistence that employees are fully protected by their contracts is essential to Easterbrook and Fischel's thesis because to recognise that employees face risk which cannot be protected by (legal) contract would be sufficient to reconstitute them as residual claimants and therefore change the way they act in the hypothetical bargaining process. However, the assumptions of contractual completeness on which their argument rests are highly problematic.

First, they contradict the transaction cost explanation of the firm (which is taken up in more detail in Chapter 3). The issue of *ex ante* quantification of risk is glossed over. Since the investment in question is firm-specific and tied to the continuation of the relationship, a present estimate of the likely future duration of the contract is required.

⁹⁹ Leaving aside for the moment Hansmann's argument about the cost increases where there is shared governance. This is taken up in Chapter 3.

¹⁰⁰ See Fischel, DR (1984) (*supra* note 98) at 1067: "At the extreme, a firm could hire a worker and then reduce his wage to a level just above the worker's opportunity wage minus the worker's cost of relocation."

¹⁰¹ A preliminary objection may be raised to this suggestion of *ex ante* contracting: given bounded rationality, and in particular a lack of knowledge about the amount of firm-specific investment which will be made, full presentation of the contract must be impossible, or at best, rather speculative. See further Chapter 3.

¹⁰² Fischel, DR (1984) (*supra* note 98) at 1067

¹⁰³ *ibid* at 1068

However, this estimate is likely to change over time in line with conditions in the firm's trading and technological environment. In addition, the contract requires present quantification of a presently uncertain amount of investment. The way in which the future will evolve cannot be known with any degree of certainty. Any *ex ante* quantification is unlikely to be correct, and so produce skewed incentives either to continue with the contract or to breach it. If these problems mean that quantification must be deferred, then the contract will not be complete, and the governance structure which is in its place will impose a risk of opportunism on the party who does not control the decision-making process.

This leads to the second problem. Their analysis blurs the distinction between economic and legal conceptions of contract, which, as we saw above, are not co-extensive. The broader economic conception of contract as "reciprocal arrangement" does not require all terms to be fixed in advance for the exchange to be pareto efficient and leave both parties better off. Informal "understandings" between the parties reduce the transaction costs of complete specification of all contingencies and permit the relationship to adapt to future change. However, the downside of these informal and flexible elements of the economic "contract" is that they are, by definition, not legally binding. Employees who rely on such undertakings and make firm-specific investments, which are vulnerable in the event of relationship breakdown, bear the risk of opportunistic breach. The flexibility which is their economic strength means that the law cannot enforce them: it is limited to enforcing the original agreement. In such a situation, the legally binding "payout" which was fixed in advance is unlikely fully to cover the employee's losses where he leaves the firm. The assumption underpinning the economic notion of contract that exchange leaves both parties better off should not be equated with an argument that their legal contracts fully protect them against all risks of the relationship ending, i.e., that there is no downside. Systems theory explicitly counsels against such direct translations of economic concepts into legal discourse without taking into account the different context in which the concept was originally used.

Fischel implicitly recognises these formidable contracting difficulties and even suggests that, as an alternative to explicit contractual solutions, employees may be protected against risk by the creation of "governance mechanisms that reduce the probability of opportunistic behavior by the firm ex post." In this regard, he discusses "[o]ne possibility [which] is for firms to strengthen the "voice" alternative for workers: grievance resolution mechanisms of various kinds decrease the ability of firms to engage in opportunistic behavior at workers' expense."¹⁰⁴ This suggestion of a governance mechanism for employees is very interesting, coming as it does from one of the most forthright proponents of the agency perspective on company law. Once it is recognised that explicit contractual protection may present difficulties for some employees, and that a governance structure may be required to maintain continuity of the relationship, the agency model begins to shade into the productive coalition model set out in Chapter 3. For the moment it will suffice to note that, given Fischel's recognition that "labor is a more heterogeneous good than capital"¹⁰⁵ and that "the exit option is much more costly for workers than for investors",¹⁰⁶ a governance mechanism limited to "grievance resolution" seems rather narrow when compared with the default governance rights provided to shareholders, particularly if one accepts that while both groups bear risk, it is harder for the employees to diversify theirs.

Finally, Fischel argues that legal intervention to protect employees who are also residual claimants is unnecessary because "the interest of the firm in minimizing the cost of all inputs in the production process will cause it to adopt the contractual mechanisms that best allay workers' and investors' rational concerns."¹⁰⁷ He expects protective structures to evolve at the level of the individual firm on the basis of each firm's desire keep its labour costs to an acceptable level.¹⁰⁸ Where such structures have not evolved at the level

¹⁰⁴ *ibid* at 1067; he recognises that the problem is reciprocal and that "Firms can have specific investments in workers just as workers can have specific investments in firms. Thus there is a need to develop governance structures that minimize opportunistic behavior by workers. Pensions with long vesting periods provide an example of a contractual mechanism that does this."

¹⁰⁵ *ibid* at 1066

¹⁰⁶ *ibid* at 1066

¹⁰⁷ *ibid* at 1068

¹⁰⁸ Of course, this same argument might be made as regards the contract between the firm and its shareholders. It certainly underlies reliance on the efficient market hypothesis.

of individual firms, three explanations might be considered. First, that employees are not prepared to pay for them, preferring to bear risk and be compensated for it. This seems unlikely given the difficulties of diversification they face. Second, that residual claimant employees are rare. This implausible argument is taken up in Chapter 3. Third, that the transaction costs incurred by the firm in establishing an appropriate structure outweigh its benefits. It can be argued that the costs of putting in place such structures are rather high. The default position set by company law means that transaction costs (in the form of negotiation and drafting and, given that this type of arrangement is not commonly found, occasional litigation) will be incurred every time a governance mechanism is created to protect firm-specific investment by employees.

Imposing a high level of transaction costs on employees and firms who co-specialise is difficult to square with the supply of standard-form corporate contracts to shareholders as a "public good".¹⁰⁹ While shareholders need do nothing to gain the protection of what the law apparently considers an optimal governance structure, the employees receive no guidance from the law, must incur costs in order to put in place a governance structure which suits their needs, and are even under certain legal disabilities when they attempt to create one collectively.¹¹⁰ It might be suggested that company law should at least suggest a variety of standard form structures to take into account the heterogeneity of firms and the different types of residual claims which exist. The neoclassical contractual explanation of company law suggests that the law's failure to do so demonstrates that firm-specific investments are the exception rather than the rule, and so even a simple requirement to select one of a range of legal regimes would be unnecessarily costly. The contractual thesis further suggests that where a firm-specific governance structure has not been adopted, this is either because the default structure was appropriate, or, at the limit, because the costs of drafting an alternative exceeded the costs occasioned by an inappropriate corporate contract.¹¹¹

¹⁰⁹ Easterbrook, F and Fischel, D (1989) (*supra* note 74) at 1445

¹¹⁰ The possibility of unions playing a role in establishing governance structures is discussed in Chapter 3.

The default provisions of company law are likely to influence the structures which are actually adopted. The majority of companies adopt the contract in its default form. Adopting the law's standard terms allows individual users to avoid the costs associated with the complex evolutionary process which leads to the development of alternative institutional designs, such as the original design, the costs of litigating, uncertainty etc. This effect may go beyond transaction costs for individual firms. Klausner suggests that network externalities significantly influence the terms which are adopted, undermining the basic assumption that rational parties will use the most efficient terms, leading to an optimal allocation of resources.¹¹² The common use of a contract term creates value¹¹³ and so may perpetuate a form which was efficient in the past but is no longer so.¹¹⁴ Expectations that other firms will continue to adopt the path dependent contract means that the form will be locked in. It will be difficult to bring about change because defectors lose the benefits of network externalities as well as incurring the transaction costs associated with customising a governance structure.¹¹⁵

Finally, the law's provision of "voluntary" structures cannot be considered entirely neutral for various reasons: besides bestowing a degree of social "approval" upon those structures, they embody a "pro-shareholder bias".¹¹⁶ In the *absence* of agreement, rights

¹¹¹ Even if this explanation is accepted, it might be argued that the high costs associated with protecting firm-specific investments undermines the willingness of employees to them in the first place, leading to a vicious circle of sub-optimal resource allocation. These arguments are taken up in more detail in chapter 3.

¹¹² See Klausner, M, "Corporations, Corporate Law and Networks of Contracts" (1995) 81 *Virginia Law Review* 757. See also Kahan, M and Klausner, M, "Path Dependence in Corporate Governance: Increasing Returns, Herd Behavior and Cognitive Biases" (1996) 74 *Washington University Law Quarterly* 347.

¹¹³ Klausner, M (1995) (*supra*) at 761: "When the use of a contract term becomes widespread, its value may rise because of several phenomena. More judicial precedents can be expected, on average, to enhance the clarity of the term. Common business practices implementing the term may become established, further reducing uncertainty. Legal advice, opinion letters and related documentation will be more readily available, more timely, less costly, and more certain. Finally, firms may find it easier to market their securities." Access to credit will also be easier where a firm has a more conventional structure.

¹¹⁴ Alternatively, if one does not subscribe to the contractual thesis, the form may never have been efficient but might have allowed a politically dominant corporate constituency to capture rents.

¹¹⁵ In conclusion at 838, Klausner suggests that "the objective of corporate law...should be to promote an optimal balance of uniformity among homogeneous firms and diversity across heterogeneous firms, and to avoid obsolescence." Accordingly, corporate law should provide menus of choices which allow homogeneous firms to form networks around their preferred terms, while allowing heterogeneous firms to customise.

¹¹⁶ Millon, "Communitarianism in Corporate Law" in Mitchell, LE (ed), *Progressive Corporate Law* (1995) 1 at 24

are granted to the shareholder constituency.¹¹⁷ This may be significant in various situations. First, the very common situation where individual bargaining by employees becomes infeasible because of transaction costs. Second, in the usual situation where employee bargaining power is not strong, "persuading management to deviate from this practice will likely be impossible."¹¹⁸ Third, it has distributional effects as employees must pay every time they want to deviate from the default position.¹¹⁹

In conclusion, if it is accepted that employees are fully protected from risk by legally-binding contracts, Easterbrook and Fischel are correct to suggest that company law should centre on the relationship between management and shareholders, and on the reduction of the (agency) costs incurred by the providers of the company's financial capital to an acceptable minimum. The law's provision of a standard form contract for incorporations which protects residual claimants is not a private benefit conferred on the shareholders alone, but benefits society as a whole. Chapter 3 will look at the issue of employee investments in firm-specific capital in more detail and suggest that this is not the case.

The Agency Model Beyond Company Law

The agency model of the firm has dominated mainstream debate about corporate governance in the US and the UK since the 1980s. Its normative influence as the intellectual underpinning of the doctrine of "shareholder value" in corporate governance debates should not be underestimated.¹²⁰ By combining the arguments that management, like any other agent, always has a tendency to act in a self-serving way (the empire-building problem), and that rational shareholders do not monitor management closely (the collective action problem), this model advocates the development of market-based solutions to the central agency problem.

¹¹⁷ Millon draws attention to the fact that "the default rule in question was not itself the result of a bargain between the parties.

¹¹⁸ Millon (1995) (*supra* note 116) at 24. This of course feeds into the network externality point above, making deviation even less likely.

¹¹⁹ *ibid* at 27

The influence of the agency model may be seen in various current developments. Shareholder value is prioritised and generated through "the carrot of CEO pay (primarily stock options) and the stick of firing the CEO."¹²¹ Stock options, encouraged by tax subsidies, have grown exponentially¹²² and the average tenure of CEOs is now only 2.75 years.¹²³ Corporate metrics, in particular quarterly earnings, further concentrate the minds of executives on share price as "financial markets have the power to value firms publicly."¹²⁴ Finally, capital market actors exert political pressure for the removal of barriers to the establishment of a market for corporate control, which is the ultimate stick to encourage management to honour "the prime directive".¹²⁵ Agency theorists argue that in matters of corporate governance the law should confine itself to taking steps which favour, or at least permit, the establishment and operation of these market-based solutions to the agency problem. The extent to which the law has contributed to the creation of a market for corporate control is addressed in the second part of the thesis.

However, despite the increasing diffusion of decentralised market-based solutions and social norms of shareholder value, the impact of agency theory on the doctrinal content of company law has to date been negligible. The formulation of the fiduciary duties imposed on management by company law (owed to "the company" rather than to the shareholders)

¹²⁰ For a critical view of the effects of the shareholder value doctrine on the capacity of companies, see Kennedy, AA (2000) (*supra* note 36).

¹²¹ Kelly, M, *The Divine Right of Capital* (2003) at 54.

¹²² Millon, D (2002) (*supra* note 85) notes at 906: "During the 1990s, the number of options outstanding increased from 5 to 15 percent of all outstanding shares. Options now account for 60 percent of a typical CEO's compensation package." Kennedy, AA (2000) (*supra* note 36) at 45 explains that "With their pay tied to stock options, senior managers began to pay greater attention to stock price levels and began to manage their companies as though a higher and higher stock price was the only legitimate objective of management itself." The 'financialisation' of executives and the disjunction of management from the underlying productive business has led to an overwhelming focus on accounting matters. Kennedy's ultimate conclusion is bleak (at 47): many companies "have mortgaged their futures in return for a higher stock price now, [which] does not bode well for the economy at large." One of the problems with share options as opposed to the grant of stock is that the board bears no risk if the company's share price declines.

¹²³ See *The Observer*, 13 July 2003, citing research by the Egremont consulting group and noting that, while only 12 per cent have held their jobs for more than a decade, 15 years ago, the average chief executive stayed in his post for 15 years.

¹²⁴ Aglietta, M, "Shareholder Value and Corporate Governance: Some Tricky Questions" (2000) 29 *Economy and Society* 146 at 149

¹²⁵ Kelly, M (2003) (*supra* note 121) at 54

has remained unchanged.¹²⁶ The law continues to enshrine managerialism at the heart of the company. Yet it is also notable that the law has not intervened on the side of managerialism, given the extent of this “encouragement” for management to use their discretion exclusively in order to enhance returns to shareholders. Agency theory suggests that the law should continue to abstain, except as regards freeing up market forces. In this regard, UK takeover regulation (and the proposed European Takeover Directive which is modelled on it) truncates managerial discretion when a takeover bid has been made, and replaces managerialism with a norm of shareholder value in the takeover context.

A Critique of the Agency Model of the Corporation

This thesis accepts that the contractual model of the company is a useful tool for analysis of the provisions of company law and its treatment of the various relationships which make up the company. However, in its agency formulation, with its insistence that employment contracts provide express protection against all contingencies and its refusal to recognise that there are internal governance aspects of corporations which can potentially adversely affect employees, it is too narrow to form a complete heuristic model for use in legal discussion. In the particular situation where employees have made investments in firm-specific capital, and thus bear some degree of risk, despite the assertions of Easterbrook and Fischel to the contrary, *ex ante* attempts to provide protection from management opportunism through contractual mechanisms will not work. A more complete model which is suitable for the law would also take into account hierarchical aspects of corporations: in a recent paper, Eisenberg argued that the corporation has a dual nature, and that theories of the company should not pretend to exclusivity:

¹²⁶ Although the UK government's proposed company law reforms go some way in the direction of implementing an agency model: see the White Paper at 2.37: "It is crucial to effective corporate governance that the owners of the company hold the directors to account for the company's performance." See Wedderburn, Lord (2002) (*supra* note 7) for criticism of this from a labour law and "partnership" angle. See also the *Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids* ("The Winter Report") at 19, which states that the directors "after all are the agents of shareholders... discipline of management and reallocation of resources is in the long term in the best interests of all stakeholders, and society at large."

"...the nexus-of-contracts conception is unsatisfactory as a positive--that is, descriptive--matter, in part because the corporation has a dual nature: In one aspect, it consists of reciprocal arrangements; in another, it is a bureaucratic hierarchy. The nexus-of-contracts conception captures only one of these two aspects of the corporation."¹²⁷

The argument that employees are voluntary participants in the corporation has somehow become confused with an argument that they face no risk that decisions may be made which unexpectedly adversely affect their interests.¹²⁸ The contractual approach ignores, and therefore offers no economic account of, the hierarchical aspects of corporate decision-making. In particular, it ignores hierarchical (or governance) arrangements as a potential mechanism for filling in the gaps in incomplete contracts and maintaining mutual trust and confidence between corporate participants in the situation where the market fails as a viable alternative allocation mechanism.

Treating employment contracts as explicit and discrete means that, for the most part, the corporation is an essentially static arrangement with no permanence, and which cannot be differentiated from the market: these arrangements lasts only until the next round of negotiations. The central agency relationship between management and shareholders is viewed as the only durable aspect of the relational corporation, and even there, stock market liquidity means that the identity of the shareholders may change. In this vein, Hutton builds on Eisenberg's critique:

"But the whole narrative is shot through with intellectual and empirical inadequacies. In the first place this is an entirely economic view of the organisation. If all contracts can be unwound at a moment's notice and reorganised around a better set of prices, this is only another way of saying that organisations have no history. In this conception, companies should be visualised as simply a peripatetic, permanently shifting network of deals between workers, suppliers, creditors and shareholders. Loyalty, trust, the

¹²⁷ Eisenberg, MA (1999) (*supra* note 12) at 820

¹²⁸ It is suggested that this position has arisen because of this model's opposition to social arguments about the corporation, such as those discussed in the following chapter, which focus on the exercise of power within corporate hierarchies.

organisation's social capabilities and the capacity to learn over time count for nothing. The truth is that they count a lot..."¹²⁹

The next two chapters attempt to fill out these methodological inadequacies and to develop a fuller heuristic model for use in the analysis of takeover law. The final model should capture both individual contractual interconnections, and those hierarchical organisational elements which are omitted from neoclassical contractual analysis. Chapter Two offers an account of the hierarchical elements of the company in political terms and suggests methods of legitimation. This account has traditionally been considered to be in conflict with the economic contractual model. Chapter Three attempts to bridge this gap and welcomes hierarchy as an effective mechanism for filling the gaps in (or "governing") incomplete contracts, providing protection for corporate participants against risk.

¹²⁹ Hutton, W, *The World We'Re In* (2002) at 134-5. The idea of the corporation as an evolving bundle of capabilities which cannot be replicated by market exchange is discussed at length in Chapter 3. The seminal discussion of organisational memory is Nelson, R and Winter, SG, *An Evolutionary Theory of Economic Change* (1982).

Chapter Two: The Political Stakeholder Model

Introduction

"One of the marks of a truly dominant intellectual paradigm is the difficulty people have in even imagining any alternative view."¹

The contractual approach is so dominant that "the end of history for corporate law" has been glimpsed.² Chapter One suggested that the neoclassical contractual model of the company has come to dominate economic analysis of company law and to set a normative agenda for corporate governance. The dominance of economic methodology, combined with structural and cultural pressures for corporate management to pursue shareholder value,³ may well mean that the normative influence of models based on political imperatives is in terminal decline. Nevertheless, in this chapter, I set out the political model of the company which has been a rival to the contractual model since the beginning of the corporate era.⁴

In this thesis, this model is termed the "Political Stakeholder" model to distinguish it from the model elaborated in Chapter 3, elements of which are sometimes referred to as the "Economic Stakeholder" model.⁵ In some of the literature, particularly that originating in the United States, this model is referred to as the "communitarian" model as opposed to the "contractarian" model discussed in the previous chapter.⁶ The

¹ Allen, WT, "Contracts and Communities in Corporation Law" (1993) 50 *Washington and Lee Law Review* 1395 at 1401

² Hansmann, H and Kraakman, R, "The End of History for Corporate Law" (2000) *Discussion Paper No 280 Harvard Law School Centre for Law, Economics and Business (Olin Center)*, who see the contractual model leading by "force of logic", "force of example" and "force of competition".

³ Mitchell, LE, *Corporate Irresponsibility: America's Newest Export* (2001) at 43

⁴ For a detailed discussion of the historical development of these theories, see Bratton, WW, "The Nexus of Contracts Corporation: A Critical Appraisal" (1989) 74 *Cornell Law Review* 407. Discussing their constant evolution and dynamic interaction over time, he explains at 411 that "Corporate law doctrine...has been shifting between contracts, hierarchies, and the state for more than a century."

⁵ While employees are treated as "stakeholders" in both models, the model in Chapter 3 justifies this on the grounds of economic efficiency rather than political imperatives.

⁶ See for example, Millon, D, "Communitarians, Contractarians, and the Crisis in Corporate Law" (1993) 50 *Washington and Lee Law Review* 1373; Millon, D, "Communitarianism in Corporate Law" in Mitchell, LE (ed), *Progressive Corporate Law* (1995), 1. The communitarian model incorporates elements of both economic and political stakeholding.

development of a "political" theory of the company poses difficulties because it seeks to draw together divergent strands of thinking whose common ground is often only their opposition to analysing the company in purely contractual terms.⁷ The political stakeholding approach therefore takes a more "pluralist"⁸ approach to the company, considering a wide range of corporate constituencies, and looking beyond simple implicit or explicit bargained exchange to the "empirical reality of social interactions 'within' corporations."⁹

In contrast to the contractual model, political stakeholding makes normative arguments in favour of regulation, on the basis either of the corporation's role in society or the democratic imperative. The two slightly divergent and contradictory strands of thinking which constitute the political stakeholding model, corporate social responsibility ("CSR") and industrial democracy, have been influential in discussions about company law and corporate governance reform, in particular as regards the position of employees.

First, CSR looks outwards and suggests that the corporation, as a social institution, has broader responsibilities to society than simply maximising returns to shareholders. Management, as the agents through whom the company acts, should seek voluntarily to ensure that the company complies with that "social responsibility". CSR, in its limited "prudential" form at least, has contributed to the widespread development of voluntary codes of conduct, a practice which continues to the present day and seems to have had some effect on corporate governance practice.¹⁰

⁷ Plender, J, *A Stake in the Future: The Stakeholding Solution* (1997) at 16; Millon, (1995) (*supra*).

⁸ Cook, J and Deakin, S, "Stakeholding and Corporate Governance: Theory and Evidence on Economic Performance" (1999) *ESRC Centre for Business Research, University of Cambridge Working Paper* at 7: "viewing companies as social institutions broadens the recognition of their contribution to overall social welfare and allows that groups other than shareholders have a legitimate interest in, and claim against, the company; and, the interests of various stakeholder groups (including shareholders) do not necessarily always coincide, either in the short or in the long run."

⁹ Allen, WT (1993) (*supra* note 1) at 1401

¹⁰ Voluntary codes of conduct, in which firms undertake to respect, for example, labour standards, and to ensure that their suppliers also do so, are very prevalent among multinational corporations. While their critics see them as an attempt to fend off more restrictive regulation, Stone, CD, "Public Interest Representation: Economic and Social Policy Inside the Enterprise" in Hopt, KJ and Teubner, G (eds), *Corporate Governance and Directors' Liabilities* (1985), 122 suggests at 138-9 that this is unlikely to be a successful strategy, given the incentives for individual firms to defect and not co-operate in self-regulation,

Second, industrial democracy looks inwards to intra-corporate relations and suggests that democracy should be extended from the public sphere to the private sphere of corporations. Industrial democracy therefore seeks reform of corporate decision-making processes to comply with the democratic imperative. Demands for industrial democracy led to (ultimately unsuccessful) proposals for the reform of corporate hierarchy which emerged at both the national and supranational levels in the 1970s.

The political stakeholding interpretation of the firm is that the contractual elements of the employment relationship are marginal and that one should concentrate on its hierarchical aspects.¹¹ By downplaying the role of market-based contracting, political stakeholding shares some common ground with Coase, but diverges in its scrutiny of the corporate institution not in terms of economic efficiency, but as the locus of an exercise of power. Since it compares the company to a community,¹² this model's primary concern is with social justice and democracy. In comparison with the inter-systemic conflicts which hindered attempts to pin down the precise scope of the term "contract" in the agency model, the political stakeholder model makes claims which are potentially more readily translatable across systems. Its advocates claim that its focus on the "empirical reality" of decision-making within the corporate hierarchy offers a more realistic model of the operation of corporations than the contractual paradigm, and therefore a more appropriate model on which the law might base regulation.¹³

The chapter is structured as follows. First, the historical context of political stakeholding is outlined. Then corporate social responsibility and industrial democracy, the two main strands of thought within this model, are considered in more detail. Second, a definition

"free riding" on those companies which do put codes in place. Sectoral codes of conduct may be an emerging solution to this particular collective action problem.

¹¹ This point is further developed at the beginning of Chapter 3 with the discussion of Williamson's Institutional Economics.

¹² See Plender, J, "A New Third Way" (1998) *Prospect* 33 at 34: "Large companies are more like communities than a mere corporate cloak for individual exchange."

¹³ Compare the defence of contractualism in similar terms in Bainbridge, SM, "Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship" (1997) 82 *Cornell Law Review* 856 at 22: "Contractarianism (like law & economics generally) succeeded because it offers a heuristic for exploring and predicting human behavior in response to regulation."

of stakeholding is attempted. Third, the possible ways in which the political stakeholding model may be implemented in law are considered. Finally, various critiques of the model are discussed. As in the last chapter, and in line with the focus of this thesis, particular attention will be paid to the position of employees within this model. This is an easier task because the stakeholder model expressly sets out to include consideration of employees.

Historical Context of Political Stakeholding

Concession theory argued that the corporation owed its existence and privileges to the state on the basis that "the corporate form was instituted by the sovereign's grant of a charter."¹⁴ It was not universally accepted: lawyers, who maintained that "only natural persons occupied the legal world",¹⁵ opposed the recognition of the corporation as an artificial person as opposed to the collection of individuals who constituted it. This "methodological individualism", which developed in opposition to the more collective concession theory, laid the ground for the development of the contractual model.

Concession theory could certainly claim to be a useful heuristic while the grant of corporate charters was dependent upon a successful appeal to the state. It was argued that since the state brought the corporation into being, so the state had a right to regulate the corporation. It is important to note that concession theory did not argue that regulation should have a specific content, simply that interference in the company's affairs was legitimate.¹⁶ In the eyes of its critics, however, these claims were weakened when incorporation became available as of right following an administrative process.¹⁷

¹⁴ Bratton, WW, "The New Economic Theory of the Firm: Critical Perspectives from History" (1989) 41 *Stanford Law Review* 1471 at 1484.

¹⁵ Bratton, WW (1989) (*supra*) at 1484.

¹⁶ For an eloquent demonstration of the role concession theory might play in justifying regulation of the company in order to protect employees, see Wedderburn, Lord, *Company Law Reform* (1965).

¹⁷ In their contractualist argument, Anderson, GM and Tollison, RD, "The Myth of the Corporation as a Creation of the State" (1983) 3 *International Review of Law and Economics* 107 argue at 116 that the "legislative availability of cheap and simple incorporation was not the stimulus to the expansion of the corporate form, but merely a response to previous developments. In effect, corporate chartering was deregulated because it was no longer feasible to regulate it." On the accuracy of concession theory's claims

While concession theory has fallen out of favour as a theoretical basis for normative arguments about company law and corporate governance, it still has legal relevance. It is applied in many countries to decide choice of law issues. The cases discussed in Chapter 4 demonstrate that the US Supreme Court still considers concession theory to be the connecting factor which identifies the state having the right to regulate matters of corporate governance,¹⁸ leading to the application of the law of the state of incorporation (*lex loci incorporationis*) in conflict of laws cases.¹⁹

However, in the realm of corporate theory, the state-creation model of the corporation was gradually superseded by the "natural entity" model of the company as the main rival to the contractual model. This model was based on the "corporate realism" of Otto Gierke and "drew on European ideas about the spiritual reality of group life...the management corporation reconstituted the classical profit maximiser in collective form."²⁰ Corporate realists recognised the moral identity of the corporate person as a voluntarily created institution which embodied knowledge and was analogous to partnership.²¹ When combined with the notion of scientific managerialism, this model also carried an anti-

to be historically descriptive, see further, Mahoney, PG, "Contract or Concession? An Essay on the History of Corporate Law" (1999) 34 *Ga. L. Rev.* 873.

¹⁸ In *Trustees of Dartmouth College v Woodward* (1819) 17 US 517 at 636, the US Supreme Court gave credence to concession theory, stating that the "corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it." The Supreme Court approved this dictum in the takeover context in *CTS Corp v Dynamics Corp of America* 481 US 69 (1987) at 90, and at 91 stated "It thus is an accepted part of the business landscape in this country for States to create corporations, to prescribe their powers, and to define the rights that are acquired by purchasing their shares." This case is discussed further in Chapter 4. The diversity of approaches to corporate governance among the US states means that this is not an insignificant matter. Lipton, M and Rosenblum, SA, "A New System of Corporate Governance: The Quinquennial Election of Directors" (1991) 58 *University of Chicago Law Review* 187 argue at 188 that "The Anglo-American corporate form is a creation of the state, conceived originally as a privilege to be conferred on specified entities for the public good and welfare. While the corporate form became more widely available as the economy demanded it, and is now generally available to any business, it remains a legal creation."

¹⁹ This is also a live issue in the European Union, with the conflict between the liberal state of incorporation rule and the more interventionist real seat (*siège réel*) rule coming to the surface in cases such as *Centros*, *Überseering* and *Inspire Art*: see further Chapter 5.

²⁰ Millon, D, "Theories of the Corporation" (1990) 39 *Duke Law Journal* 201 at 202; Ripert, G, *Aspects Juridiques Du Capitalisme Moderne* (1951) at 52 states that "Déjà les anciens commercialistes avaient eu l'idée que, dans le contrat de société, un *corpus mysticum* se dégage de la volonté commune des associés. Mais cette idée était bien vague. Ils voyaient flotter ce corps mystique au-dessus du contrat comme une sorte d'ectoplasme sorti de la personne des associés. L'esprit a pris corps. La personne morale est vivante et agissante. Elle est créée par les associés, mais la créature est plus forte que le créateur."

²¹ Millon, D (1990) (*supra*) at 202

regulatory agenda: the way in which the corporation was run was a private matter, and so it should be left to regulate itself internally. Its anti-regulatory agenda taken away from it, the contractual model went into abeyance until the 1980s, when managerialism came under fire for allowing management to act in a self-serving way and to build empires rather than concentrate on objectively verifiable tasks like improving productive efficiency and shareholder value. The political stakeholder model must now be considered in the light of this re-emergence of the contractual model. As we shall see in Chapter 3, it was not until the 1990s that a comprehensive economic response to the contractual model began to be elaborated.

The Company as Social Institution: Corporate Social Responsibility

Corporate Social Responsibility (CSR) embodies the notion that the corporate entity as a social actor should be responsible to the society in which it operates. It draws the attention of management who make decisions on behalf of the corporate "entity" to their broader social responsibilities. CSR dates back at least as far as the Great Depression, and perhaps even to the Industrial Revolution and Robert Owen's New Lanark project. An explicit formulation of the corporate social responsibility perspective may be found in Berle and Means' radical conclusion that the modern corporation had become "quasi-public". Great power to affect society was becoming concentrated in the hands of those holding managerial positions and decision-making power, and so the "organizations which they control have passed far beyond the realm of private enterprise - they have become more nearly social institutions."²² The corporation was now characterised by "the interrelation of a wide diversity of economic interests,- those of the 'owners' who supply capital, those of the workers who 'create', those of the consumers who give value to the products of enterprise, and above all those of the control who wield power."²³ This more pluralistic and relational conception of the company suggests that it is both embedded in, and functionally differentiated from, society.²⁴ Since the company consists of social relationships, it is desirable that the "control" should act in the interests of society.

²² Berle, AA and Means, G, *The Modern Corporation and Private Property* (1932) at 46

²³ *ibid* at 309-10

²⁴ Where the corporation is considered as a differentiated functional subsystem of broader society, a systems theory approach to CSR is possible. CSR, whatever form it eventually takes, is a mechanism at the

Berle appears to have been influenced by his famous 1931-2 exchange with Dodd.²⁵ Berle had opened the debate by asserting that "all powers granted to a corporation or to the management of a corporation...are necessarily and at all times exercisable only for the ratable benefit of all the shareholders as their interest appears."²⁶ In response, Dodd argued that since the company was a legal entity distinct from its shareholders,²⁷ it should not be run by management directly for the shareholders without taking into account non-shareholder constituencies, such as employees and customers. More generally, management should choose to run the corporation so that it behaves as a responsible citizen according to the society in which it does business.²⁸ The managers of the corporation should be considered the trustees of an institution, which "has a social service as well as a profit-making function",²⁹ and should use their discretion to take into account stakeholders other than shareholders when making decisions.³⁰

level of the individual company which allows the concerns of broader society to be internalised within the corporation's decision-making process, while permitting the functional subsystem to retain its autonomy: "Functional differentiation requires a displacement of integrative mechanisms from the level of society to the level of subsystems." (Teubner, "Corporate Fiduciary Duties and their Beneficiaries: A Functional Approach to the Legal Institutionalization of Corporate Responsibility" in Hopt, KJ and Teubner, G (eds), *Corporate Governance and Directors' Liabilities* (1985), 149 at 162. This sets the law the task of "stimulating" self- (or "reflexive") regulation rather than its more traditional direct "command" regulation or facilitation.

²⁵ See Berle, AA, "Corporate Powers as Powers in Trust" (1931) 44 *Harvard Law Review* 1049; Dodd, EM, "For Whom are Corporate Managers Trustees?" (1932) 45 *Harvard Law Journal* 1145; Berle, AA, "For Whom Corporate Managers Are Trustees: A Note" (1932) 45 *Harvard Law Review* 1365.

²⁶ Berle, AA (1931) (*supra*) at 1049; of course, as one would expect from a reading of his seminal work which would appear later in 1932, Berle was concerned that if management were not accountable to someone, "management and 'control' [would] become for all practical purposes absolute". Hence his reply to Dodd that "you cannot abandon emphasis on 'the view that business corporations exist for the sole purpose of making profits for their stockholders' until such time as you are prepared to offer a clear and reasonably enforceable scheme of responsibilities to someone else." (Berle, AA (1932) (*supra*) at 1367)

²⁷ Dodd's ontology of the corporation followed in the tradition of the corporate realists. He argued at 1160 that "...any organized group, particularly if its organization is of a permanent character, is a factual unit, 'a body which from no fiction of law but from the very nature of things differs from the individuals of whom it is constituted' ...If the unity of the corporate body is real, then there is reality and not simply legal fiction in the proposition that the managers of the unit are fiduciaries for it and not merely for its individual members...trustees for an institution rather than attorneys for the stockholders."

²⁸ According to Dodd, EM (1932) (*supra* note 25) at 1161, the company, "like other persons engaged in business, is affected not only by the laws which regulate business, but by the attitude of public and business opinion as to the social obligations of business."

²⁹ *ibid* at 1148

³⁰ From a contractualist perspective, this imposes agency costs on the shareholders.

Both Berle and Dodd's arguments about the way in which management should run corporations may be accommodated within the current legal fabric of managerialism.³¹ CSR, as formulated by Dodd, encompasses both "prudential"³² actions and "other-regarding"³³ actions. Manne argues that the term "CSR" should be restricted to "elements of voluntarism and charitable intent."³⁴ "Prudential" action aimed at maximising the firm's profits by instrumentalising, for example, the employees, should simply be recognised as "good business because it is good public relations,"³⁵ although "it is often extremely difficult, if not impossible, to distinguish a purely business expenditure only alleged to have been made for the public's good from one actually made with real charitable intent."³⁶ Dodd also recognised that where managers "take into consideration the welfare of employees and consumers... [this] will in the long run increase the profits of stockholders."³⁷ Yet his notion of CSR was not as attenuated and narrowly instrumental as the concept of "enlightened shareholder value", and he refused to limit management's responsibility to developing "a more intelligent appreciation of what tends to the ultimate benefit of their stockholders."³⁸ Dodd optimistically predicted the development of "other-regarding" CSR according to which management would occupy a more neutral role among the various constituencies, on the basis both that "[p]ower over

³¹ Teubner (1985) (*supra* note 24), with his notion of the corporation's interest in itself, suggests at 151 that Berle and Dodd's discussion "poses the wrong question by searching for those social groups which are to be regarded as beneficiaries of fiduciary duties." Social groups may be instrumental in articulating the interests of society, but they themselves should not be considered as the beneficiaries of duties. The true goal of the corporation is to further the social function of the economy, defined at 162 as "*ensuring the satisfaction of future social needs...the diversion of as large as possible a yield from the production process to guarantee the satisfaction of future needs, which in concrete terms is manifested by different forms of profit, taxes and wages.*" (emphasis in original)

³² Parkinson, J, *Corporate Power and Responsibility: Issues in the Theory of Company Law* (1993) at 268-9: "Prudential constraints are reflected in rules and practices that require a sacrifice of profits in the short term, but which have a long-term profit pay-off for the company."

³³ *ibid* at 269-70: "Other-regarding constraints are directly focused on protecting the interests of parties likely to be affected by the company's activities. They are adopted not with the ultimate aim of protecting profitability, but for the sake of the relevant interests themselves."

³⁴ Manne, HG and Wallich, HC, *The Modern Corporation and Social Responsibility* (1972) at 6. Manne theorised at 15-19 that the scope for "other regarding" or "charitable" CSR on the part of incumbent management is limited to the transaction costs of the takeover which would remove them from office. "If there were no transaction costs in the operation of the market for corporate control, no manager who did not himself own sufficient shares to control a corporation could ever use corporate funds for non-profitable social purposes." (at 18)

³⁵ *ibid* at 11

³⁶ *ibid* at 8

³⁷ Dodd, EM (1932) (*supra* note 25) at 1156

³⁸ *ibid*

the lives of others tends to create on the part of those most worthy to exercise it a sense of responsibility", leading to the development of a "community of interest" between management and employees.

However, Dodd's idea that management might develop a broader conception of their role has not become either legal or market reality, and debate about CSR has been largely confined to arguments that corporations should voluntarily accept their social responsibilities as a matter of good business practice. For example, the European Commission recently defined CSR as "a concept whereby companies decide voluntarily to contribute to a better society and a cleaner environment...companies integrate social and environmental concerns in their business operations and in their interaction with stakeholders on a voluntary basis."³⁹ Voluntary self-regulation is compatible with profit-maximisation where it is an "economically rational response to the preferences of the parties with whom the company interacts in various markets or public opinion more generally."⁴⁰ A code of conduct which contains an undertaking to treat employees well will enable companies to recruit and retain better employees, leading to better performance over time, and consequently higher returns to shareholders.⁴¹

The limitation of the scope of CSR to voluntary action within the existing legal framework has been explained on the basis that "Legal solutions to the responsibility conundrum are not, however, easy to find."⁴² In particular, as we saw in the previous chapter, dominant norms of shareholder value and agency theory insist that profit maximisation within the law is a good proxy for social welfare.⁴³ By contrast, enshrining a wider set of considerations into company law risks leaving management with an

³⁹ Commission Green Paper on Promoting a European Framework for Corporate Social Responsibility, COM (2001) 366 final, 18.7.2001, pp4-6

⁴⁰ Parkinson, J (1993) (*supra* note 32) at 269

⁴¹ Voluntary CSR may intersect with industrial democracy and participation where, for example, the company's employees are also involved in the development, implementation and oversight of the company's code of conduct. See Sobczak, A, *Réseaux De Sociétés Et Codes De Conduite: Un Nouveau Modèle De Régulation Des Relations De Travail Pour Les Entreprises Européennes* (2002) at 219 *et seq.*

⁴² Wedderburn, "The Legal Development of Corporate Responsibility: For Whom Will Corporate Managers Be Trustees?" in Hopt, KJ and Teubner, G (eds), *Corporate Governance and Directors' Liabilities* (1985), 3 at 15.

unacceptable degree of autonomy to pursue their notion of the public interest whenever it serves their own.⁴⁴ These arguments are discussed in some detail below.

Industrial Democracy

In contrast to these recent more outward-looking voluntary CSR initiatives, the political stakeholding debate historically tended to concentrate on the position of employees within the corporate enterprise, and in particular on the idea that corporate decision-making should be democratised. Wedderburn notes that the "reasons why the British debate about corporate social responsibility became in the 1970s a debate mainly about 'industrial democracy' are, however, very complex and still unclear."⁴⁵ Industrial democracy may be distinguished from CSR on the basis that it sought employee participation in internal corporate decision-making structures, not only at workplace or shop-floor levels, but also at board level,⁴⁶ rather than simply to persuade or mandate decision-makers to take into account a broader range of interests.⁴⁷ Accordingly, while industrial democracy may be "incapable of definition,"⁴⁸ it asks in essence whether "we can, by law, create a new, bipartite control, out of which to achieve a redefinition of corporate powers held in trust."⁴⁹ Critics such as Hansmann argue that employee involvement in decision-making would institutionalise conflict and slow down decision-

⁴³ Teubner, (1985) (*supra* note 24) at 158: "In this view, it is the political process that defines society's expectations for the scope of CSR, in terms of legal norms."

⁴⁴ In addition, as Stone, (1985) (*supra* note 10) suggests at 135, "even if we regard the law-corrected market signal as an imperfect proxy for the social welfare, it may nonetheless, process legitimacy and so on considered, be superior to the judgment of the managers as to what's best for the whole society on the whole."

⁴⁵ Wedderburn, (1985) (*supra* note 42) at 32. Perhaps the reason for the difference in the debate between Europe and America may be traced to the more radical orientation of European trade unions: as O'Sullivan, MA, *Contests for Corporate Control: Corporate Governance and Economic Performance in the United States and Germany* (2000) explains at 57, American unions, as part of the broader industrial settlement, did not in general challenge the principle of managerial control.

⁴⁶ For example, the mandate of the Bullock Committee (below note 77) referred to "the need for a radical extension of industrial democracy in the control of companies by means of representation on boards of directors."

⁴⁷ Unger, RM, *Democracy Realized: The Progressive Alternative* (1998) suggests at 42 that a "radical-democratic program would change the institutional forms of the regulated market economy."

⁴⁸ Kahn-Freund, O, "Industrial Democracy" (1977) 6 *Industrial Law Journal* 65 at 65. The Webbs were among early users of the term, although according to Kahn-Freund, their usage referred to the collective bargaining functions of trade unions. The Bullock Report (below note 77) at 20 includes an extensive discussion.

making. However, it has equally been suggested by analogy with political constitutionalism that a "scheme of checks and balances" requiring "consensus among the constituencies of the firm for every major decision"⁵⁰ might actually improve the quality of decision-making.

As a section of society, which is merely functionally differentiated, the company remains subject to the same democratic imperative as wider society. The corporation is treated as a system of government, which is used to facilitate production through the hierarchical division of labour. The dominant contractual view, according to which the corporation is a purely private arrangement in which citizens' waive their right to self-determination while they are at work, is rejected. Since labour cannot be separated from the person who supplies it, the direction of work necessarily also involves the direction of people. The democratic imperative insists that:

"Any company with people *working* in it is an institution of governance—so the question of democracy arises...Democracy is a structure for the governance of people, not the management of property."⁵¹

In attempting to counteract the rather coercive character of the corporate authority structure, "[s]takeholding offers a distinctive view on 'labour', seeing 'labour' as a member of an organisation rather than as a commodity, one which is sharply at variance with that of mainstream economics."⁵² In this sense, the stakeholder model aims for the

⁴⁹ Wedderburn, Lord, "Trust, Corporation and the Worker" (1985) 23 *Osgood Hall Law Journal* 203 at 235; in this sense it seems to consider shareholders and employees as the potential controllers of the corporation: see the discussion of the Bullock report below.

⁵⁰ Unger, RM (1998) (*supra* note 47) at 44. Unger compares this institutional reform to the American Constitution's restrictions on the powers of the president, which were "designed to slow politics down (for the sake of liberty and property)".

⁵¹ Ellerman, D, *The Democratic Firm* (1997), ch2; this is not a new approach: see for example Berle, AA (1932) (*supra* note 25) at 1366: "the task of...administrators is, fundamentally, that of industrial government." Ellerman asks whether "a company [is] an organization for the governance of people or only for the administration of things?" and concludes that "If a company carries out any productive or service operations, then the people conducting those operations are governed by the company within the scope of those operations."

⁵² Sachdev and Wilkinson, "Raising the Stakes: Stakeholding and the Organisation of Work" in Collins, H Davies P and Rideout, R (eds), *Legal Regulation of the Employment Relation* (2000), at 564

decommodification of labour, insisting on a role for status⁵³ and, like labour law, seeking to emancipate and redress inequalities of bargaining power, rather than to resolve the narrowly-defined agency problem at the heart of most discussions of company law and corporate governance. Its emphasis on hierarchical aspects of the corporation at the expense of contractual elements echoes Kahn-Freund's claim that "submission and... subordination may be concealed by that indispensable figment of the legal mind known as the "contract of employment."⁵⁴

Despite these parallels with the goals of labour law, advocates of industrial democracy demanded participatory mechanisms at the level of the individual company rather than at a sectoral or industrial level.⁵⁵ Employees would be granted rights simply by virtue of their status as members of the company, rights which would affect the allocation of decision-making power within the corporation, and so should be considered more typical of company law than labour law.⁵⁶ In this sense, demands for industrial democracy put doctrinal distinctions under some pressure, as internal corporate decision-making and the concerns of employees had hitherto tended to kept in different "boxes" (at least in common law jurisdictions).⁵⁷ While the concerns of the agency model delimit, more or

⁵³ See Streeck, "Status and Contract: Basic Categories of a Sociological Theory of Industrial Relations" in Sugarman, D and Teubner, G (eds), *Regulating Corporate Groups in Europe* (1990), 107-141

⁵⁴ Kahn-Freund, O, *Labour and the Law* (1983) at 18

⁵⁵ If truly participatory democratic structures are introduced in the corporate decision-making process, then employees may be freed from the dual colonisation of their "life-world" by both legislative intervention and collective agreements, both of which treat them as members of a collective only. See further Simitis, "The Rediscovery of the Individual in Labour Law" in Rogowski, R and Wilthagen, T (eds), *Reflexive Labour Law* (1994). Of course, whether participatory rather than representative democracy is likely to result from the reforms proposed by this model is a moot point.

⁵⁶ Streeck, W, "Industrial Citizenship under Regime Competition: the Case of the European Works Councils" (1997) 4 *Journal of European Public Policy* 643 at 644: "Rights based in company law ensure collective participation of workforces in a firm's economic decision-making; as they touch upon the exercise of property rights, they represent a stronger version of industrial citizenship that is politically more demanding to institute. Rights based in labour law are more concerned with the workplace as such, or with the plant as distinguished from the enterprise. While company-law participation rights interfere with the rights of owners in the firm, labour-law participation rights modify managerial prerogative in the day-to-day governance of the employment relationship. The two kinds of participation rights are not always entirely separable, and some issues can in principle be addressed under either company or labour law."

⁵⁷ The controversy generated by these proposals may be seen, for example, in Kahn-Freund, O (1977) (*supra* note 48) at 75-7. He insisted that pluralistic regulation through collective bargaining at the enterprise level was preferable to company law reform. Measures falling short of representation, like "mere consultation, though well meant, may have the psychological effect of a charade." Further, the employees' representatives would be afflicted with a conflict of interest as they would owe duties both to the employees and to the company. An additional supporting substructure is required where a two-tier board

less comprehensively, the scope to date of Anglo-American company law, the concerns of the political stakeholding model have traditionally been met in those legal systems through the provisions of collective labour law. Some political stakeholding measures have traditionally been included in continental systems of company law. The clash between these two different conceptions of the scope of company law is visible in the "industrial restructuring" directives, and should become apparent in the final chapter's analysis of the proposed EC takeover directive.

Instrumental Rationales for Industrial Democracy

Looked at through the lens of the democratic imperative, the introduction of employee participation in corporate decision-making has a value *per se*.⁵⁸ As part of society, the corporation may only be legitimised through the democratisation of its governance procedures. This primary rationale is often supported by secondary arguments to the effect that reform of corporate decision-making might also be instrumentalised in order to achieve other goals. For example, some discussions suggest that economic efficiency may be a favourable by-product of more democratic firms.⁵⁹ Similarly, the introduction

structure is created so that the supervisory board is not marginalised, and a one-tier board structure requires extensive delegation if it is to avoid "management by negotiation". The end result is that the likely "ineffective representation...may, in this respect, be the equivalent of mere consultation." For a more positive assessment of consultation and its historical role as part of a "double helix" with collective bargaining, see Wedderburn, Lord, "Consultation and Collective Bargaining in Europe: Success or Ideology?" (1997) 26 *Industrial Law Journal* 1 at 30-32, although he also insists it is not a suitable replacement for collective bargaining. Armour, J and Deakin, S, "Insolvency and Employment Protection: the Mixed Effects of the Acquired Rights Directive" (*ESRC Working Paper 2002*) suggest that the legislative provision of rights to consultation create sequential process rights in corporate governance which are only triggered by events that threaten a certain constituency's interests. For example, the board's right to sell part of the enterprise may be de facto limited by the requirement of the Acquired Rights Directive (2001/23/EC) that employees be consulted, and the CRD (98/59/EC) may similarly limit their right to make large scale redundancies. Although these are measures of employment protection, they impinge on the board's company law right to manage because failure to comply may give rise to an obligation to pay compensation. These directives played an important role in the outcome of the Rover/BMW affair by penalising bids which sought to break up the company: see Armour, J, Deakin, S, and Konzelmann, S, "Shareholder Primacy and the Trajectory of UK Corporate Governance" (2003) *ESRC Centre for Business Research, University of Cambridge, Working Paper No. 266* at 14-16.

⁵⁸ For example, Stone, (1985) (*supra* note 10) at 136 (footnote added) refers to "a moral good that deserves an accounting independent of its social welfare consequences... democratic process can be defended on grounds other than that it provides more beneficial results."

⁵⁹ See for example, Hurst, "From the Economic to the Political" in Kelly, D, Kelly, G, and Gamble, A (eds), *Stakeholder Capitalism* (1997), 63 who argues that "uncontrolled power is not the most efficient route to wealth creation if it ignores the knowledge and experience of employees, and if it fails to motivate employees by not actively involving them." See also generally Kelly, G, Kelly, D, and Gamble, A eds, *Stakeholder Capitalism* (1997). In more interventionist terms, Hutton, W, *The State We'Re In* (1996) argues

of democracy might also be justified politically on the grounds of redistribution of wealth. Cheffins suggests that "a legal regime which provides workers with rights and bargaining leverage unavailable in an unregulated market may well help to yield a more equal allocation of wealth in society. Hence, it is possible to develop a plausible redistribution argument to support corporate law rules which will improve the position of the workforce."⁶⁰

Advocates of an instrumental approach to industrial democracy advance three main inter-related arguments for improving "participation"⁶¹: humanistic, power-sharing and economic efficiency.⁶²

The *humanistic* case for participation is that one should aim to "satisfy employees' non-pecuniary needs including those for creativity, achievement and social approval. For employees, having a voice in how they do their work may be as important as how much they are paid for it."⁶³ It is argued that participation enables individuals to learn about socially responsible action since this is the only type of action to which others will agree, and that this in turn might be instrumental in bringing about change at the societal level.⁶⁴

The *power-sharing* case raises a moral and political argument based on the inalienable right of human beings to self-government.⁶⁵ "traditional autocratic relationships are inherently unjust and inconsistent with the values of a democratic society."⁶⁶ Going further, one might say that "if democracy is justified in the government of our state, then

at 285 that "Free markets do not necessarily produce the "best" institutions and outcomes; they must be carefully sustained by social and public action."

⁶⁰ Cheffins, BR, *Company Law: Theory, Structure, Operation* (1997) at 151

⁶¹ Defined as "how people interact with each other in an organizational context" by Heller, F, Pusia, E, Strauss, G, and Wilpert, B, *Organizational Participation: Myth and Reality* (1998) at 6

⁶² *ibid* at 8-10

⁶³ *ibid* at 8. The authors argue at 68 that it is often impossible to separate satisfaction derived from taking part from sharing in the results. the outcomes to which that participation leads.

⁶⁴ Pateman, C, *Participation and Democratic Theory* (1970). Similarly Dahl, RA, *A Preface to Economic Democracy* (1985) argues at 94 that "democracy within firms would improve the quality of democracy in the government of the state by transforming us into better citizens and by facilitating greater political equality among us."

⁶⁵ See for example, Dahl, RA (1985) (*supra*) at 61

⁶⁶ Heller, F, Pusia, E, Strauss, G, and Wilpert, B (1998) (*supra* note 61) at 8-9

it is also justified in the governments that make decisions within firms."⁶⁷ The actual measures needed to achieve industrial democracy will depend on existing institutional arrangements in the jurisdiction and industrial sector in question. The democratic goal is more important than the precise way in which it is achieved. For example, there may be no need for second channel representation if there is a strong workplace union.⁶⁸ Alternatively, firm level participation mechanisms may compensate for the lack of a union. As Streeck and Rogers point out, a whole spectrum of combinations between collective bargaining and other participation methods is possible:

"The purpose of second channel institutions is to give workers a voice in the governance of the shop floor and the firm, and to facilitate communication and cooperation between management and labor on production-related matters, more or less free of direct distributive conflicts over wages...Where unions and collective bargaining are centralized at the national or sectoral level, outside the firm - as in the Netherlands and Germany - or where unions are weak and not widely present at the workplace - as in France and Spain - second channel functions are usually performed by what are known as *works councils*...."⁶⁹

They argue that the continuing decline of union membership in the UK raises fears of a US-style "representation gap" in which "basic democratic ideals are compromised."⁷⁰ These representational concerns demonstrate the importance of recent EC directives concerning works councils and information and consultation procedures from a democratic perspective.

⁶⁷ Dahl, RA (1985) (*supra* note 64) at 94

⁶⁸ See Gospel, H and Willman, P, "High Performance Workplaces: the Role of Employee Involvement in a Modern Economy" (*Centre for Economic Performance Working Paper February 2003* at 8-11

⁶⁹ Rogers and Streeck, "Workplace Representation Overseas: The Works Councils Story" in Freeman, RB (ed), *Working Under Different Rules* (1994), 97-156 at 97-8. In Germany, works councils and board level representation together constitute the system of co-determination - see further chapter 6. On the other hand, the EC Works Council Directive appears to treat works councils as qualitatively different from co-determination.

⁷⁰ *ibid* at 98

The *economic efficiency* argument for political stakeholding is that participation will lead to improvements in decision-making through the circulation of information, easier implementation of decisions, enhanced motivation of the workforce through goal-setting, and may improve cooperation and coordination as well as organizational learning.⁷¹ This uses a dynamic as opposed to static notion of efficiency,⁷² i.e., efficiency which increases over time with repeated interactions, and which may offer the following benefits: less supervision required as self-supervision becomes possible; resultant non-adversarial relations; employees learn new skills and leadership potential is developed and identified.⁷³ It should also provide the company with "the economic benefits of a stable workforce with low turnover and correspondingly high social integration."⁷⁴

The Fate of Industrial Democracy

Demands for industrial democracy during the 1970s were reflected in a number of high level reports. The European Commission issued a Green Paper in 1975 entitled "Employee Participation and Company Structure",⁷⁵ in which it referred to the "democratic imperative" that "those who will be substantially affected by decisions made by social and political institutions must be involved in the making of those decisions."⁷⁶ Similarly, the Bullock Report in Britain referred to "the principle that a socially responsible company in a democratic society cannot operate without taking account of the interests of its employees."⁷⁷ The report explained that these "[n]ew conceptions of

⁷¹ Heller, F, Pusia, E, Strauss, G, and Wilpert, B (1998) (*supra* note 61) at 10; Bowles and Gintis, "Is the Demand for Workplace Democracy Redundant in a Liberal Economy?" in Pagano, U and Rowthorn, R (eds), *Democracy and Efficiency in the Economic Enterprise* (1996), 64-81 at 75; in a similar vein, Kelly, G, Kelly, D, and Gamble, A eds (1997) (*supra* note 59) at 244 argue that "companies which draw on the experience of all their stakeholders will be more efficient." O'Sullivan, MA (2000) (*supra* note 45) at 53 describes this as a "rather hopeful" statement. Economic arguments in favour of participation are taken up in more detail in Chapter 3.

⁷² Aoki, M, "Towards an Economic Model of the Japanese Firm" (1990) 28 *Journal of Economic Literature* 1

⁷³ Heller, F, Pusia, E, Strauss, G, and Wilpert, B (1998) (*supra* note 61) note at 10 and in Chapter 6 that participation cannot be introduced in isolation from other policies such as training, performance-based pay and job security.

⁷⁴ Streeck, W, "The Transformation of Corporate Organization in Europe: An Overview" (2001) *MPIfG Working Paper 01/8, December 2001*

⁷⁵ Bull Supp 8/75

⁷⁶ *ibid* at 9

⁷⁷ *Report of the Committee of Inquiry on Industrial Democracy* (Cmd. 6706, 1977) ("the Bullock Report") at 21. Coming when it did, the Bullock Report also generated a great deal of interest in Europe: see for

the role of employees in decision-making at company level are not just reactions to economic trends. They also derive from social changes which have taken place since the war, especially rising standards of education and higher standards of living."⁷⁸

These reports and accompanying reform proposals were not well received by those already involved in the governance of the employment relationship. Proposals to introduce industrial democracy in its co-determination form were opposed not only, as might be expected, by industrialists⁷⁹ but also by trade unions that favoured "pluralist" collective bargaining over a "unitary" conception of industrial relations.⁸⁰ In response to these objections, others questioned whether weaker forms of worker involvement would be sufficient to achieve the democratization goal, noting that "participation in decision-making is a very different animal in the labour relations zoo from consultation of workers by a management which retains full discretion to make the critical decisions."⁸¹

These objections meant that, in contrast to CSR, which basically left the existing structure of corporate decision-making intact, the industrial democracy debate was inextricably caught up with discussions about company law reform.⁸² As Wedderburn said of the Bullock Committee, of which he was a member, "the view was widespread that if workers' influence was to be felt in the taking of critical decisions about the enterprise, new institutions should at least be considered.... It seemed quite absurd to say that directors in the modern company were subjected to fiduciary duties which involved

example, Sciarra, S (ed), *Democrazia Politica e Democrazia Industriale* (1978); Montalenti, P (ed), *Operai Ed Europa: La Partecipazione Dei Lavoratori Alla Gestione Dell'Impresa* (1981).

⁷⁸ *ibid* at 22

⁷⁹ Among many others, Wedderburn, (1985) (*supra* note 42) at 37 cites the CBI's "Replies to Bullock" and the Institute of Directors' "The EEC Vth Directive - A Trojan Bullock". Wedderburn notes that while there was an "overwhelming" interest in participatory management, only a minority realised that this would have an effect on the managerial prerogative.

⁸⁰ See, for an example of this logic, Kahn-Freund, O (1977) (*supra* note 48) , who argued that there was a straight dichotomy between "unitary" and "pluralistic" forms of employee representation. For criticism that these "old maps...are inadequate", see Davies, P and Wedderburn, Lord, "The Land of Industrial Democracy" (1977) 6 *Industrial Law Journal* 197-211 at 211. They saw the Bullock report as seeking "conflictual partnership", and argued that collective bargaining was merely one form of joint regulation of the employment relationship.

⁸¹ Wedderburn, Lord (1985) (*supra* note 49) at 248; however in Wedderburn, Lord (1997) (*supra* note 57) at 28 he recognises that consultation and collective bargaining may be complementary and that the distinction may even become blurred.

⁸² Wedderburn, Lord (1985) (*supra* note 49) at 249

shareholders and employees equally and then to omit the employees altogether from the constitution of the incorporated enterprise. Such an offer to the workers would be little better than a fraudulent prospectus."⁸³

A Definition of Political Stakeholding

The stakeholding model of the company draws heavily on these varied and rich intellectual traditions. Although mainly developed and applied to companies,⁸⁴ as a political theory it demands increased participation in other institutions, such as local government and universities.

As recently as 1984, stakeholders were broadly defined as "any group or individual who can affect or is affected by the achievement of a corporation's objectives."⁸⁵ Ellerman gave this definition a more precise texture, uniting the industrial democracy and CSR constituencies into a single formulation, insisting that the "*stakeholders* in an enterprise [are] all those people who are either governed by the enterprise management or whose interests are affected by the enterprise...."⁸⁶ Some communitarians even claim that the "stakeholders in this corporate entity include...the immediate community, and indeed, the general society."⁸⁷

Such sweeping definitions have been heavily criticised both within economics and law for indeterminacy, and for being of little use in assessing management performance or giving concrete form to the law.⁸⁸ However, the difficult question of whether "the general

⁸³ *ibid* at 240; of course, this was to some extent the outcome, in the form of the unenforceable "window dressing" (per Birds, J, "Making Directors do their Duties" (1980) Co Law 67 at 73) of section 309, introduced in the Companies Act 1980, mandating the board to "have regard" to the interests of employees.

⁸⁴ Plender, J (1997) (*supra* note 7) at 16

⁸⁵ Freeman, RE, *Strategic Management: A Stakeholder Approach* (1984, Pitman, Boston)

⁸⁶ Ellerman, D (1997) (*supra* note 51), ch2

⁸⁷ Dinh, VD, "Codetermination and Corporate Governance in a Multinational Business Enterprise" (1999) 24 *Iowa Journal of Corporation Law* 975 at 985

⁸⁸ For example, Jensen, MC, "Value Maximization, Stakeholder Theory, and the Corporate Objective Function" (2001) *Harvard Business School Working Paper 00-058* at 2-3 argues, with some exaggeration, that under this model the stakeholder category may be considered to "include all individuals or groups who can substantially affect the welfare of the firm: not only the financial claimants but also employees, customers, communities, and government officials - and under some interpretations, the environment, terrorists, blackmailers, and thieves." See also Johnston, JF, "No Man Can Serve Two Masters" (1998) *Social Affairs Unit Research Report 25*.

society" may in any meaningful *legal* as opposed to political sense be considered a stakeholder of a corporation may be left aside because the focus of this thesis is on the position of employees. In any account of political stakeholding, employees are considered "internal" to the company⁸⁹ because they are "governed" while other constituencies are merely "affected". Employees fall within the "governed" category because they "(within certain limits) take orders from the enterprise management, i.e., ... are under the authority of the managers."⁹⁰ Accordingly, their interests should be dealt with within the corporation's internal structure, while the affected should be protected through legislation.⁹¹

Implementation into Law

As a general project, political stakeholding offers several suggestions for reform of company law:

i) Board as trustees

"Stakeholder theory proposed instead a view of the managerial role which came closer to trusteeship, where the trustees' role was to balance the interests of the various constituencies in the business and to recognize a wider responsibility to society."⁹²

Establishing the board as mediating figures is a paradigmatic example of the implementation of other-regarding CSR, and is arguably what company law already does with its insistence that management owe their duties to the corporate entity rather than to the shareholders collectively. While the precise extent to which the law (as opposed to capital market pressure) obliges management to advance the interests of shareholders, management is certainly entitled, in the exercise of its discretion, to make long-term plans in which the pay-off to shareholders will be considerably deferred. This allows the board to take employees' interests into account in running the business, and the link between the treatment of employees and the return to shareholders does not have to be

⁸⁹ See Kelly, M, *The Divine Right of Capital* (2003) at 145-6

⁹⁰ Ellerman, D (1997) (*supra* note 51)

⁹¹ Kelly, M (2003) (*supra* note 89) at 145-6

⁹² Plender, J (1997) (*supra* note 7) at 17

too specific. As long as the company is a going concern, any actions taken by the board to favour employees may be considered in terms of developing good industrial relations. In any review of management's actions, the courts will simply look at whether the action in question was capable of benefiting the shareholders. The business judgement rule mandates a fairly hands-off approach by the courts on the basis that the task of formulating business policy belongs to the directors and not to the courts. The courts therefore will not intervene unless it is clear that an action could not benefit the shareholders.⁹³ The proper response for dissatisfied shareholders is to use their power to remove the board rather than to attempt to litigate the matter before the courts. This "prudential" interpretation of the board's duties is consistent with both the agency and stakeholder models, and is widely disseminated through voluntary CSR measures, such as codes of conduct.

In England and Wales,⁹⁴ management is also required to take into account the interests of employees, although this duty is unenforceable by the employees.⁹⁵ A broad reading of the obligation suggests that they are entitled to do so even where there is no conceivable benefit for the shareholders, and suggests that further reform to give management greater autonomy from the various corporate constituencies would be appropriate.⁹⁶ The problem with attempting to implement a political stakeholder model through legal reform of directors' duties in isolation is that "the mechanisms of corporate governance are now largely aligned to ensure that shareholders' interests actually do get primacy."⁹⁷ The market mechanisms discussed in chapter one, and the hostile takeover, discussed in part two, which all encourage management to pursue the interests of shareholders, clearly undermine management's capacity to act as neutral trustees. Changes to the legal regime

⁹³ The facts of *Hutton v West Cork Railway* ((1883) 23 Ch 654), the main authority on this point, were exceptional because the company had no future as a going concern.

⁹⁴ Under s309 of the Companies Act 1985. This is also true of many US jurisdictions: see Chapter 4 for a discussion of corporate constituency statutes, albeit in the narrower context of takeovers.

⁹⁵ Although Parkinson, J (1993) (*supra* note 32) argues at 84 that the unenforceability of the duty reduces it to a discretion to take into account the interests of employees.

⁹⁶ See for example, Xuereb, PG, "The Juridification of Industrial Relations through Company Law Reform" (1988) 51 *Modern Law Review* 156-172, Teubner, G, "Enterprise Corporatism: New Industrial Policy and the "Essence" of the Legal Person" (1988) 36 *American Journal of Comparative Law* 130, Ireland, P, "Company Law and the Myth of Shareholder Ownership" (1999) 62 *Modern Law Review* 32

aimed at increasing managerial autonomy would have to be coupled with a reassessment of the compatibility of such market mechanisms with fiduciary duties, as well as reform of the system by which the board is appointed along more pluralistic lines. Such reforms clearly conflict with the dominant agency model, and are at present politically unlikely.

ii) Voluntary Solutions

However, there is more normative variety to the political stakeholding model than the simple categorisation of the directors as trustees. The CSR limb of political stakeholding emphasises voluntary action by the board within the current legal framework. Some commentators consider it no more than a guide to management decision-making⁹⁸ which might assist them either to indirectly enhance shareholder value through taking stakeholders into account or, more controversially, to act for other purposes. Such a guide is useful given the effects of "bounded rationality"⁹⁹ in creating "profit-undifferentiable situations": in many situations it is difficult for management to clearly identify the ideal course of action in terms of generating profits.¹⁰⁰ A code of conduct may provide useful pointers in terms of value-creation strategy.

Voluntary CSR is currently very influential, at least in terms of stimulating production of codes of conduct and other methods of highlighting corporations' socially responsible behaviour, such as social accounting. The European Commission is trying to stimulate more action in this direction, issuing a Green Paper, *Promoting a European Framework for Corporate Social Responsibility*.¹⁰¹ In that Green Paper, the Commission attempts, but ultimately fails, to bridge the gap between CSR and industrial democracy. It refers to CSR's "internal" and "external" dimensions, while emphasising the importance of voluntary solutions. "Socially responsible practices" along the "internal" dimensions

⁹⁷ Roberts, J and Van den Steen, E, "Shareholder Interests, Human Capital Investment and Corporate Governance" (*Working Paper Stanford Graduate School of Business April 2000*) at 2

⁹⁸ See for example the "balanced scorecard" approach of Kaplan, RS and Norton, DP, *The Balanced Scorecard* (1996, Harvard University Press). Jensen, MC (2001) (*supra* note 88) suggests that it should operate as "a specification tool to help managers understand what creates value in their business" rather than a legal obligation.

⁹⁹ Discussed in Chapter 3.

¹⁰⁰ Stone, (1985) (*supra* note 10) at 137

¹⁰¹ COM (2001) 366 final, 18.7.2001

appear to replace industrial democracy concerns, and "primarily involve employees and relate to issues such as investing in human capital, health and safety, and managing change..."¹⁰²

iii) Introduction of Participation

Despite these recent attempts at synthesis by the Commission, the industrial democracy strand of stakeholding is generally considered to be more normatively demanding, calling for the introduction of democratic principles into companies. Participation is a broad concept, and need not necessarily extend as far as co-determination on the German model and the right for employees to appoint representatives to the board. Lower-order procedural rights, such as informational and consultational participation can also contribute to the achievement of industrial democracy, and in particular may be combined with adversarial participation through collective bargaining. The essence of these procedures from an industrial democracy perspective is that, regardless of the identity of the final decision-maker, employees have the right to exercise some "voice" in the corporate decision-making process, whether directly or indirectly through representatives. This category may intersect with the idea of management as trustees where industrial democracy takes the form of deliberative procedures, in which employees put forward their point of view on a given issue to the decision-making trustees.

A Critique of Political Stakeholding

i) The "Multiple Goals" Argument

The main critique made of political stakeholding in the corporate context is that the concept is too broad. Critics argue that, despite its descriptive weaknesses, the agency model of the company does at least provide a useful guide to inform board decision-making, and therefore a standard against which the performance of the board may be judged. To broaden the guide to include so many other constituencies raises the old fear that management will be left accountable to no-one if they are given a completely free

¹⁰² *ibid* at 8; the potential impact of the Commission's Green Paper on takeovers is discussed in Chapter 6.

rein to identify which possibly conflicting goals they are to pursue. Managers will be able to defend self-serving actions on the basis that they were pursuing whichever goal coincides most closely with their own self-interest.¹⁰³ Easterbrook and Fischel argue that:

"...a manager told to serve two masters (a little for the equity holders, a little for the community) has been freed of both and is answerable to neither. Faced with a demand from either group, the manager can appeal to the interests of the other. Agency costs rise and social wealth falls."¹⁰⁴

Many other commentators have raised this "classic argument".¹⁰⁵ Even Wedderburn agrees that "no markers of parallel clarity to that of the profit test have yet been offered to modern management by government or society."¹⁰⁶

As suggested above, stakeholders might be narrowed down to the "governed" employees. Alternatively, stakeholding could be limited to those whose interests are not adequately protected by the law, and who therefore require some kind of protection at the level of the corporate constitution.¹⁰⁷ However, even confining political stakeholding to the interests of employees is not a complete response to the "classic argument". If the board is mandated to take into account the interests of employees alongside those of the shareholders, either in a prudential or other-regarding sense, they are still faced with

¹⁰³ Alternatively, Johnston, JF (1998) (*supra* note 88) argues at 15 that if managers act in good faith, "either they will not be able to make a decision at all, or any decision will be a watered-down compromise."

¹⁰⁴ Easterbrook, F and Fischel, D, *The Economic Structure of Company Law* (1991) at 38.

¹⁰⁵ Slinger, G, "Spanning the Gap: The Theoretical Principles that connect Stakeholder Policies to Business Performance" (*ESRC Working Paper 111, Dec 1998*) at 4; see for example, Bainbridge, SM, "In Defense of the Shareholder Wealth Maximization Norm" (1993) 50 *Washington and Lee Law Review* 1423. For a detailed exposition of the "classic argument" see Johnston, JF (1998) (*supra* note 88) who traces its origin in the corporate context to Berle, AA (1932) (*supra* note 25), and its wider societal application to 2000BC!

¹⁰⁶ Wedderburn, (1985) (*supra* note 42) at 9

¹⁰⁷ Leader, S, "Participation and Property Rights" (1999) 21 *Journal of Business Ethics* 97-109 at 106. Similarly, Kochan, TA and Rubinstein, SA, "Toward a Stakeholder Theory of the Firm: The Saturn Partnership" (2000) 11 *Organization Science* 367 suggest at 369 that stakeholders should be identified by reference to their "saliency" which is "a function of (1) the extent to which potential stakeholders contribute valued resources to the firm, (2) the extent to which they put these resources at risk and would experience costs if the firm fails or their relationship with the firm terminates, and (3) the power they have in or over an organization. Contributing valued resources creates incentives for others to recognize a potential stakeholder, while putting resources at risk gives one a moral claim to stakeholder status...however, without the other two features, a powerful group may not be perceived as legitimate by other stakeholders." This definition begins to shade into the model developed in Ch3.

multiple goals and will take whichever course of action most closely coincides with their own interests. The risk of this, as we shall see in the second part, is particularly acute in the hostile takeover situation where the incumbents' positions are under threat. Since the business judgement rule renders management's decisions broadly unreviewable, this leads to capital market pressure for deviations from the general company law rule of managerialism in the takeover situation.

ii) The "Institutional Paralysis" Argument

In terms of participation mechanisms, the representation of employees on the board alongside the shareholders' "agents" is, of course, very controversial. Calls for democratisation and employee board-level representation contradict the agency model's normative argument that the board is a specialised governance device to resolve incompleteness in shareholders' contracts. Even if one accepts, as do new institutional economists, that employees' contracts may be incomplete, the rational solution is for them to set up an appropriate governance structure to fill out the details.¹⁰⁸ To suggest that they share the shareholders' device runs the risk that the single-purpose character of the board might be subverted and will fulfil neither of its goals.

Placing employee representatives on the board runs the risk not only of rendering management unaccountable, but also of paralysing the company's decision-making organ, or simply forcing decision-making out of its formal environment to be taken elsewhere:

"Participation is not free...It brings with it all the costs of collective decision making."¹⁰⁹

Hansmann and Kraakman argue that the "growing view today is that meaningful direct worker voting participation in corporate affairs tends to produce inefficient decisions, paralysis, or weak boards, and that these costs are likely to exceed any potential benefits

¹⁰⁸ For this argument, see Williamson, OE, "Corporate Governance" (1984) 93 *Yale Law Journal* 1197, discussed in Chapter 3.

¹⁰⁹ Hansmann, H, *The Ownership of Enterprise* (1996) at 89; this argument was also made by Kahn-Freund, O (1977) (*supra* note 48), who at 79-80 referred to "management by negotiation" and the problem of deciding how much delegation the board would be allowed to make.

that worker participation might bring."¹¹⁰ While employees do bring certain strengths to the governance process, such as better incentives and ability to monitor management than shareholders, they are also afflicted by significant weaknesses. While shareholders are likely to be passive and give management free rein, employees are more likely to disagree among themselves about wages and other distributional issues such as which plants to keep open. The "extent to which employee's interests diverge in these respects is likely to increase as the division of labor within the firm increases."¹¹¹ The costs of collective decision-making make governance by employees feasible only where they are particularly homogeneous.¹¹²

Despite the difficulties associated with involving employees in governance for democratic reasons, Hansmann considers that "forms of employee participation that fall short of true ownership may offer better prospects for improving on the efficiency of the classical model...quality circles, shop floor committees, works councils, labor-management committees, and informational seats for labor on the board of directors may be more workable means of improving the flow of information between management and employees."¹¹³ Information and consultation participation fits better with an efficiency rationale than a democratic one as it may be considered to reduce transaction costs. This point is taken up in chapter 3.

iii) The "Unnecessary Duplication of Protection" Argument

Finally, Paul Davies asks whether the political stakeholding model in fact necessitates any changes to the existing system of legal protection of stakeholder interests. He suggests that the interests of non-shareholder constituencies might be considered to be

¹¹⁰ Hansmann, H and Kraakman, R (2000) (*supra* note 2) at 6; the root cause of the problem is that "the workforce in typical firms is too heterogeneous in its interests to make an effective governing body and the problems are magnified greatly when employees must share governance with investors, as in codetermined firms."

¹¹¹ Hansmann, H (1996) (*supra* note 109) at 90. A similar distributional conflict afflicts joint governance by shareholders and labour.

¹¹² *ibid* at 119. He argues that where worker representation on boards has succeeded in the US, there has tended to be little hierarchy, workers doing similar jobs, and broad equality of earnings to prevent dissension and reduce costs of collective decision-making. By contrast, co-determination was "imposed on German firms by force of law; no similar system seems to have been adopted by any significant number of firms either inside or outside of Germany in the absence of compulsion." (at 111)

fully protected by the provisions of labour, environmental and tax law.¹¹⁴ As regards employees specifically, Davies argues that employees are not employed exclusively by corporations but also by partnerships and sole traders. Regulation of the employment relationship should not depend on the form of the legal vehicle adopted by the employer.¹¹⁵ The provisions of labour law apply whenever a worker is considered to be an "employee", and do not depend in any way on the legal form of the employer.¹¹⁶

Similarly Bowles and Gintis point out that critics "have claimed that the project of democratizing the workplace is redundant given that worker autonomy is already secured by the competitive structure of labour markets and the liberal democratic structure of the state."¹¹⁷ The first aspect of this claim, of course, assumes that competitive markets will allow the worker in question to exit the firm without suffering any loss. This issue is addressed in the next chapter. The second aspect of the critique was one of the main tenets of industrial democracy, namely that democracy should be extended to the firm. In its legislative form, industrial democracy was to have been imposed by the democratic state as an extension of itself.

Davies backs up his argument by reference to the inefficiencies identified by Hansmann whenever heterogeneous employees become involved in corporate decision-making. Company law cannot be considered "the most efficient mechanism for providing that governance"¹¹⁸ if one assumes that

"the core function of company law is to regulate the input of risk capital (primarily ordinary share capital) and to some extent of loan finance (because shareholders' desire in large companies for limited liability creates extra risks for creditors) and of senior managerial exercise (because of shareholders' reliance in large companies on centralized

¹¹³ *ibid*

¹¹⁴ This argument is echoed in the Winter Report: see Chapter 6.

¹¹⁵ Davies, P, *Introduction to Company Law* (2002) at 272.

¹¹⁶ This argument does gloss over the fact that non-corporate employers tend to be smaller and less bureaucratic, making it easier for employees to gain access to the decision-makers, even if they do not have the right to actually make the decision.

¹¹⁷ Bowles and Gintis, (1996) (*supra* note 71) at 64

¹¹⁸ Davies, P (2002) (*supra* note 115) at 272

management). The law needs to provide a framework for the co-ordination of the other inputs upon which business success depends, but the process of contracting for labour or supplies, for example, does not have to be seen as part of company law."¹¹⁹

Of course, this understanding of company law is grounded in the agency model. If company law is about ensuring economic efficiency, then it appears that arguments based on the democratic rationale or the company as a social institution are not sufficient to justify the representation of employees in corporate governance processes. Industrial democracy may be achieved through the system of adversarial collective bargaining between unions and employers, and companies may act rationally and fulfil their social responsibilities voluntarily without any need for legal intervention. Nevertheless, Davies' broad formulation of the task of company law, namely the provision of "a framework for the co-ordination of the other inputs upon which business success depends", does open the door to the main argument of the next chapter, that the position of employees is analogous to that of shareholders rather than suppliers because they bear residual risk. If an economic rationale can be advanced for employee participation, then the fact that the measures also enhance democracy is another factor in favour of their adoption.

¹¹⁹ *ibid* at 272

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Chapter Three: The Productive Coalition Model

Introduction

The two models already considered either assume that employment contracts may be made explicit and thus fully protect employees from risk, or downplay the contractual aspects of the employment relationship in order to concentrate on the political detriment of corporate hierarchy to the individual. The more complete model developed in this chapter treats corporations as mechanisms for developing, and maintaining the integrity of, systems of production of which the constituent elements become co-specialised and therefore interdependent. In this model, transaction costs frequently prevent employment contracts (the employees' gateway to the productive coalition or "pactum subjectionis"¹) from being fully "presentiated" at the time of their conclusion. The firm is a governance mechanism capable of resolving this contracting problem by filling in the gaps in incomplete contracts.² Applying Easterbrook and Fischel's methodology to this contracting problem means that company law may then be explained normatively as providing a standard-form governance structure for voluntary adoption by the members of a productive coalition where it leads to lower transaction costs than market-based explicit contracting.

Despite sharing the neoclassical model's methodology, this model's normative agenda for company law differs considerably because it recognises that contracting failures may occur in respect of a wider range of key productive inputs than simply share capital. The corporate constituencies which need the benefit of a governance structure are identified by reference to the contracting problems they experience. This process suggests that many, if not all, of the corporation's employees should be considered residual claimants on the basis that

¹ Blair, MM and Stout, LA, "A Team Production Theory of Corporate Law" (1999) 85 *Virginia Law Review* 247 at 278

² Of course, this model of the employment contract has strong parallels with the agency model's assumptions about the management-shareholder contract.

"when investments in highly specialized human capital are important to the way the firm creates wealth, employees, as well as shareholders, are likely to be residual claimants and, therefore, residual risk-bearers...."³

Accordingly, in "many kinds of corporations, employees (and sometimes other major stakeholders) have as much of a claim to being owners of the corporation as do shareholders, and perhaps more so."⁴ Many employees may even bear more risk than shareholders because they are unable to minimise their risk through diversification of their investments.⁵ In addition, the job market is less liquid than the stock market, and so exit from the firm is likely to impose additional costs on employees in terms of the time it takes to find another (lower paying) job.⁶

The basic premise of this model is that when employees acquire skills which are "sunk" into the business, these should be treated as capital investments because they generate value. This "human capital" is, in the context of many modern public corporations not only scarcer and more important in creating value than financial capital, but also more difficult to attract and maintain. This change in the nature of capital complicates the role of company law: while it continues to bear responsibility for facilitating the gathering of capital, it must now ensure that the corporation's governance structure reflects and supports the changing dynamics of the productive coalition. The economic rationale for company law remains that of maximising the wealth of society by supporting the firm's

³ Blair, MM, *Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century* (1995) at 238-9: this has important normative implications: "If other stakeholders could be shown to share in the residual gains and risks, their interest in being able to exercise some control over corporations would be significantly legitimized." (ibid at 231)

⁴ ibid at 238-9

⁵ The dominance of shareholder value as a mission statement for management, combined with full portfolio diversification, makes shares even less risky. O'Sullivan, MA, *Contests for Corporate Control: Corporate Governance and Economic Performance in the United States and Germany* (2000) at 50 refers to empirical evidence which suggests that the "equity risk premium", that is the difference between the return to equity holders and the return to holders of risk-free assets like t-bills, is "a 'puzzle' because the measured risk of equity returns is not high enough to justify premia of the order of 6 per cent without resorting to unreasonable assumptions about risk aversion among investors." For statistical evidence of the extent of the premium, see Mehra, R, "The Equity Premium: Why is it a Puzzle?" (*NBER Working Paper 9512, February 2003*) at 2-4.

⁶ See O'Connor, M, "Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers" (1990) 69 *N.C.L.Rev.* 1189 at 1197 who notes that "Workers who lose their jobs to layoffs and plant closings spend an average of eight weeks trying to find other jobs."

transaction cost reduction function. However, company law and corporate governance should reflect the fact that almost all employees provide capital and bear risk, and that governance of the employment relationship is required at the level of the individual company because of increasing differentiation.

The traditional legal view of the company as a separate entity is perfectly adequate where we are dealing with explicit contracts. However, where contracts remain implicit and not legally enforceable, a systems theory perspective becomes useful. It allows a recognition that ontologically, the "corporation, in principle, is just an empty shell"⁷ which may become valuable because of "the claims the legal shell has on an underlying economic entity...the firm."⁸ The legal shell establishes a structure which governs decision-making processes and claims over the underlying firm. Accordingly, the shell should reflect the needs of that underlying productive entity for continuity and trust.

The rationale for reinforcing the modern company as a multi-party governance structure may be seen through an analogy with communitarianism. Specialisation makes all productive inputs dependent on each other and the continued existence of their "community" to sustain current levels of productivity and the generation of rents. This is a narrower notion of communitarianism than the one considered in the previous chapter. It fixes the limits of community by reference to a factual test of interdependence, which turns on the availability of a viable exit option or the ready availability of replacements, rather than simple status arising by virtue of being, for example, an employee or a supplier. The continued existence of the community depends on the maintenance of mutual confidence, so that the various factors will be prepared to "sink" the necessary investments for the enterprise to flourish in its competitive environment. The increased permanence anticipated for the productive coalition may allow a reconciliation of the contractual model of the firm with the sociological model espoused by Teubner, which

⁷ Zingales, "Corporate Governance" in Newman, P (ed), *The New Palgrave Dictionary of Economics and the Law* (1998), 495 at 498

⁸ *ibid.*

treats the interest of the company as being in itself, *unitas multiplex*, rather than giving priority to the interests of any single constituency.⁹

"...stakeholding amounts to precious little if it is deprived of its economic dimension."¹⁰

In recognising that many employees have a stake or interest in the way the corporation is governed, this model's normative conclusions are closer to those reached by the political stakeholder model than the agency model, albeit that it is concerned with economic efficiency rather than political emancipation. This synthesis of theories complements the normative arguments made by political stakeholding with a more durable economic methodology than the one typically used by political stakeholder theorists.¹¹ As Deakin and Slinger put it, the "stakeholder approach, whatever its moral justification, has always required an economic justification consisting of net benefits to the group, or society that adopted it."¹²

The Historical Evolution of the Productive Coalition Model

Company law should reflect the fact that productive relations, and the nature of "capital", have evolved considerably since the corporation was first reified and treated as a legal entity separate from its owners, the shareholders.¹³ The discovery of the corporate "entity" was a product of its times, coinciding with the demands of large-scale projects for financial capital which far exceeded the credit and scope for risk-taking of any individual entrepreneur or entrepreneurial family. The corporation emerged as an ingenious juridical invention which offered several distinct advantages. It facilitated the collection and co-ordination of the large amounts of financial capital from dispersed

⁹ See Teubner, "Company Interest: The Public Interest of the Enterprise 'in Itself'" in Rogowski, R and Wiltshagen, T (eds), *Reflexive Labour Law* (1994),

¹⁰ Plender, J, *A Stake in the Future: The Stakeholding Solution* (1997) at 16

¹¹ Who tend to "rely on sweeping and unsubstantiated assumptions about the foundations of economic success" (O'Sullivan, MA (2000) (*supra* note 5) at 52) to sustain their "hopeful" arguments that the participatory company will be more efficient.

¹² Slinger, G and Deakin, S, "Company Law as an Instrument of Inclusion: Re-Regulating Stakeholder Relations in the Context of Takeovers" (1999) *ESRC Centre for Business Research, University of Cambridge Working Paper No 145* at 3-4

investors, limiting their liability and rendering the identity of their co-investors irrelevant. It also allowed *ex ante* unpredictable returns to be allocated *ex post* in a systematic way which respected all investors.¹⁴ The corporation's utility was further broadened by the development of stock markets, which provided investors with liquidity and the opportunity to diversify their investments, while the company's management had a supply of committed capital.¹⁵ The larger the undertaking's requirement for finance, the more useful the corporation proved: this was particularly significant given the demands for financial capital involved in the construction of the railways.¹⁶

Through its provision of the corporate vehicle, the law supported the needs of underlying productive industry for scarce financial capital. Yet, while the law continued to provide essentially the same "off the peg" contract for productive organisations throughout the twentieth century, the capital requirements of firms did not remain static. It has been suggested that Western society moved during that period from the Industrial Age to the Information Age, and correspondingly from corporations based on physical assets to the "knowledge company."¹⁷ Previously, financial capital, which was required for investment in "highly specialized inanimate assets, ranging from plant and machinery to world-famous brand names"¹⁸ had been scarce,¹⁹ while the unskilled labour which would

¹³ On the emergence of the corporation from partnership, and its ongoing influence on corporate law doctrine, see Ireland, P, "Company Law and the Myth of Shareholder Ownership" (1999) 62 *Modern Law Review* 32.

¹⁴ Ripert, G, *Aspects Juridiques Du Capitalisme Moderne* (1951) at 111 sees the company as "la machine juridique...pour la simple gestion des capitaux"; Easterbrook and Fischel also define the corporation in terms of capital claims against income. As we shall see in this chapter, defining the corporation in terms of being a device for managing capital only conflicts with the agency model if one broadens the notion of capital to include human capital.

¹⁵ Although, as we saw in Chapter 1, this did undermine the willingness of shareholders to monitor management.

¹⁶ Chandler, AD, *The Visible Hand: The Managerial Revolution in American Business* (1977) at 90-2; Bratton, WW, "The New Economic Theory of the Firm: Critical Perspectives from History" (1989) 41 *Stanford Law Review* 1471 at 1488

¹⁷ Stewart, TA, *Intellectual Capital: The New Wealth of Organizations* (1997)

¹⁸ Rajan and Zingales, "The Governance of the New Enterprise" in Vives, X (ed), *Corporate Governance: Theoretical and Empirical Perspectives* (2000), 201 at 201

¹⁹ Rajan, RG and Zingales, L, *Saving Capitalism From the Capitalists* (2003) point out at 37 that between 1869 and 1899, capital invested per worker in the United States nearly tripled.

operate those machines was plentiful and interchangeable.²⁰ This was reflected in Taylorist forms of work organisation and collective representation of employees. Now, however, technological change and increased competition means that the modern knowledge corporation depends less on specialised machines and more on the skills of its workforce for its competitive advantage.²¹ Financial capital has become more readily available, whether in the form of retained earnings in the case of mature enterprises, or more generally as a result of deregulation and the globalisation of capital markets. By contrast, it is increasingly difficult to guarantee continuity of labour supply, since firm-specific skills, embodied in employees, cannot be vertically integrated.

This change in the balance of productive relations creates a new but analogous function for company law and corporate governance. With a view to ensuring continued co-operation, human capital from many sources must be combined with financial capital, coordinated, and the *ex ante* unpredictable returns allocated to all concerned in proportion to their productive contribution.²² The "sunk" investments made by these investors are of

²⁰ Rajan and Zingales (*ibid* at 41) argue that while unskilled workers could obtain employment in other firms, managers or skilled employees who were specialised to a particular firm were disadvantaged from a power perspective because they would leave behind their firm-specific human capital.

²¹ Stewart, TA (1997) (*supra* note 17) at 30 argues that in the previous age, "machines embodied all the knowledge necessary for them to do their jobs" whereas in the information age it is embodied in humans.

²² Kelly, M, *The Divine Right of Capital* (2003) argues at 35 that in fact shareholders, with their net negative equity contributions are "an immense cash drain on corporations" rather than a contributor to corporate productivity. It might be suggested, as Hansmann does in *The Ownership of Enterprise*, that, during the period when large companies were being formed, shareholders who supplied risk capital demanded control rights on the basis that they were contracting with the company for a return which could not be guaranteed *ex ante*. The productive coalition model concedes that this argument is *historically* accurate, but argues that it no longer reflects the reality of intra-corporate relations in established publicly-held companies, where dispersed shareholders no longer rely on control rights but market mechanisms to ensure their returns. Accordingly, from the perspective of the productive coalition model, path dependency may have locked the law into a sub-optimal distribution of control rights. Empirical support for this argument may be found in Singh, A, "Corporate Governance, Corporate Finance and Stock Markets in Emerging Countries" (2003) *JCLS* 41. Singh provides empirical evidence at 48-50 that companies in developing countries rely quite heavily on equity finance to fund their growth, while in developed countries such as the US and UK, new equity finance actually makes a net negative contribution to the financing of corporate growth. This is particularly notable given the imperfections in developing country stock markets (*ibid* at 50). In response to these arguments, advocates of the status quo make two points. First, they claim that the allocation of rights is still efficient because shareholders, although lacking the best incentives, are still better at monitoring than other constituencies: see text accompanying notes 109-113 in Chapter Two. Second, they claim that "impatient" shareholders are the best means available to "recycle" capital from declining industries to those new industries which need new risk capital to fund their growth. The argument that these reallocations are efficient of course depends upon the efficient markets hypothesis (which is critiqued in Chapter Four). However, the collapse of the technology bubble suggests that much of the recycled investment in the "new economy" was wasted rather than efficiently allocated: see, for example,

less value elsewhere and so generate quasi-rents,²³ so, although their interests in the distribution of rents normally conflict, continued co-operation in the framework of the corporation will be more beneficial overall to them than defection. From a macro-economic perspective, maintaining resources in the use to which they are specialised is a *pareto* efficient allocation. By maintaining the integrity of the coalition, company law helps maximise the wealth of society.²⁴

Company law has not kept pace with these changes. Margaret Blair terms the "primitive model of corporations in which shareholders are seen as earning all the returns and bearing all the risk... a throwback to an earlier time"²⁵ when entrepreneurial function and labour input were strictly separated. There the source of wealth generation could be traced back to those who bore risk and engaged in entrepreneurial endeavour, i.e., the shareholders and their agents, the managers, and before their separation, the entrepreneur. Taylorist models of production required the shop-floor to be de-skilled and management to take all decisions. Employees took no decisions and no (financial) risk. Company law does not reflect the fact that "in the 1990s, fewer and fewer publicly traded corporations actually look like the factory model. Much of the wealth-generating capacity of most modern firms is based on the skills and knowledge of the employees and the ability of the organization as a whole to put those skills to work for customers and clients."²⁶ The "downsizing" of layers of middle management, and the growth of "high-performance work practices" such as "direct workforce meetings, briefing groups, and problem solving

Stiglitz, JE, *The Roaring Nineties: Seeds of Destruction* (2003) at 62-3. For a detailed discussion of the causes behind the divergence of market prices from "fundamental value", see Shiller, RJ, *Irrational Exuberance* (2000).

²³ A rent is the surplus produced by co-operation. According to Zingales, (1998) (*supra* note 7) at 497, "The difference between what the two parties generate together and what they can obtain in the marketplace represents a quasi-rent, which needs to be divided *ex post*." In other words, the quasi-rent is the increased profit which a particular relationship generates over and above what could be achieved by the deployment of the same assets in their next best use.

²⁴ For the purposes of this chapter, it is assumed that this is a valid aim for company law; for a contrary view see Dworkin, RM, "Is Wealth a Value?" (1980) *Journal of Legal Studies* 191.

²⁵ Blair, MM (1995) (*supra* note 3) at 233

²⁶ *ibid* at 233-4: similarly, at 238: "Investments in human capital are most likely to be important in technology-intensive or service-oriented enterprises, where most of the value added comes from innovation, product customization, or specialized services." Stewart, TA (1997) (*supra* note 17) says at 49 that when "work is about knowledge, the professional model of organizational design inevitably begins to supersede the bureaucratic... When those in authority no longer comprehend the work of their subordinates, chains of command should cease to be viable for coordination."

circles"²⁷ are testimony to the new flatter hierarchy within the modern knowledge corporation and the entrepreneurial functions being exercised by individual "employees".

It is possible to go further and argue that in the modern public corporation, shareholders do not contribute to productivity and in fact "for decades have been an immense cash drain on corporations."²⁸ People who purchase stock in established publicly-traded companies rarely contribute new capital, and are more akin to speculators "buying the right to extract wealth."²⁹ The argument is that issues of new stock in a given year amount to a very small percentage of market capitalisation³⁰; when stock buy-backs, which have reached extraordinary levels, are included, the net contribution of shareholders becomes negative.³¹ The reasons companies repurchase their shares are as follows. First, while the tax treatment may differ, buybacks are functionally equivalent to paying dividends to shareholders and allow firms to divest themselves of cash flow for which they have no better use.³² Second, reducing the supply of a given stock has the effect of increasing that stock's price, benefiting those who hold stock options, increasing "shareholder value", deterring hostile takeover bids and reducing the company's cost of borrowing or taking over other enterprises. Company law continues to recognise the rights of these "most unproductive stakeholders", while denying a governance role to employees who make firm-specific investments in human capital.

²⁷ Gospel, H and Willman, P, "High Performance Workplaces: the Role of Employee Involvement in a Modern Economy" (*Centre for Economic Performance Working Paper February 2003* at 7; Osterman, P, Kochan, T, Locke, RM, and Piore, MJ, *Working in America: A Blueprint for the New Labor Market* (2001) at 81 refer to 1997 data which demonstrates the growing importance of "high-performance work practices". However, despite rapid diffusion, self-managed work teams still present problems because they "are probably the category most affected by layoffs and other radical organizational changes, since they are hard to manage successfully if the personnel keep shifting."

²⁸ Kelly, M (2003) (*supra* note 22) at 35

²⁹ *ibid*

³⁰ In 1999, around 1 percent. For precise figures see Kelly, M (2003) (*supra* note 22) at 33. "Stockholders make a onetime investment when a new share of stock is purchased, and beyond that contribute nothing. Yet the company aims to create maximum income for them forever..." (*ibid* at 39)

³¹ Latest figures from www.FederalReserve.gov (Z.1, June 5, 2003, *Flow of Funds Accounts of the United States*, Federal Reserve statistical release, first quarter 2003, F.102 Nonfarm Nonfinancial Corporate Business at 18) indicate that net new equity issues in the US for 2002 were -\$40.5 bn. In 1998 they were as high as -\$215.5bn.

³² Rajan, RG and Zingales, L (2003) (*supra* note 19) at 60-1. This is an aspect of "marketisation" of corporations: earnings should only be retained if they can produce a return higher than the market.

Transaction Cost Theory and the Development of Institutional Economics

This section looks at the nature of the transaction costs which prevent presentation of contracts and mean that employees often bear risk. It builds on Coase's insight that the firm may reduce the costs of contracting, in particular with regard to long-term arrangements. In *The Economic Institutions of Capitalism*, Williamson defines a firm transaction as co-operation within a governance framework,³³ whereas a market transaction is competition regulated by contract. The transaction cost approach compares the costs of establishing "institutional arrangements, normally referred to as governance structures"³⁴ and market contracting against their benefits in terms of maintaining the integrity of transactions.³⁵ Transaction costs arise both *ex ante* (in the form of "drafting, negotiating and safeguarding an agreement"³⁶) and *ex post* (in the form of "haggling costs incurred if bilateral efforts are made to correct *ex post* misalignments...the setup and running costs associated with the governance structures (often not the courts to which disputes are referred), and...the bonding costs of effecting secure commitments").³⁷ However, these costs are "interdependent" and "must be addressed simultaneously rather than sequentially."³⁸

Williamson insists that his analysis is "complementary to, rather than a substitute for, conventional analysis"³⁹ as embodied in the neoclassical model of the firm. His model simply fills in the gaps where the neoclassical model "operates at too high a level of abstraction".⁴⁰ It concentrates, in particular, on the difficulties (or transaction costs)

³³ Williamson, OE, *The Economic Institutions of Capitalism* (1985) at 18. His approach is contractual because it treats the business firm as a governance structure rather than a production function.

³⁴ Williamson, "The Firm as a Nexus of Treaties: An Introduction" in Aoki, M, Gustafsson, B, and Williamson, OE (eds), *The Firm As a Nexus of Treaties* (1990), at 9; Ripert, G (1951) (*supra* note 14) asks at 96 whether the concept of "institution" is really new: "Depuis fort longtemps les juristes remarquaient que le mot société a un double sens et désigne à la fois le contrat créateur et la personne morale créée. L'institution est à la mode. L'expression est pourtant bien vague. En droit privé, elle ne prend guère de sens que par opposition au contrat."

³⁵ Williamson, OE, "Transaction-Cost Economics: The Governance of Contractual Relations" (1979) 2 *Journal of Law and Economics* 233 at 234

³⁶ Williamson, OE (1985) (*supra* note 33) at 20

³⁷ *ibid* at 21

³⁸ *ibid* at 21

³⁹ Williamson, OE, *Markets and Hierarchies: Analysis and Antitrust Implications* (1975) at 1

⁴⁰ *ibid*

associated with the *ex ante* production of contracts which accurately reflect the agreement between the parties and their anticipation of future contingencies.⁴¹ By contrast, Macneil argues that the institutional model of the firm conflicts with the neoclassical model because it does not consider the parties to the transaction as individual maximisers, but as a "single maximizing unit" with a governance structure to prevent them from reverting to individual maximisers.⁴² Macneil considers the institutional model to be more realistic because "it is impossible to conduct exchange without transaction costs, and since they are variable, they are as much a factor of production as are capital and labor. Any sensible application of the neoclassical model requires the inclusion of these costs whenever they are variable, affect other factors and are significant. This usually will be the case."⁴³

Williamson treats the transaction as the "basic unit of analysis,"⁴⁴ and transaction costs are defined as "the economic equivalent of friction in physical systems."⁴⁵ Kreps explains that "to consummate a transaction or an exchange [the parties] must expend resources other than those contained in the terms of the transaction."⁴⁶ A rational choice between market contracting and a "firm" reduces transaction costs, but institutional economists recognise that, like friction, these costs can never be eliminated entirely and so should be taken into account in system design. Williamson explains that, in conditions of uncertainty, transaction costs are caused by three interconnected factors: "bounded rationality", "opportunism" and "asset-specificity".

⁴¹ Williamson's conception of contract is closer to the "legal" contract because it recognises that the difficulties involved in making full provision for the future may be so great as to render legally binding contracts unviable.

⁴² Macneil, I, *The Relational Theory of Contract: Selected Works of Ian Macneil* (2001) at 255

⁴³ Macneil, I, "Economic Analysis of Contractual Relations: Its Shortfalls and the Need for a "Rich Classificatory Apparatus" in Macneil, I (2001) (*supra*) at 255; originally published at 75 *Northwestern University Law Review* 1018 at 1022

⁴⁴ Williamson, OE (1985) (*supra* note 33) at 41.

⁴⁵ *ibid* at 19

⁴⁶ Kreps, "Corporate Culture and Economic Theory" in Alt, JE and Shepsle, KA (eds), *Perspectives on Positive Political Economy* (1990), reprinted in Buckley, PJ and Michie, J eds, *Firms, Organizations and Contracts* (1996) at 224

First, human agents suffer from "bounded rationality", which means that their behaviour is "intendedly rational, but only limitedly so."⁴⁷ When coupled with uncertainty about the future, bounded rationality makes it either impossible, or very costly, to identify in advance all, or even most, of the eventualities which might arise during a long-term contract. This means that many issues which the parties would address in advance if they had unlimited resources are in reality only addressed as and when they arise.⁴⁸ Man's inherently limited cognitive competence therefore imposes limits on the use of *ex ante* legally-binding long-term contracts. Bounded rationality, to use Macneil's term, frequently rules out full *presentation* of the contract. This consideration is missing from the neoclassical approach, which views all contracts for productive inputs as discrete and with full risk allocation. Institutional economists ask how the parties to the exchange can arrange their affairs so as to make the best use of their limited competence. In particular, where the exchange is a long-term one, "contracts may be supplanted by internal organization...[which] permits adaptations to uncertainty to be accomplished by administrative processes."⁴⁹

Second, human beings have a tendency for "opportunism", or "self-interest seeking with guile."⁵⁰ Where there is no information asymmetry and the parties' obligations are comprehensively expressed in a legally binding contract, this is not a factor. In the neoclassical model of the firm, opportunism takes the form of shirking, as employees take advantage of the information asymmetry between management and labour in a team production situation by putting in as little effort as possible while still obtaining the remuneration which has been contracted for. Williamson's analysis goes far beyond shirking, because his model views the employment relationship in dynamic, constitutive

⁴⁷ Williamson, OE (1985) (*supra* note 33) at 30, citing Simon, HA, *Administrative Behaviour* (2nd Ed: 1961: Macmillan) at xxiv. Simon argues elsewhere that "The capacity of the human mind for formulating and solving complex problems is very small compared with the size of the problems whose solution is required for objectively rational behavior in the real world" (*Models of Man* (New York: John Wiley & Sons: 1957) at 198, cited in Williamson, OE (1975) (*supra* note 39) at 9).

⁴⁸ As Eric Posner (Posner, EA, "Economic Analysis of Contract Law After Three Decades: Success or Failure?" (2003) 112 *Yale Law Journal* 829) says at 865, "If individuals were rational, with no cognitive limits, and if transaction costs were zero, the role of contract law would be simple and uninteresting. Parties would foresee every possible future state of the world, and - the story goes - their contract would describe each parties' obligation in each of these possible states."

⁴⁹ Williamson, OE (1975) (*supra* note 39) at 9

terms. During the course of the relationship, one party may become more valuable to the other than alternatives available on the market. The resulting dependency gives the more valuable party an opportunity, by "rent-seeking" or "hold up",⁵¹ to increase their share of the surplus by threatening to defect. The risk of opportunism in the event of a change in the dependency balance is exacerbated where the combination of bounded rationality and uncertainty has prevented the parties from making fully explicit contractual provision. Williamson's third factor, asset specificity, explains the reason that changes in the dependency balance might occur.

"Asset specificity" is the "most critical dimension,"⁵² and refers to the "idiosyncratic attributes of transactions". The absence of asset specificity "describes the world where discrete market contracting is efficacious,"⁵³ i.e., the world of neoclassical contract. Once the identity of buyer and seller begins to matter (because they have made "non-trivial investments in transaction-specific assets"), the transaction ceases to be "faceless" and "instantaneous" and the parties are "effectively operating in a bilateral trading relation with one another."⁵⁴ Asset specificity makes a contract relational, in the sense that the other party is not readily replaceable on the market. Where this is the case, "Harmonizing the contractual interface that joins the parties, thereby to effect adaptability and promote continuity, becomes the source of real economic value."⁵⁵

When all three of these factors are present, explicit contracting devices break down: "Planning is necessarily incomplete (because of bounded rationality), promise predictably breaks down (because of opportunism), and the pairwise identity of the parties now matters (because of asset specificity)."⁵⁶ This combination of factors causes a "fundamental transformation", in which the simple exchange transaction becomes highly specific in the sense that "the identity of the parties will begin to matter" and "continuity

⁵⁰ Williamson, OE (1985) (*supra* note 33) at 30

⁵¹ This expression originates in Klein, B, Crawford, R and Alchian, A, "Vertical Integration, Appropriable Rents, and the Competitive Contracting Process" (1978) *Journal of Law and Economics* 21

⁵² Williamson, OE (1985) (*supra* note 33) at 30

⁵³ *ibid* at 31

⁵⁴ *ibid* at 30

⁵⁵ *ibid*

⁵⁶ *ibid* at 32

of the trading relation is thus valued."⁵⁷ The parties know that if the relationship ends, they cannot readily and costlessly find replacement trading partners on the market. Williamson terms this situation "bilateral monopoly" and describes the difficulties which may arise:

"both buyer and seller are strategically situated to bargain over the disposition of any incremental gain whenever a proposal to adapt is made by the other party. Although both have a long-term interest in effecting adaptations of a joint profit-maximising kind, each also has an interest in appropriating as much of the gain as he can on each occasion to adapt. Efficient adaptations that would otherwise be made thus result in costly haggling or even go unmentioned, lest the gains be dissipated by costly subgoal pursuit. Governance structures that attenuate opportunism and otherwise infuse confidence are evidently needed."⁵⁸

The role of the governance structure is to maintain the integrity of a relationship which is not suitable for contractual market governance because transaction costs are either too high, or cause the market to fail altogether. Governance structures generate and maintain trust and confidence between the parties, reducing the risk of defection. They impose "a complex set of constraints"⁵⁹ on the bargaining processes that may be used to "work things out"⁶⁰ concerning the distribution of quasi-rents generated in the course of the relationship. At the macro-level, governance structures raise the level of asset-specificity in the economy as whole, and allow assets to be deployed and maintained in their most highly valued contexts.

⁵⁷ *ibid* at 75: while at the initial bidding stage there are many potential contractors, their number is reduced by the acquisition of firm specific skills by the providers of factors of production, meaning that costs will be incurred if it becomes necessary to replace a contractor. It should be noted that for Macneil, the relationship would become relational long before this: his definition is much broader and includes social and cultural, as well as economic, factors.

⁵⁸ *ibid* at 63

⁵⁹ Zingales, (1998) (*supra* note 7) at 497; at 498 he defines corporate governance as "the complex set of constraints that shape the ex post bargaining over the quasi-rents generated by the firm."

⁶⁰ Williamson, OE (1985) (*supra* note 33) at 79

Given that the first and second factors are always likely to be present and to impose costs on all *ex ante* contracting, "asset specificity" is likely to determine whether a specialised governance structure or market contracting will be more cost-effective. If there is no "asset specificity", no quasi-rents will be generated, and *ex ante* (or neoclassical) contracting, supported by its associated legal remedies, will be sufficient to allocate returns. Where there is some asset specificity, the weight to be attached to it will depend on the frequency or volume of transactions, which will in turn determine whether the quasi-rents generated are sufficient to justify the additional costs of setting up and operating a governance structure.

Transaction Costs Applied to the Employment Relationship

Asset specificity presents acute contracting problems in the context of the employment relationship. It has even been said that "the whole rationale for the employer-employee status, and even for the existence of firms, rests on [asset specificity]; without it there is no known reason for firms to exist."⁶¹ Vertical integration, which is the normal solution advocated for "harmonizing the contractual interface" in the presence of asset specificity,⁶² is of course impossible in the case of "asset-specific" employees because this would amount to slavery. Employer and employee therefore remain mutually vulnerable: the employer because specialised factors of production which are fundamental to the business may leave at any time, the employee because if he loses his job is likely to suffer a drastic decline in income.⁶³

When applied to the employment relationship, "asset specificity" is now usually referred to as "firm-specific human capital". An analogy is drawn between the provision of

⁶¹ In a dramatic apparent U-turn by Alchian, "First National Maintenance vs National Labor Relations Board", unpublished manuscript, 1982 at 6-7 cited in Williamson, OE (1985) (*supra* note 33) at 53.

⁶² See for example, the property rights theory of Grossman, S and Hart, O, "The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration" (1986) 94 *Journal of Political Economy* 691.

⁶³ The reason for the likely loss of income is discussed in more detail below. Williamson traces the economic recognition of asset-specificity back as far as Marshall's 1948 *Principles of Economics*. Marshall (at 626) referred to the situation where "the head clerk in a business has an acquaintance with men and things, the use of which he could in some cases sell at a high price to rival firms. But in other cases it is of a kind to be of no value save to the business in which he already is; and then his departure would perhaps injure it by several times the value of his salary, while probably he could not get half that salary elsewhere."

financial capital by shareholders and the provision of human capital by employees. "Knowledge and skills that are specialized to a given enterprise, as well as effort that has been put forth towards the goals of the enterprise, are 'assets' at risk in much the same way that equity capital is at risk once it has been committed to a given enterprise."⁶⁴ Just as transaction costs prevent investments in share capital from being supported by complete contracts, because the use to which the capital will be put, and the returns it will generate, cannot be known in advance, so investments in firm-specific human capital must also be protected by implicit contracts. Investments in human capital cannot be quantified *ex ante*, nor the returns that they generate correctly anticipated. In fact, investments in human capital have a more dynamic *sui generis* character which make them even harder to protect *ex ante* than investments in share capital: "human capital may not depreciate with use, but may, instead, appreciate. Knowledge and skills that are used may build on themselves and become more valuable."⁶⁵

The making of investments in firm-specific human capital presents formidable obstacles. The development of trust between the parties is hindered because they have difficulty making credible commitments to each other. Uncertainty about the future success of the enterprise means that the company cannot make a long-term legally binding commitment *ex ante*. Yet, as Shleifer and Summers put it, an "employee will spend time and effort to learn how to do his job well only if he knows that his increased productivity will be subsequently rewarded."⁶⁶ The unavailability of legally binding contracts obviously makes potential investors in firm-specific skills vulnerable to opportunism and other breakdowns in the employment relationship, and renders them less willing to risk "sinking" such investments. Yet such investments are desirable from an overall efficiency standpoint because "continuity of association between firm and employees directly or indirectly generates a substantial productivity premium."⁶⁷ Investments in firm-specific human capital are one of the key assets on which firms can build competitive

⁶⁴ Blair, "Firm-Specific Human Capital and Theories of the Firm" in Blair, MM and Roe, MJ (eds), *Employees & Corporate Governance* (1999), 58 at 62

⁶⁵ *ibid* at 74

⁶⁶ Shleifer and Summers, "Breach of Trust in Hostile Takeovers" in Auerbach, AJ ed, *Corporate Takeovers: Causes and Consequences* (1988), 33-56 at 37

advantage.⁶⁸ It is the ability to rely on such investments which differentiates firms from each other (and from the market) and allows them to "possess distinctive assets...referred to as 'competencies' or 'capabilities'...The essential feature of a 'capability' is that its value as a resource depends upon its being put to use over time within the organizational setting of the firm."⁶⁹ These investments may be seen as absolutely crucial in the move by firms to focus on their 'core competencies' and to outsource more generic work.⁷⁰

The notion of the firm as a unique collection of "competencies" originated with Edith Penrose,⁷¹ whose theory of the growth of the firm was based on organisational learning.⁷² An extension of that theory to embrace employees at lower levels of the corporate hierarchy⁷³ is arguably appropriate at the current stage of industrial development, and requires a focus on "firm-specific skills which depend on tacit or non-codifiable knowledge, transmitted through learning by doing and enterprise training."⁷⁴ Evolutionary theory goes further and argues that "'competencies within the firm are both context-dependent and organically related to each other.' The firm's resources, in other words, amount to more than the sum total of the resources which are owned by or at the disposal of its individual members (whether they be shareholders, employees or third-party contractors)."⁷⁵ The apparent conflict between the exchange focus of the transaction

⁶⁷ Schultze, C, *Wealth Creation and Wealth Sharing: A Colloquium on Corporate Governance and Investments in Human Capital* (1996) at 18

⁶⁸ Slinger, G and Deakin, S (1999) (*supra* note 12) at 1

⁶⁹ Deakin, S and Slinger, G, "Hostile Takeovers, Corporate Law, and the Theory of the Firm" (1997) 24 *Journal of Law and Society* 124 at 130

⁷⁰ Osterman, P, Kochan, T, Locke, RM, and Piore, MJ (2001) (*supra* note 27) at 57. Accordingly, there is "fierce competition for scarce 'knowledge workers', often entailing incentive-based wages and various stock options, at the expense of more traditional semi-skilled manufacturing and clerical workers."

⁷¹ Edith Penrose, "The Theory of the Growth of the Firm" (1959)

⁷² Although her application of that theory has been criticised for being focused solely on managerial learning and so failing to consider "the possibility of integrating the capabilities of other employees of the enterprise with a process of collective learning": see O'Sullivan, MA (2000) (*supra* note 5) at 17. For a theory in the context of takeover regulation which also limits its consideration of investments in firm-specific capital to management, see Coffee, JC, "The Uncertain Case for Takeover Reform: An Essay on Stockholders, Stakeholders and Bust-ups" (1988) *Wisconsin Law Review* 435.

⁷³ See the analysis of the Saturn project in O'Sullivan, MA (2000) (*supra* note 5) at 211-19 or in Kochan, TA and Rubinstein, SA, "Toward a Stakeholder Theory of the Firm: The Saturn Partnership" (2000) 11 *Organization Science* 367-86

⁷⁴ Deakin, S and Slinger, G (1997) (*supra* note 69) at 130

⁷⁵ *ibid* at 130, citing Hodgson, G, "Evolutionary and Competence-Based Theories of the Firm" in Pitelis, C (ed), *The Economics of Industrial and Business Strategy* (1997). Whitley, R, *Divergent Capitalisms: The Social Structuring and Change of Business Systems* (1999) suggests at 73 that "through employment

cost model and the production-orientated perspective of evolutionary theory⁷⁶ is discussed at the end of the chapter.

The Mechanisms of Implicit Contracting

Given the mutual benefits which firm-specific investment brings, it is in the best interests of both parties to co-operate in the long-term. However, transaction costs rule out *ex ante* explicit contracting: bounded rationality prevents the precise extent of the employee's asset-specificity, and the returns it will generate, from being known in advance, so the governance structure must take the form of "tacit or implicit understandings, or *implicit contracts*."⁷⁷ These include social norms and conventions (such as lifetime employment) and other expectations (for example, career ladders and internal labour markets). Since they are not legally binding, these arrangements should be supported by additional governance structures which encourage and support investments in firm-specific skills from the beginning of the relationship by assuring both parties that their relationship will continue by adapting to unanticipated events in the future and preventing damaging haggling once bilateral monopoly arises.⁷⁸ Governed in this way, the resulting increased productive capacity may be enjoyed for as long as possible.

Although the details vary, companies often promise their employees supra-competitive remuneration to reflect their firm-specific skills. This is a way of sharing the co-operative surplus which arises because the employees' firm-specific skills "make it possible for employees to be more productive than they would be in alternative employment and thus

contracts firms are able to develop idiosyncratic and flexible collective competences by organizing people in a variety of ways to undertake a range of tasks"; therefore we should focus on the "contribution of employees to the development and improvement of organizational capabilities", which are contrasted with "loosely coupled collections of individuals or small groups co-ordinated in quasi-contractual ways." See also Kay, J and Silberston, A, "Corporate Governance" (1995) *National Institute Economic Review* 84, discussed below.

⁷⁶ See for example Chandler, AD, "Organizational Capabilities and the Economic History of the Industrial Enterprise" (1992) 6 *Journal of Economic Perspectives* 79-100 at 86.

⁷⁷ Deakin, S and Slinger, G (1997) (*supra* note 69) at 131; also Slinger, G and Deakin, S (1999) (*supra* note 12)

⁷⁸ In the context of a discussion about radical democratic reform, Unger, RM, *Democracy Realized: The Progressive Alternative* (1998) suggests at 49 that "workers can best be defended by arrangements that enhance their capabilities rather than entrench their positions."

to generate rents."⁷⁹ However, the agreement must remain implicit because "...it is difficult for a corporation to accurately detect, measure, and reward human capital investments as they are made. Instead, the firm must wait to observe and reward the ultimate increase in employee performance that results."⁸⁰ The implicit agreement by the company to share with the employee the "quasi-rents"⁸¹ generated by the relationship, it is argued, is sufficient to constitute the employees as residual claimants since, like the shareholders, they will suffer loss in the event of the company failing.⁸²

The failure of *ex ante* legally-binding contract complicates the process by which investments are made in firm-specific skills. The parties find it difficult to make "credible commitments" to each other before and during the investment process. If the company funds the employees' acquisition of skills, in the sense of meeting all the training costs up front, it will have to agree to pay them wages which are higher than their opportunity cost (i.e., than they could earn elsewhere) once those skills begin to generate returns for the business. This is because employees who are only paid market wages have nothing to lose by walking away, and therefore must be given an incentive to remain in their employment. The payment of supra-competitive wages often forms part of a larger implicit contract which reflects investments in firm-specific capital and the employee's corresponding value to the firm, including, for example, a "tacit or open commitment of the firm to guarantee its personnel that their wage rates, hours worked, employment status, or a combination of all such factors, will be in some degree independent of vicissitudes of the business cycle...[these] assurances...will not be handed out evenly to all personnel. In breadth and firmness of commitment, employers will discriminate in

⁷⁹ Blair, MM (1995) (*supra* note 3) at 267

⁸⁰ Stout, LA, "Stock Prices and Social Wealth" (*Harvard Law School Center for Law and Economics Discussion Paper No 301 (November 2000)*) at 29

⁸¹ *Supra* note 23

⁸² It might even be suggested that such employees bear considerably more risk than shareholders. While shareholders can (and should) diversify their investments and minimise the risk associated with any one firm, employees are unable to diversify and so risk the entirety of their remuneration which is referable to their firm-specific skills.

favor of persons in whose training substantial investment has been or is about to be made."⁸³

The vulnerability of the employer to threats to defect from employees who are fundamental to the enterprise and have strong bargaining power means that employers often structure remuneration at the beginning of the relationship to encourage employees to remain with the enterprise in the longer term. Employees often "pay" for the acquisition of firm-specific skills by accepting a below-market wage during the period of training, on the (once again, non-contractual) understanding that they will be paid more than their "short-run opportunity cost once they are fully trained and the business is up and running."⁸⁴ In the early days of the contract, this arrangement allows the employer to appropriate the rents which are attributable to the employee's firm-specific skills and offset them against the costs of training. The reduced pay accepted by the employee in the early days of the employment relationship constitutes a form of "bond"⁸⁵ laid down by the employee to underwrite his long-term commitment to the enterprise. In return, the employer sets out a detailed implicit contract containing career ladders, promotions and pay rises etc., although these remain "informal, unwritten understandings...social conventions governing relationships and determining what is considered fair and appropriate and expected treatment."⁸⁶ As long as he believes it will be honoured, it is rational for the employee to accept this payment structure because the total remuneration he expects under it exceeds what he could earn from a series of market-based spot contracts.

The increased efficiency arising from firm-specific investment in skills, in the form of the larger rents which are generated, means that companies agree to share the corporate surplus with employees eventually, irrespective of the identity of the party who initially financed the firm-specific investment.

⁸³ Azariadis, C, "Implicit Contracts and Underemployment Equilibria" (1975) 83 *Journal of Political Economy* 1183 at 1184. Azariadis is credited with coining the term "implicit labor contract" to describe this "implicit set of commitments" which differs from an auction for fresh fruit.

⁸⁴ Blair, MM, "Rethinking Assumptions Behind Corporate Governance" (1995) *Challenge* 12 at 14

⁸⁵ Daniels, R, "Stakeholders and Takeovers: Can Contractarianism be Compassionate?" (1993) 43 *University of Toronto Law Journal* 315 at 318-9.

Where the employee "bonds" his future performance, the company is able to eliminate the risk of the employee defecting, even where it funds the employees' acquisition of skills up front. On the other hand, the employee bears considerable risk, both of changes in the firm's environment (such as changes in competition and technology) and of opportunism on the part of management (because the return on his investment is only protected by non-legally binding "understandings"⁸⁷). An employee who loses his job while his remuneration is at below market levels will never recover the deferred compensation, while one who loses his job when in receipt of deferred compensation is statistically likely to suffer a significant decline in income in his next job.⁸⁸ Little can be done about changes in the company's environment, and accordingly it is unlikely to have a strong impact on the degree of firm-specific investment across the economy as a whole. On the other hand, opportunistic breaches of implicit contract are far more damaging. Such breaches are not only wasteful in terms of destroying productive capacities by moving resources out of their most highly-valued uses, but also undermine the ability of other actors to rely on implicit contracts, by reducing trust and therefore raising transaction costs across the economy as a whole. This is discussed below in the section on reputation. Opportunistic breaches are particularly likely to occur where incumbent management is removed following a hostile takeover bid, and replaced by new management who do not feel bound by their predecessors' undertakings. New management may decide to pay employees at a level below their productivity but above their opportunity cost, expropriating employees' share of the quasi-rents to service the debt which funded the takeover.

Before considering whether there is a role for the law to play in sustaining productive coalitions, the question of the prevalence of firm-specific investment by employees in

⁸⁶ Schultze, C (1996) (*supra* note 67) at 19

⁸⁷ Franks and Mayer, "European Capital Markets and Corporate Control" in Bishop, M and Kay, J (eds), *European Mergers and Merger Policy* (1993), 162 at 188. Shleifer and Summers, (1988) (*supra* note 66) at 38: "Although both shareholders and stakeholders benefit ex ante from implicit long-term contracts, ex post it might pay shareholders to renege. For example, it will pay shareholders to fire old workers whose wage exceeds their marginal product in a contract that, for incentive reasons, underpaid them when they were young."

⁸⁸ The extent of this decline in wages is discussed below.

advanced industrial economies must be addressed. If investments in firm-specific capital are important to the way in which a society's wealth is generated, then it becomes arguable that company law should reflect this in its provisions.

How Prevalent is Employee Investment in Firm-Specific Capital?

Margaret Blair accepts that it is very difficult to measure investments in firm-specific human capital "because the process of developing firm-specific skills and organizational capabilities and routines is not distinguishable from the process of developing generic skills."⁸⁹ Theoretically, the distinction between generic and firm-specific skills is clear enough, but empirical proof gives rise to difficulties.

Proponents of shareholder value frequently argue that employee investments in firm-specific skills cannot be proved.⁹⁰ Yet it should be noted that it has not been proven that shareholders make firm-specific investments either. Williamson argues that while individual shareholders may exit and recover the market price for their shares, it is a "fallacy of composition" to argue that this is available to "stockholders in the aggregate".⁹¹ In contrast to employees (some of whose investment is generic and transferrable), the whole of the shareholders' investments are firm-specific and at risk because they "invest for the life of the firm". While this is true if one focuses on a single firm, it is misleading with regard to the position of investors in the modern capital market. Acting rationally and carefully, and assisted by technology and mutual funds which track overall market movements, shareholders diversify their investments in liquid assets to the level at which they do not risk much on the survival of a single company. Their interest is in the performance of the stock market as a whole.⁹² Where a particular

⁸⁹ See for example Blair, MM, *Wealth Creation and Wealth Sharing: A Colloquium on Corporate Governance and Investments in Human Capital* (1996) at 8

⁹⁰ See, for example, Romano, "A Guide to Takeovers: Theory, Evidence and Regulation" in Hopt, K and Wymeersch E (eds), *European Takeovers: Law and Practice* (1992). She argues at 17 that Shleifer and Summers (1988) (*supra* note 66) "never identify what is firm-specific about unionized TWA workers' skills".

⁹¹ Williamson, OE (1985) (*supra* note 33) at 304

⁹² This argument seems to undermine Easterbrook and Fischel's assumption that shareholders bear risk because they are residual claimants; it suggests that in fact they bear minimal risk unless they are careless. One crucial exception to this rational diversification is the employee whose savings are invested heavily in his employer's shares through their company pension plan.

company is underperforming, anonymous shareholders who are diversified across the market as a whole may exit without great cost to themselves. This will of course drive down the price of shares and open an opportunity for a hostile takeover. The exception to this argument are the holders of large blocks of shares, who face much larger losses if they exit via the market. Institutional investors are not anonymous, and may be "locked in" to a particular company or to the market as a whole through a series of blockholdings which cannot be liquidated without incurring considerable loss. Agency theorists argue that systems of takeover regulation such as the UK City Code, which underpin a market for corporate control, are essential to solve this market failure and allow large shareholders to exit from their "locked in" position without loss.⁹³

i) What Kinds of Skills Might be Termed Firm-Specific?

The umbrella category of firm-specific investment may be broken down into various sub-categories. "Specific investment can be with respect to the firm's assets (the employee learns to use a specialized lathe or write in a specialized software language). Alternatively, it can be with respect to other employees (the secretary learns to work with his boss)."⁹⁴ Equally, the investment could also take the form of a relationship with the firm's clients.⁹⁵ Finally, "even if skills are to some degree transferable, the effect of working in a single organisation for a prolonged period of time can give rise to a wage-specific premium which is lost when the worker is made redundant. This may derive from a worker's tacit knowledge of organisational practices, and also through the opportunities for mutual learning between employer and employee in the matching of skills and job requirements over time."⁹⁶ It has been suggested that almost all jobs have some firm-specific element. For example, in 1990, Weiler wrote that

"Very few jobs have demands which are so rudimentary or necessary skills which are so adequately taught elsewhere that a newcomer can step in and do a satisfactory job

⁹³ See, for example, Yarrow, GK, "Shareholder Protection, Compulsory Acquisition and the Efficiency of the Takeover Process" (1985) 34 *Journal of Industrial Economics* 3; Grossman, S and Hart, O, "Takeover bids, the Free-Rider Problem and the Theory of the Corporation" (1980) 11 *Bell J of Economics* 42.

⁹⁴ Rajan and Zingales, (2000) (*supra* note 18) at 206 fn 9

⁹⁵ This would involve learning about how the client's needs intersect with the firm's competencies.

immediately. At a minimum, the new employee will have to learn the location and idiosyncracies of the physical equipment and the routines and expectations of fellow workers. Typically, much of the necessary basic knowledge and skills for the position will have to be learned on the job rather than at school; either because learning by doing is the soundest pedagogical technique for teaching certain skills, or because the relevant aptitudes are peculiar to a particular firm's operations, so that only that firm has the means and the economic incentive to provide such training."⁹⁷

a) Firm-specific investment within the manufacturing sector

Many factory workers are still involved in Fordist methods of production which require few, if any, non-transferrable skills. In those workplaces, only limited numbers of employees will be operating, and becoming "co-specialised" with, machinery and other assets which are not used in other firms, most discretion and decision-making power being vested in management. However, the number of employees gaining industry- or firm-specific skills appears to be increasing: competitive pressures mean that manufacturing firms must either compete in terms of cost or quality. Competing with firms located in developing countries is unlikely to be successful in terms of labour cost; competition in terms of quality is more likely, requiring a greater emphasis on skills and specialisation as the source of firms' and nations' comparative advantage. Recent research within the "varieties of capitalism" literature has indicated that comparative advantage may be acquired through diversified mass production (which requires industry-specific skills) and diversified quality production (which requires firm-specific skills).⁹⁸ It is often suggested that these routes to advantage are not likely to emerge spontaneously through market contracting and depend on the support or "beneficial constraints" of institutional

⁹⁶ Armour, J and Deakin, S, "Insolvency and Employment Protection: the Mixed Effects of the Acquired Rights Directive" (*ESRC Working Paper 2002*) at 5

⁹⁷ Weiler, PC, *Governing the Workplace: The Future of Labor and Employment Law* (1990) at 147; also Smith, SC, "On the Economic Rationale for Codetermination Law" (1991) 16 *Journal of Economic Behavior and Organization* 261 at 264: "Most employees make investments in the organization that employs them. Some will buy shares of stock but most such investments are in the form of specific human capital, or in acquiring knowledge, skills, and even "corporate culture" which increases their productive value to that organization (but not to other organizations)."

⁹⁸ Estevez-Abe, Iversen, and Soskice, "Social Protection and the Formation of Skills: A Reinterpretation of the Welfare State" in Hall, PA and Soskice, D (eds), *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (2001) at 149.

structures.⁹⁹ In addition, one should arguably take into account the relational aspects of employees' work, particularly in complex DQP manufacturing, where the stages of the process are interdependent and require a degree of co-operation in team production as evidenced by the prevalence of team working and discussion groups. If these learning aspects of co-operative production are taken into account, then almost all employees involved in manufacturing make some firm-specific investment.

b) Firm-specific investment within the service sector

In the service sector, co-specialisation to firm-specific assets is less dominant, although there may be firm-specific computer software etc. However, the relational aspects of employees' work take on more importance. They must gain familiarity with chains of command and different styles of working. They must build up relationships with clients, and learn to work in the way in which work is structured within that particular organisation.¹⁰⁰ If one also includes gaining "familiarity with the firm's business culture,"¹⁰¹ then it might plausibly be argued that most, if not all, employees in the service sector make at least some non-redeployable investment. These relational aspects of employment are becoming more important with the growing dominance of the service sector in advanced economies.¹⁰²

At its extreme, the service sector corporation may be simply a set of highly-developed relationships. For example, Kay and Silberston suggest that the corporation is "a set of systems and routines and a structure of organisation... The essence of the company is a

⁹⁹ Streeck, "Productive Constraints: on the Institutional Conditions of Diversified Quality Production" in Streeck, W (ed), *Social Institutions and Economic Performance* (1992), at 26: "...diversified quality production presupposes an affirmative polity in which major conditions of competitive performance are, and have to be, collectively created and maintained." While the relationship between neoclassical and new institutional economics is complex and opaque, both schools only consider institutional arrangements as remedies for contracting failure. By contrast, Streeck conceives of institutions as allowing a type of production which would never be possible under a "a regime of free markets and private hierarchies" (ibid at 10).

¹⁰⁰ Rajan, RG and Zingales, L (2003) (*supra* note 19) at 86 discuss the growing importance of customising the firm's services for customers in the banking sector, something which clearly requires firm-specific skills.

¹⁰¹ Blair, MM and Stout, LA (1999) (*supra* note 1) at 276 fn 61; Williamson, OE (1985) (*supra* note 33) suggests at 242 "knowledge of a particular firm's filing system" as a highly specific skill. This would tend to suggest that investment in firm-specific skills is rather ubiquitous in the service sector.

¹⁰² See Turner, A, *Just Capital* (2001) at 53-9

structure of internal relationships among the staff, and a collection of external relationships with suppliers...."¹⁰³ This context allows "what are, in the main, individually rather unexceptional people to perform, in aggregate, in very exceptional ways." They suggest that looking at the modern corporation in this way demonstrates that it is meaningless to consider "ownership of a set of routines, or a structure of relationships...You can benefit from the returns they generate, but that is not at all the same as owning them. If anyone did own these things, it is more likely to be the employees than the shareholders. But they do not really own them either."¹⁰⁴

ii) How Can the Existence of Firm-Specific Investments be Proved Empirically?

Empirical proof of the existence of firm-specific investment is more difficult. The relative importance of firm-specific investment will, of course, differ from firm to firm, from industry to industry, and even from state to state, depending on their strategy for competitiveness. In addition, outsiders are not normally able to identify the portion of an employee's human capital which is firm-specific. This of course is one reason why implicit contracts are used. It is often suggested that the constraints imposed by the more pluralistic systems of corporate governance found in Germany and Japan have led to a competition strategy based on higher degrees of firm-specific investment. The dominance of the agency model of the company in Anglo-American corporate governance does not necessarily mean that firm-specific investments are not important to wealth creation; it may mean that the Anglo-American system does not encourage them, and so there may be a sub-optimal level of such investments.

In the (likely continued) absence of conclusive empirical evidence one way or another, Margaret Blair says, "the most compelling evidence that firm-specific human capital is important is the simple fact that much economic activity is organized in ways that involve long-term stable employment relationships rather than a series of spot contracts and subcontracts."¹⁰⁵ If paying market wages to strangers on the basis of "spot" contracts

¹⁰³ Kay, J and Silberston, A (1995) (*supra* note 75)

¹⁰⁴ *ibid.*

¹⁰⁵ Blair, MM (1995) (*supra* note 3) at 16; of course not all long term employment relations involve firm-specific capital or supra-competitive wages: see Armour, J and Deakin, S (*supra* note 96) at 5 fn 9

were an adequate way of arranging production, then rational managers would carry on their business in this way.¹⁰⁶ In other words, the existence (although not necessarily an optimal level) of investments in firm-specific human capital can be inferred from the very use of the implicit contracts and bonding mechanisms discussed above, the extra value generated being more than sufficient to offset the additional costs incurred.

Using such arrangements as a proxy, the existence of firm-specific human capital within the economy as a whole is usually demonstrated indirectly by reference to three factors.

"First, wages typically rise with job tenure by more than they would be expected to rise solely as a result of the employee's increased general experience. These higher wages are generally taken as evidence that the employee becomes more productive as he accumulates firm-specific human capital."¹⁰⁷ If the identity of the employee did not matter, the company could seek to engage replacement employees on the market at the lower market rate. Advocates of the market for corporate control do not accept this, arguing that rising wages could equally indicate that managers who have been with the firm for a long time do not bargain as hard with employees as new managers do.¹⁰⁸ Further, the "efficiency wage theory" suggests that the increased remuneration does not reflect firm-specific skills but that "higher wages improve worker morale, motivation and stability and reduce recruiting costs, thereby increasing the productivity and reducing the costs of having a permanent workforce."¹⁰⁹

¹⁰⁶ Blair, MM (1995) (*supra* note 3) at 14.

¹⁰⁷ *ibid* at 263; see Topel, R, "Specific Capital, Mobility and Wages: Wages Rise with Job Security" (1991) 99 *Journal of Political Economy* 145-76 at 147: "estimates imply that 10 years of job seniority raise the wage of the typical male worker in the United States by over 25 per cent relative to what he could earn elsewhere." However, O'Sullivan, MA (2000) (*supra* note 5) suggests at 57 that the increase of wages with seniority may rather be attributable to the settlement between management and labour, according to which managerial prerogative was established in the US in return for seniority ladders.

¹⁰⁸ See for example, Romano, (1992) (*supra* note 90) at 17-18: "managers may be burdened with a reputation for weakness from past practices of capitulating to labor demands in order to make their jobs as managers more comfortable, and this reputation affects their credibility as bargainers." Such non-adversarial bargaining with employees is considered an aspect of empire-building on the part of incumbent management (see Bebchuk, LA, "The Case Against Board Veto in Corporate Takeovers" (2002) 69 *University of Chicago Law Review* 973 at 994) and an agency cost for shareholders (see Jensen, MC, "Takeovers: Their Causes and Consequences" (1988) 2 *Journal of Economic Perspectives* 21-48 at 28). Their prescription is the reintroduction of elements of market contracting into firms.

"Second, job turnover rates (both layoffs and quits) typically fall with tenure. This is also construed as evidence that employees accumulate firm-specific human capital that makes them more valuable to the firm and the jobs more valuable to the workers."¹¹⁰ Again, if those employees who have served the firm long-term did not bring benefits to the firm in terms of productivity, the firm would instead make a series of spot contracts on the relevant market.¹¹¹

"Third...that the costs of being laid off are typically larger for workers with more tenure."¹¹² As Topel points out, "human capital investments are mainly general rather than firm-specific, so that the main component of workers' embodied skills is portable among firms."¹¹³ However, evidence suggests that "'displaced' workers have a subsequent 'wage path' significantly below those of workers who are not made redundant."¹¹⁴ This constitutes circumstantial evidence for an argument that employees who move to new jobs are unable to use the firm-specific skills to which their earlier higher remuneration was attributable.¹¹⁵ Schultze suggests that alternatively the payment of higher wages may be evidence of a "process of learning by which the existence of a good match is

¹⁰⁹ Blair, MM (1995) (*supra* note 3) at 254

¹¹⁰ *ibid* at 263

¹¹¹ Schultze, C (1996) (*supra* note 67) and O'Connor, M, "The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation" (1993) 78 *Cornell Law Review* 899-965 at 905 both refer to research by Robert Hall, "The Importance of Lifetime Jobs in the US Economy" (1982) *Am Econ Rev* 716. This demonstrates the prevalence of continuity of association within US firms: a quarter of the total workforce remain at the same firm for at least twenty years. It should be noted that this research is 20 years old and that these figures may have decreased. But even if turnover rates have increased, this is not fatal to the argument as one could simply argue that the economy as a whole is underperforming because of sub-optimal levels of investment in firm-specific skills.

¹¹² Blair, MM (1995) (*supra* note 3) at 265; again see Topel, R (1991) (*supra* note 107) for evidence of this. See also O'Connor, M (1990) (*supra* note 6) at 1198. Armour, J and Deakin, S (*supra* note 96) at 5 fn 9 note that supra-competitive earnings by employees could be explained as "the result of rent-seeking by 'insider' worker groups who 'hold up' other stakeholders, such as shareholders and creditors." This point may not be so important if a broader evolutionary perspective on the firm is used, which suggests that almost all employees have invested in firm-specific capital. As Stewart, TA (1997) (*supra* note 17) notes at 92, companies are able to outsource work which does not require proprietary (that is firm-specific) knowledge.

¹¹³ Topel, R (1991) (*supra* note 107) at 147; Schultze, "Has Job Security Eroded for American Workers?" in Blair, MM and Kochan, TA (eds), *The New Relationship: Human Capital in the American Corporation* (2000), 28 at 49 confirms that "wage premiums attributable to generally applicable skills are not 'at risk' from layoffs."

¹¹⁴ Armour, J and Deakin, S (*supra* note 96) at 5, referring to Schultze, (2000).

¹¹⁵ Of course, as Williamson, OE (1985) (*supra* note 33) points out at 259, the employee who has only acquired generic skills has a wide choice of employers and only bears the risk of incurring costs while using the market to find another job.

confirmed, tested with promotion, and reconfirmed."¹¹⁶ Accordingly, lower wages in new employment either reflect the employee's reduced productivity in a job requiring only generic skills, or the start of a new period of mutual observation, or a fresh "bonding" process which has begun as the employees fund the acquisition of a new set of firm-specific skills.

iii) What Proportion of the Corporate Surplus is Allocated as a Return to Firm-Specific Human Capital rather than Finance Capital?

In attempting to discern the relative importance of this phenomenon, Margaret Blair has estimated that "as much as 14 per cent of total wages and benefits paid to employees of corporations in the United States may represent a return to firm-specific human capital."¹¹⁷ This appears to be of a similar order to accounting profits, suggesting that the true rents and quasi-rents generated within US corporations may be seriously underestimated. As to the size of these rents, Blair estimates that "the value of the rents that employees have at risk in the typical large corporation is, in the aggregate, roughly the same order of magnitude as the value of the stake that shareholders have."¹¹⁸

However, more accurate estimations are hampered by accounting practice. Margaret Blair notes a systemic bias against human capital because the "accounting system that US corporations use...provides no information about the return a company can earn on other kinds of investments, such as investments in the skills of its employees or in organizational capabilities."¹¹⁹ Profits for distribution are calculated net of payments to the workforce, so where premium wages are paid to employees, these are considered as a cost of the business rather than as a prior distribution of surplus.¹²⁰ Accordingly, capital markets insist that reduction of these costs forms part of good management and bring all

¹¹⁶ Schultze, (2000) (*supra* note 113) at 50. This is because of "the inherent inability of firms and workers, but especially the former, to make a full evaluation of each other except over time, through observing actual performance." He also suggests that the premia may be considered anti-shirking bonuses.

¹¹⁷ Blair, MM (1995) (*supra* note 3) at 266

¹¹⁸ Blair, MM (1996) (*supra* note 89) at 11

¹¹⁹ Blair, MM (1995) (*supra* note 3) at 327

¹²⁰ It may be noted that while supra-competitive payments to employees are treated as an expense rather than a distribution of profits, managerial stock options are controversially still not treated as an expense until they are exercised. See Millon, D, "Why is Corporate Management Obsessed with Quarterly Earnings and What Should Be Done About It?" (2002) 70 *George Washington Law Review* 890 at 909 fn 87 who

their influence to bear: "many firms with strong performance will nonetheless lay off employees to send signals to the capital markets and to improve their stocks' trading prices."¹²¹ Viewing employees supra-competitive wages in this way creates a danger that firms "will have an incentive to shut down operations that are not generating profits for shareholders even though those operations may still be generating substantial real economic rents. From the point of view of society at large, this is, obviously, inefficient."¹²²

Some commentators have recommended changes to the accounting treatment of employee remuneration on the basis that investments in human capital play an important role in increasing the wealth of society. Lawrence Mitchell makes detailed proposals for the capitalisation of that portion of employees' pay which is referable to their investments in firm-specific human capital.¹²³ Remuneration above a certain level, as well as the costs of training workers, should be capitalised, and then depreciated in line with the average tenure of employees. Where an employee is dismissed, the investment should be written off immediately to prevent transfers from employees to shareholders. This would also have the benefit that wage premia do not impact on the bottom line and therefore the price of the company's shares. Provision would also have to be made for the situation where the employee "bonds" the investment by accepting deferred compensation. The deferred portion of the remuneration could also be capitalised. If these changes were adopted, then figures could be provided as to the employees' share in the quasi-rents. Similarly, Blair suggests both corporate governance and financial market reform.¹²⁴ However, such reform proposals face the same difficulty as other attempts to formally recognise investments in firm-specific capital, namely that only corporate insiders can verify their existence and extent. There is accordingly a risk of collusion, given that only employer and employee may observe the extent of the investment. From an agency perspective, this is clearly unacceptable.

notes that "A decision by the Financial Standards Accounting Board in 1993 to change this rule to require expensing when issued was met with massive political opposition and was withdrawn by the end of 1994."

¹²¹ Osterman, P, Kochan, T, Locke, RM, and Piore, MJ (2001) (*supra* note 27) at 67.

¹²² Blair, MM (1996) (*supra* note 89) at 12

¹²³ Mitchell, LE, *Corporate Irresponsibility: America's Newest Export* (2001) at 246

¹²⁴ Blair, MM (1995) (*supra* note 3), ch9

Should the Law Play a Role in Maintaining the Integrity of the Productive Coalition?

Mainstream economic debate has given little consideration to the legal implications of the fact that employees who make investments in firm-specific skills bear risk, with the result that the discussion in most of the literature is underdeveloped about the way in which such investments might be encouraged and protected, and about whether the law has a role to play in this process.

The typical implicit contracting process discussed above presents several problems. First, putting in place appropriate undertakings from scratch each time a firm desires to rely on firm-specific investment necessarily involves costs, whether this done by collective or individual bargaining, or imposed unilaterally by management.

Second, informational asymmetry will affect the process of dividing up rents *ex post*. Since third party arbitration devices are unsuitable, the division must be performed internally. The problem is that management has access to far more information than the employees do, for example, because of their monitoring role, which means that management is more likely than the employees to know the extent of each employee's contribution to rent generation. This may lead to under- or over-estimation by the employee of his contribution and subsequent conflict, and so to rents being wasted through haggling, which, when combined with "bilateral monopoly" risks becoming intractable because of the "difficulty of computing and assigning residuals".¹²⁵

Third, and most importantly, the employees' bargaining position is weakened because, while they remain in receipt of above-market wages, they are vulnerable to threats to close down the business in an attempt to "expropriate some of the rents promised to workers...unless workers agree to work at a wage that is lower than what they had been promised."¹²⁶ The risk of opportunism becomes particularly acute immediately before the expiry of their "bond" when their above-market remuneration is due to kick in. The reverse situation may also hold true: the employee may "hold up" the employer for higher

¹²⁵ Blair, (1999) (*supra* note 64) at 74

wages by threatening seriously to disrupt the business by withdrawing his firm-specific skills. While this type of confrontation is unlikely on its own to lead to the termination of the productive relationship, the credibility gap that emerges is costly both in terms of resources wasted and in undermining trust. Reduction of trust across the economy as a whole leads to increased contracting costs and sub-optimal resource allocation.

We saw in Chapter one that Easterbrook and Fischel argue that company law ought to perform a cost-saving function and provide default terms which most corporate constituencies would want. A hypothetical bargaining process would determine the law's initial allocation of decision-making rights, they suggested, and at the same time, maximise the wealth of society by providing them to those who valued them most highly. It may be argued by analogy that where firm-specific investments by employees are important to the way in which a given economy generates wealth, the law should similarly anticipate the demand for structures to encourage and sustain those investments. Since their claim is partly residual, employees, like shareholders, hypothetically place value on obtaining some rights over the decision-making process because they can use those rights to maximise the value of their claim. Moreover, the fact that employees, unlike shareholders, are not (and cannot be) diversified, means that it is rational for them not to be apathetic and to take an active role in monitoring management.¹²⁷ The law could therefore be given the task of providing default rules which establish a protective multi-party governance structure. Where firm-specific investments are prevalent, the law would contribute to reducing the costs of producing individually-tailored governance structures. Only companies that do not rely on firm-specific investments to create wealth would then incur the costs of contracting around the default rules. These costs might encourage companies to adopt a business strategy which relies on firm-specific skills, and therefore a more efficient use of resources.¹²⁸ A governance structure which is imposed from the beginning of the relationship would also help solve the credibility problems associated

¹²⁶ Blair, MM (1995) (*supra* note 3) at 14

¹²⁷ They also lack market-based mechanisms with which to align the interests of management with theirs.

¹²⁸ Compare the argument of Deakin, S and Wilkinson, F, "Rights vs Efficiency? The Economic Case for Transnational Labour Standards" (1994) 23 *Industrial Law Journal* 289 that labour standards can encourage efficiency.

with implicit contracts, which lead to sub-optimal levels of firm-specific investment in the economy as a whole, and so increase the overall wealth of society.

However, Easterbrook and Fischel's hypothetical bargaining methodology has been applied remarkably rarely to the employment relationship. An important exception is found in the work of Oliver Williamson. Although he recognises that transaction costs may make non-contractual governance structures appropriate in order to safeguard the economic value of idiosyncratic relations, he anticipates that, outside the shareholder-management relationship, such structures will normally be put in place voluntarily by bargaining between the parties.¹²⁹

Rational actors, who are, or will be, in a situation of "bilateral monopoly" will demand and put in place governance structures which are appropriate from a cost-benefit perspective to maintain the integrity of their relationship, and therefore the value of their idiosyncratic investments.¹³⁰ These structures will tend to be bilateral because it is very difficult for third parties to observe the extent of firm-specific investment.¹³¹ The rational employer will provide appropriate governance mechanisms so that the employee investor does not charge a risk premium, keeping wage costs down.¹³² In most cases, therefore, Williamson argues, suitable governance structures will be put in place by agreement between the parties without any need for external intervention.¹³³

However, Williamson's expectation of bargained solutions makes certain assumptions which are problematic from the perspective of transaction cost economics. First, it fails to take into account that informational failures may preclude appropriate arrangements. It is

¹²⁹ In this respect, Williamson shares common ground with Fischel - see Fischel, DR, "Labor Markets and Labor Law Compared with Capital Markets and Corporate Law" (1984) 51 *University of Chicago Law Review* 1061-1077 at 1068, discussed in Chapter one.

¹³⁰ Williamson at 259 (emphasis added): "workers who accept employment of a firm-specific kind will presumably recognize the risks and insist on surrounding such jobs with protective governance structures."

¹³¹ This makes trilateral dispute resolution processes like mediation and arbitration less likely.

¹³² Williamson, OE, "Corporate Governance" (1984) 93 *Yale Law Journal* 1197 at 1204

¹³³ The implication is that the absence of a tailored governance mechanism should be equated either with a lack of firm-specific investment (or rather, that the costs of putting in place such a structure were greater than the benefits to be drawn from maintenance of the relationship) or with the employees preferring to take a risk premium as part of their remuneration.

assumed that the parties will have full information about the extent to which their skills are (or will be) firm-specific, and therefore how much risk they will be bearing. This may not be the case where management has strong control over information flow. This objection is dealt with below; it will be noted that Williamson proposes liberal information disclosure rules. Second, it does not take into account the cognitive limitations and bounded rationality of the parties. It is assumed that they will be able to match an appropriate governance structure to their needs. In order to do this, "the relation between each constituency and the firm needs to be evaluated in contractual terms."¹³⁴ This is important because "To use a simple structure to govern a complex transaction will predictably have disruptive consequences - and possibly fracture the relationship - while to use a complex structure to govern a simple transaction is to incur excessive costs."¹³⁵ Yet there is an assumption not only that the parties will be able to anticipate the extent to which they will make firm-specific investment and conceive of the best way to protect their interests and maintain the relationship, but also that the measure they put in place will be successful in dealing with future contingencies. This is particularly problematic where employees are not organised collectively. Third, it is assumed that the costs involved in the *ad hoc* creation of governance structures (including but not limited to negotiation and conflict costs) will not eat up a substantial portion of the quasi-rents generated by the relationship. Finally, and perhaps most fundamentally, it must rest on an assumption that firm-specific investment is not particularly common.¹³⁶ A governance structure for employees must not be something that "almost everyone will want to adopt."¹³⁷ Otherwise it would, if the transaction cost approach to company law were descriptive, already be included in company law. The content of the law must be based on an assumption that the costs of creating an *ad hoc* governance structure in every firm where it will be beneficial will be lower than the costs of either making choices among a menu of different governance choices or bargaining away from a default structure imposed by the law.

¹³⁴ Williamson, OE (1984) (*supra* note 132) at 1198

¹³⁵ Williamson, OE (1985) (*supra* note 33) at 241

¹³⁶ Although Williamson, (1990) (*supra* note 34) at 12 describes asset specificity as a "common" condition.

¹³⁷ Easterbrook, F and Fischel, D, *The Economic Structure of Company Law* (1991) at 34-5

The bargaining process itself also potentially gives rise to difficulty. While society as a whole may benefit from the use of a governance structure (on the basis that co-specialised assets will be maintained in their most highly valued usage, and that the residual claims of the employees and the shareholders will be maximised), there is no guarantee that this will be the outcome of a bargaining process between individual maximisers. Sadowski *et al* suggest that where the parties pursue self-interest, they are unlikely to realise that their best interests are served by co-operation, and therefore are unlikely to put in place *ex ante* structures which maximise the wealth of society:

"In distributional conflicts about contractually unprotected quasi-rents, it is at least optimistic, if not naïve, to expect an efficient voluntary agreement about the firm's constitution. A selfish rational agent will prefer a constitution that strengthens his absolute position in *ex post* bargaining, even if this is detrimental to the firm value. One cannot then expect an efficient constitution of the corporation as a result of a bargaining process between co-specialised investors. Investors will find themselves locked in a sub-optimal position. Are legal interventions an efficient way out?"¹³⁸

Similarly, the argument that the parties might, of their own accord, bargain to produce a governance structure to regulate their relationship *after its inception* faces certain difficulties. First, if no governance structure is in place *ex ante*, employees (who are in possession of full information and are rational) are going to be reluctant to make non-transferrable investments as these would not be protected. In this case, no governance structure would be needed. Second, if such investments are made, despite the absence of a governance structure, management will be able to opportunistically appropriate (on behalf of either themselves or the shareholders) the quasi-rents attributable to those investments (by paying the employees above their opportunity cost but below their productivity), even if this has the consequence of reducing the overall level of rents generated by the enterprise. There is no incentive for management or shareholders to

¹³⁸ Sadowski, D, Junkes, J, and Lindenthal, S, "Labour Co-Determination and Corporate Governance in Germany: The Economic Impact of Marginal and Symbolic Rights" (*Quint-Essenzen Nr 65, August 2001, JAAEG* at 3.1.3

create a governance structure in this situation, although to do so would maximise society's wealth.

Further difficulties may arise. Managers may resist the establishment of governance mechanisms, not because they are serving the interests the shareholders, but because politically they do not want to share their authority with employees (or some other constituency), or to open themselves up to potential monitoring by employees.¹³⁹ The employees collectively may not hold or express strong preferences. Given that they have different amounts of investment at risk (and that it will be difficult to anticipate in advance the extent to which they will bear risk), they too may be affected by a collective action problem and be rationally apathetic towards the creation of a governance structure to protect their interests.¹⁴⁰ By comparison, management is likely to have a strong and clear preference for no such structure.¹⁴¹ Finally, the shareholders, if they can overcome their apathy and have any effect on the bargaining process, might prefer to appropriate a larger proportion of a smaller pool of rents.

Legal intervention, while by no means a simple project, could arguably help circumvent some of these difficulties, while still fitting with a contractual methodology. The imposition by law of a governance structure *ex ante* would enhance the parties' ability to make credible commitments to each other before the investments are made, thus increasing the level of such investments in, and the overall productivity of, the economy. Further by ensuring that at least minimal standards of protection are available, the law would contribute to keeping those investments in their more productive, highly valued uses. Finally, an appropriate governance structure should contribute to the flow of information within the corporation. This would allow management to communicate

¹³⁹ See for example, Smith, SC (1991) (*supra* note 97) at 269-271

¹⁴⁰ It may be rational for individual employees not to organise collectively, and not to incur costs lobbying for the establishment of a governance structure, because free riders may take advantage of the resulting governance structure without incurring the costs of organisation or lobbying.

¹⁴¹ Per Smith, SC (1991) (*supra* note 97) at 273: "private external benefits of unchecked hierarchy are concentrated in a few managers, while the private external costs are widely scattered among many employees. Each employee has relatively little to gain...and each manager has relatively much to lose."

credibly about the firm's state of finances, and therefore to seek compromises with employees in a time of crisis.¹⁴²

More institutional imagination would be required from lawmakers. Many options are available and some have even been tested: formal co-determination at supervisory board level on the German model;¹⁴³ informational participation at board level; indirect influence over the board through voting rights in management elections; decision-making bodies below board level, such as works councils, working groups, consultative committees etc; consultation on any number of models, allowing greater elaboration of employee interests in dialogue internal to the corporation; and information obligations on management, which may be seen as maintaining trust that management are taking the interests of employees into account.¹⁴⁴

Alternatively, the law could aim for reflexive regulation by granting basic procedural rights with the aim of facilitating the bargaining process over the establishment of a governance structure. These procedural rights would not be aimed at achieving contractual completeness but rather at encouraging "a flow of information and cooperation which goes beyond the terms of any express or implied contract."¹⁴⁵ The continual dialogue established by such rights would itself constitute the appropriate governance structure for the parties. It is more flexible than an approach based on the grant of specific governance rights to employees, and would be able to take into account

¹⁴² On this point see Sadowski, D, Junkes, J, and Lindenthal, S, "The German Model of Corporate and Labor Governance" (2000) 22 *Comp. Labor Law & Policy Journal* 33 at 47; also Williamson, note 170 below.

¹⁴³ Sadowski, D, Junkes, J, and Lindenthal, S (*supra* note 138) at 4 have suggested that this is a way to "securitise" non-liquid employee investments, although they recognise that there may be difficulties with ensuring that this governance structure works in the interests of the company as a whole rather than in a partisan manner. The incentives for board members to act in a fiduciary capacity (i.e., comply with the German obligation to act in the interests of the company as a whole), rather than favour the constituency which elected them by ballot, are weak, especially in terms of monetary incentives and legal sanctions. They suggest that board members may be constrained by reputational mechanisms, or that the requirement of voice by employees, even if rendered "ceremonial and symbolic" because they can always be outvoted, "may help to keep in mind the common interests of the conflicting parties, i.e., the norms and duties required for or at least conducive to the common endeavour. State constitutions as well as guidelines for corporate behaviour often have such programmatic, educational functions."

¹⁴⁴ Many of these proposals would also be justifiable under a political stakeholder model.

¹⁴⁵ Slinger, G and Deakin, S (1999) (*supra* note 12) at 5

the idea that the extent of employee investment may change over time. The provision of fundamental procedural rights may be seen in this way.

If it is accepted that investments by employees in firm-specific human capital are not exceptional, two possible courses are open to the law. First, in order to save as much of the costs of negotiation as possible, the law could offer a variety of "off-the-peg" business formats which may be varied freely according to the needs of the business in question.¹⁴⁶ The variety should be broad enough to capture the full range of possible employee investments, from entirely generic to entirely firm-specific, and to provide appropriate governance for that degree of investment. The default position taken by the law would be determined by a process of hypothetical bargaining, which would reflect the average level of firm-specific investment across the economy as a whole, so that the costs of negotiating away from the law's default position would be minimised. The conduct of any subsequent bargaining process would send reliable signals to the employees about the firm's commitment to protecting their investments. If, through hard bargaining, a new firm disallowed all employee involvement provisions, it would send a clear signal to its employees that they should not make substantial non-redeployable investment in that firm. The use of default rules in this way would invert the current position (where no employee involvement exists except that for which they bargain) with the aim of encouraging more firm-specific investment by employees.

Alternatively, the law could impose a mandatory governance structure.¹⁴⁷ The effect of this would be that firms which do not rely on firm-specific human capital would be saddled with an excessively expensive governance procedure. For those firms, market governance of labour relationships would be more suitable. However, given the empirical

¹⁴⁶ See, for example, Klausner, M, "Corporations, Corporate Law and Networks of Contracts" (1995) 81 *Virginia Law Review* 757 at 838; discussed in more detail in Chapter one.

¹⁴⁷ Smith, SC (1991) (*supra* note 97) at 271 draws an analogy with the protection given to financial capital investors by law and regulation, which results in an increased supply of such capital, and argues that "If human capital investment were subject to "disclosure" requirements...its supply might also be expanded." He justifies the imposition by law of internal procedural rules on the basis that "The transaction costs for an individual company to set up credible guarantees without an overall legal framework may simply be too high; by analogy consider the lower value of voluntary disclosure of financial information without government auditing and sanction authority."

difficulties of ascertaining which firms rely on firm-specific investments, a simple opt-out of the governance structure is inappropriate.¹⁴⁸ As discussed above, the outcome of bargaining between individual maximisers is likely to lead to optimal allocations for the economy as a whole. The decision to impose a mandatory governance structure on all firms would ideally be made on the basis of an overall cost-benefit analysis; a macro-economic decision about whether or not more wealth would be generated one way or the other. However since this would not be possible on the basis of currently available empirical data,¹⁴⁹ the decision would have to be taken on the basis of macro-economic policy: whether it is considered desirable for firms to rely on firm-specific investment for the generation of wealth and the creation of comparative advantage, or to compete in terms of reducing costs.

Objections to legal intervention

Leaving aside the argument from the agency model that company law should have a single objective in order to ensure managerial accountability, arguments in favour of legal intervention to protect employees from risk have been opposed on two main grounds. First, that employees are already adequately protected through reputational mechanisms. Second, that mechanisms outside company law, such as trade unions, already protect employees against risk.

i) Protection Through Reputation

It is frequently suggested that intervention is unnecessary because the "implicit understandings between employees, employers, and investors... are sustained by the desire of different parties to maintain reputations."¹⁵⁰ If management reneges on an implicit contract to reward employees in line with their investment and the returns it

¹⁴⁸ In seeking the rationale for the mandatory nature of German co-determination laws, Sadowski, D, Junkes, J, and Lindenthal, S (2000) (*supra* note 142) at 64-5 consider, as a possible alternative, the imposition of sector-specific co-determination arrangements to deal with different levels of firm-specific investment, but rule them out on the basis that "even if they were theoretically advisable, [they] appear very difficult to implement."

¹⁴⁹ One possibly adequate proxy would be an operating assumption that firms rationally contract out all work which does not depend on firm-specific skills.

¹⁵⁰ Franks and Mayer, (1993) (*supra* note 87) at 188; similarly O'Connor, M (1990) (*supra* note 6) at 1204-5 suggests that "implicit contracts are...social arrangements typically enforced through the operation of market forces."

generates, so the argument goes, they will find it harder both to recruit good employees, and to persuade those that they do employ to make such investments.¹⁵¹ Advocates of this perspective suggest that "Private pressures effectively limit [the] scope [of arbitrary behavior]. The lack of legal protection to the employees is therefore in part explained by the increased informal protections that they obtain by working in large concerns".¹⁵²

Voluntary CSR measures, such as codes of conduct and social accounting, might be seen not as political stakeholding measures but rather as an instrument for formalising and disseminating a corporate reputation for fair dealing (or lack of opportunism) *inter alia* in interactions with employees. Such statements are accordingly not attempts to head off more formal regulation, but a solution to the firm's contracting problem. The costs of sustaining a reputation are met by the increased efficiency of firms' operations. These measures are designed to give employees more credible indications about the standard of treatment they can expect and the anticipated division of rents where firm-specific investments are made. Accordingly, they should be seen as voluntary limitations on the exercise of managerial prerogative (gap-filling). The considerable costs of building up and publicising a reputation, which becomes a valuable asset of the firm since it reduces the firm's transaction costs, makes breaches of implicit contract less likely because they dissipate the asset.¹⁵³ While defection may bring short-term benefits, in the longer term it will be more costly since reputations are quickly destroyed and difficult to rebuild.

¹⁵¹ Per O'Connor, M (1990) (*supra* note 6) at 1209: "The firm has a strong incentive to abide by an ethical code to treat workers fairly because they want to attract and retain the most qualified employees." Similarly, Williamson, OE (1985) (*supra* note 33) at 261 puts some faith in the reputational mechanism, arguing that the reputational mechanism effectively restricts "the strategy of exploiting the specific investments of incumbent employees...to circumstances where (1) firms are of a fly-by-night kind, (2) firms are playing end games, and (3) intergenerational learning is negligible." Epstein, R, "In Defense of the Contract at Will" (1984) 51 *University of Chicago Law Review* 947 at 967-8 describes the adverse consequences which follow destruction of an employer's reputation for fair dealing with employees, which he describes as "functionally indistinguishable from a reduction in wages unilaterally imposed by an employer. At the margin, some workers will look elsewhere, and typically the best workers will have the greatest opportunities."

¹⁵² Epstein, R (1984) (*supra* note 151) at 968

¹⁵³ Social norms, such as the long-standing tradition of lifetime employment in Japan, may also push companies to honour their commitments, at least during periods of growth: see Dore, R, *Stock Market Capitalism: Welfare Capitalism - Japan and Germany Versus the Anglo-Saxons* (2000) at 102-4.

David Kreps models the role played by corporate culture in sustaining reputation and reducing transaction costs at the level of individual corporations. Reputations provide an incentive to individual companies to abide by their implicit contracts as long as they desire to undertake "future beneficial transactions".¹⁵⁴ Once this is no longer the case, a return to "self-interest seeking with guile" is to be expected. Kreps argues that "for a reputation to have an effect, both sides involved in a transaction must *ex ante* have some idea of the meaning of appropriate or equitable fulfilment of the contract."¹⁵⁵ The "focal point" will be a "principle or rule that has wide (preferably universal) applicability", which is then disseminated by means of corporate culture which is "partly the principle itself...and partly the means by which the principle is communicated to hierarchical inferiors (so they can monitor its application) and hierarchical superiors (so they can apply it faithfully)."¹⁵⁶

It might be suggested that reputation is a rather fragile mechanism to rely on to establish and maintain a productive coalition for the following reasons. At a general level, "the waves of takeovers, buy-outs, spinoffs, corporate reorganizations, restructurings, and downsizings"¹⁵⁷ may have undermined employees' confidence in the idea that reputation matters to firms across the economy as a whole, and made implicit undertakings by firms generally less credible. This could lead to a generalised reluctance on the part of employees across the economy as a whole to make firm-specific investment. This may be exacerbated by the diffusion of cultural and economic norms of shareholder value, according to which the capital market rewards breaches of implicit contracts with an increase in stock prices. Similarly, social norms take a long time to build up yet are easily broken. Where one or two "bad apples" renege on implicit contracts, this creates an externality by increasing transaction costs across the economy as a whole as implicit commitments become less credible.

¹⁵⁴ Kreps, (1990) (*supra* note 46) at 224

¹⁵⁵ *ibid*

¹⁵⁶ *ibid*

¹⁵⁷ Blair, MM (1995) (*supra* note 3) at 259

Employees who have already invested are not well protected by reputations in two situations. Firms operating in a declining industry have less incentive to play fair and maintain their reputation. Employees with skills specific to that sector, and even more so with firm-specific skills, are unlikely to have many exit options and so will be forced to accept pay cuts. The "endgame" problem may also be significant. Where a firm decides to leave the jurisdiction and relocate production abroad, its reputation is unlikely to precede it, and it has little incentive to pay regard to its reputation in the state from which it is exiting.¹⁵⁸ Indeed, a firm need only locate outside the area where its reputation is operational. Similarly, where a firm is winding down its operations, it is less likely to care about its reputation. Further, reputation need not constrain a firm which no longer intends to rely on employees' firm-specific skills for its competitive advantage.¹⁵⁹ Finally, replacement management installed after a hostile takeover are unlikely to feel bound by the reputation of their predecessors.¹⁶⁰

Employees who have not yet made such investments face a different, but related, set of problems. First, reputations of individual firms can only be effective where monitoring takes place. Most employees do not have the resources to individually monitor the reputations of all possible corporate employers. The task of monitoring a reputation is complicated by continual merger, takeover, spinoffs and other forms of corporate engineering which may make it difficult to identify successor companies. In this regard, it might be suggested that one of the "agency" functions trade unions might perform on behalf of their members is to act as monitors of firms' reputations.¹⁶¹ Unions certainly appear able to fulfil informational functions on behalf of their members with regard to pay structures and other terms and conditions. But the suggestion that they might monitor

¹⁵⁸ O'Connor, M (1990) (*supra* note 6) at 1209: "labor economists note that the risk of opportunistic behavior is very high when the employer leaves a regional labor market and relocates to another part of the country or world."

¹⁵⁹ This may be because the sector is in terminal decline. Alternatively, the firm may have decided to take the low-cost, low skill route to production. Finally, there may have been technological change.

¹⁶⁰ This point is taken up in chapter 4.

¹⁶¹ Alchian, AA and Demsetz, H, "Production, Information Costs, and Economic Organization" (1972) 62 *American Economic Review* 777 at 790: "unions, whatever else they do, perform as monitors for employees". It is notable that Easterbrook and Fischel go further and argue at 24 that unions may make complete contracting possible: "Participation in companies is uniquely amenable to contracting because

firms' compliance with implicit contracts is more problematic. There will be much duplication of effort as unions tend not to be connected to specific firms: several unions may end up monitoring the same firm, and each union will have many firms to monitor. They may also reach different conclusions about compliance, as precise tests for monitoring conformity with reputation are not feasible. There may also be problems of observability. More significantly, the degree of non-transferrable investment will vary across members of the same union, and even more so across members of different unions. Opportunistic management will not necessarily break all implicit contracts at once. A corporate reputation is likely to be more complicated than a simple statement that "such and such corporation observes its informal undertakings to employees." Instead it should contain information about the treatment of different categories of employees by reference to their level of investment, tenure, level of seniority within the organisation etc. One might also question whether unions are equipped to take on this role, given that differences in level of firm-specific investment between members may create conflicts of interest within the union. Finally, and perhaps most problematically, given the low density of union membership, this appears a rather marginal and tenuous mechanism for protecting employees from expropriation of their investments.

ii) Protection Outside Company Law

Williamson expects that employees' collective organisations will normally play a key role in establishing appropriate governance structures, rendering legal intervention unnecessary and inappropriate. However, he does recognise that this will present difficulties where employees are particularly heterogeneous:

"More complex labor governance structures are needed as investments in firm-specific human capital deepen, *ceteris paribus*. In consideration of that, and given heterogeneity in the typical work force, it may be that a series of bargains rather than a single bargain applicable to the entire labor force should be struck. Among other things, a single union operating under a uniform agreement will have difficulty aggregating the preferences of a

even the ignorant have an army of helpers... Employees work at terms negotiated by unions (and nonunion employees can observe the terms offered at other firms, which supply much information)."

disparate membership. To negotiate discriminating terms is at variance, however, with the egalitarian purposes of unions."¹⁶²

Another problem is that trade union membership is in serious, perhaps terminal, decline. It might even be suggested that this decline is in part driven by changes in productive organisation: collective representation is becoming more costly as contracting out and the fragmentation of large establishments increases,¹⁶³ employees become increasingly differentiated in terms of skills, and more precisely-tailored (firm- or even individual employee-specific) governance structures are needed. The collective agreement as governance structure, protecting the interests of employees *ex ante* by fixing the terms on which employees enter (including grievance procedures), and *ex post* by the co-administration with the employer of the agreed grievance procedures, becomes less appropriate with increasing heterogeneity of employees. Employees face a collective action problem and are less likely to organise themselves into a union, which means that the transaction costs for both parties of establishing a governance mechanism will be much higher since there is no common agent acting on behalf of the employees. Further, the extent of employee differentiation may mean that the costs of producing governance mechanisms with a small scope of application may be higher than the benefits they provide in terms of allowing continuity of high productivity relationships. These difficulties arguably support a transaction-cost reducing role for the law in offering a selection of "off the peg" governance structures which can accommodate the increasing idiosyncrasy of firms.

Williamson suggests that these difficulties of employee "aggregation" mean that jobs with a high degree of firm-specificity will tend to be "unstable" and to evolve either by "sacrificing" their idiosyncratic attributes (and reverting to market governance) or by "devising" protective governance mechanisms ("collective organization (often in the form of union)").¹⁶⁴ Where this occurs, he suggests, appropriate governance mechanisms might be put in place by agreement between the union and the employer. These might include

¹⁶² Williamson, OE (1985) (*supra* note 33) at 265

¹⁶³ See "Déjà vu?", *The Economist*, 5th June 2003.

severance payments which reflect firm-specific investments¹⁶⁵ and "Machinery for settling disputes and for adapting to changed circumstances...The grievance machinery and associated job structures -- ports of entry, promotion ladders, bumping, and so forth - - are thus important parts of efficient governance."¹⁶⁶

The argument for legal intervention is that economic efficiency requires firm-specific investments to be maintained in their highest value locations. It seems counter-intuitive that shareholders should be provided with protective default mechanisms as a public good by company law on economic efficiency grounds, while employees either have to organise and incur the costs of creating *ad hoc* mechanisms, or rely on the vagaries of corporate reputation to protect their non-redeployable investments.

Acceptable Legal Interventions in Company Decision-Making

Where a role for the law is contemplated, it normally takes one of the following forms: information provision, board representation or the strengthening of managerialism.

i) Provision of Information

The provision of information (or consultation) to employees fits with any of the three models of the company discussed in this thesis. Looked at in terms of the agency model, it may help make contracts more complete and therefore sustain that model's central argument that additional governance structures are unnecessary. In addition, the provision of information to employees may lead to better monitoring of management, leading to a reduction in agency costs (to the extent that the interests of employees and shareholders overlap).¹⁶⁷ In terms of the political stakeholder model, the provision of information may

¹⁶⁴ Williamson, OE (1985) (*supra* note 33) at 272

¹⁶⁵ Which are the reverse of the "bond" posted by employees at the beginning of their employment; severance payments allow firms to bond their performance to employees: see O'Connor, M (1990) (*supra* note 6) at 1210. Like bonding, this also suffers from the weakness that neither the extent of firm-specific capital investment nor the quasi-rents it generates are *ex ante* knowable, so any bond will be at best an estimate of these figures.

¹⁶⁶ Williamson, OE (1984) (*supra* note 132) at 1208

¹⁶⁷ Note that Williamson, OE (1985) (*supra* note 33) argues at 302 that "where neither party values continuity in its relationship with the other, a costly effort to reduce informational asymmetries serves no useful veracity purposes either." However, it must be doubted whether many (or indeed, any) employment relationships fall into this category.

be seen as a weak form of participation and moderation of hierarchy, which may sustain more adversarial labour law mechanisms. Finally, it may support a productive coalition. Where there is no collective organisation, the provision of information should allow individual employees to gauge more accurately the risk they face, and therefore the risk premium they should demand. In terms of collective governance, it may assist with the reflexive establishment and operation of an appropriate bilateral structure, where it anticipates future change and threats to firm-specific investment. It may also, according to Williamson, supplement the structure by facilitating adjustments and avoiding misallocation during a long-term agreement; its absence may cause "the less informed party to disbelieve the representations of the more informed and lead to a costly contractual impasse."¹⁶⁸

Williamson proposes that information should be supplied to the labour constituency via representatives who are placed on the board *for informational purposes only*.¹⁶⁹ This is useful "during periods of actual or alleged adversity, especially when firms are asking workers for give-backs. Labor's board membership might mitigate worker skepticism by promoting the exchange of credible information...."¹⁷⁰ These arrangements would only be put in place where contracting difficulties justify it; they would "sometimes" be justified to supplement an already established bilateral governance structure, but the role of employee representatives should "normally" be limited to informational participation.¹⁷¹ The reason for the caution about extending to informational participation to all companies is that unwarranted decision-making participation (for example, on the basis of democratic imperatives rather than in support of idiosyncratic investment) imposes unnecessary transaction costs on the business without any corresponding increases in productive efficiency. These costs include the costs of "supplying

¹⁶⁸ *ibid* at 302

¹⁶⁹ *ibid*. Williamson defines informational participation in terms of "allow[ing] a constituency to observe strategic planning and to be apprised of the information on which decisions are based, but allows no vote on investments or management." He adds at fn 3 that "Allowing only informational participation to a constituency could be implemented through two-tier boards, but more often it takes the form of implicit understandings among the members of the board. In principle, members are equals, but a subset understands that its useful participation is limited to supplying and receiving information."

¹⁷⁰ Williamson, OE (1984) (*supra* note 132) at 1209

¹⁷¹ *ibid* at 1206. He does not give any examples of abnormal circumstances

information. Huge educational needs arise if specialized constituencies are to be informed participants on the board"; "deflecting strategic decisionmakers from their main purposes by forcing them to redress operating-level complaints. This squanders a valuable resource"; and finally opportunistic use of leverage to extract extra concessions during the execution of the contract.¹⁷² It may also cause an adverse adjustment of the terms on which corporate finance is available because the governance structure becomes more diffuse and less adept at resolving agency problems between management and shareholders.¹⁷³ Accordingly, as a general rule, the parties' "specialized structures will normally be better attuned to the adaptive needs and dispute settlement requirements of a constituency than will access to a generalized instrument."¹⁷⁴

Despite these arguments in favour of informational participation, Williamson notes that

"This practice does not, however, enjoy widespread support. Some opponents fear that it will be difficult to resist the transformation of informational roles into decision-making participation. It is also possible, however, that the informational benefits of labor membership are not adequately appreciated."¹⁷⁵

ii) Board Representation

Despite the difficulties with the bargaining process discussed above, Williamson insists that only shareholders merit exemption from the requirement of explicit bargaining. They are the only constituency which needs a "generalized safeguard" because they "cannot devise effective bilateral safeguards."¹⁷⁶ The reason for their difficulty is two-fold: the unique nature of their contract with the "company" means that, unlike those of other constituencies, their position does not come up for periodic contractual renewal. They

¹⁷² *ibid* at 1206-7; Hansmann, H, *The Ownership of Enterprise* (1996) considers in detail the costs where employees are involved in corporate decision-making.

¹⁷³ Of course, employees do have limited cognitive resources which they may allocate to consideration of the information supplied by management. This may suggest that the information supplied should take a form and have a content which is likely to be useful for such rent-dividing negotiations, for example by including information about firm-specific capital.

¹⁷⁴ Williamson, OE (1984) (*supra* note 132) at 1206

¹⁷⁵ *ibid* at 1209

¹⁷⁶ *ibid* at 1206

"are also unique in that their investments are not associated with particular assets. The diffuse character of their investments puts shareholders at an enormous disadvantage in crafting...bilateral safeguards..."¹⁷⁷ and so they contract for "a governance structure of broad scope"¹⁷⁸ in view of the risk of expropriation of their investment. Williamson accordingly explains "the board of directors to be a governance structure whose principal purpose is to safeguard those who face a diffuse but significant risk of expropriation because the assets in question are numerous and ill-defined, and cannot be protected in a well-focused, transaction-specific way. Thus regarded, the board of directors should be seen as a governance instrument of the stockholders."¹⁷⁹

Williamson's reluctance to extend the protection offered by the board to the employees (or other constituencies) is explained on the basis that "...special-purpose governance structures (of which the board of directors is one) arise in response to the needs of an exchange relation for contractual integrity. And...lest the design benefits be dissipated, the special purpose character of each governance structure must be respected."¹⁸⁰ It is only if "parties cannot devise effective bilateral safeguards, [that] generalized safeguards through voting board membership may be warranted."¹⁸¹ Williamson does not rule out the use of the board to protect the investments of employees in principle. A decision must be based on "their contracting relation with the firm."¹⁸² The grant of voting participation on the board may be permissible, but the question of why a constituency with idiosyncratic investments "has not successfully forged a bilateral governance structure...is germane".¹⁸³ As discussed above, the absence of bilateral safeguards is generally construed as an indication that there are no firm-specific investments, or that the employees in question prefer to take a risk premium, rather than an indication of high transaction costs. It appears from Williamson's willingness to "[s]uppose, arguendo, that

¹⁷⁷ *ibid* at 1210

¹⁷⁸ *ibid*

¹⁷⁹ *ibid*; in Williamson, OE (1985) (*supra* note 33) at 316 he suggests that given its monitoring role, managerial participation on the board, while useful in terms of stimulating information flow, should not be so extensive as to lead management to dominate and prevent the board operating as a governance structure for the benefit of shareholders.

¹⁸⁰ Williamson, OE (1984) (*supra* note 132) at 1198

¹⁸¹ *ibid* at 1206

¹⁸² *ibid* at 1210

¹⁸³ *ibid* at 1206

voting membership for [some] constituencies is granted"¹⁸⁴ that he anticipates the existence of situations in which bilateral safeguards are not possible, but unfortunately he does not elaborate further.

The German experience with employee representation on supervisory boards (which has its origins in *social* rather than corporate governance) certainly suggests that it affects the costs and the dynamics of the corporate governance process. Pistor notes that, as Hansmann argues, codetermination raises the costs of the governance process as the greater heterogeneity of interests on the supervisory board¹⁸⁵ leads to more autonomy for the management board, and accordingly to an increase in agency costs.¹⁸⁶ Codetermination also changes the dynamics of the corporate governance process. While there may be a tendency for a division of supervisory labour along functional lines,¹⁸⁷ corporate governance essentially becomes a game of coalition-building as each constituency seeks to protect their fundamental interests. Unlike coalitions in the US and UK, which tend to emerge spontaneously in response to specific threats like hostile takeovers, German supervisory board coalitions tend to stabilise as a result of repeated interactions. From a productive coalition perspective, therefore, the German system offers a degree of protection for employee investment in firm-specific human capital through a combination of institutional and legal arrangements: employee involvement in board level governance, combined with a collective labour contract system, means that firms do not need to rely on unenforceable implicit contracts in order to encourage firm-specific investment.¹⁸⁸

¹⁸⁴ *ibid*

¹⁸⁵ Including differences in interest among various groups of employees, including time horizons and risk-aversion. Union representatives may also have more sectoral interests which extend beyond the future of the individual company.

¹⁸⁶ See Pistor, K, "Codetermination: A Sociopolitical Model with Governance Externalities" in Blair, MM and Roe, MJ (eds), *Employees & Corporate Governance* (Brookings Institute, Washington DC, 1999) at 177-9

¹⁸⁷ Pistor (*supra*) suggests at 170 that "the shareholder bench focused on investment decisions and financial returns, while the employee bench concentrated on the working conditions for the company's work force."

¹⁸⁸ *ibid* at 180. The role of co-determination in underpinning a productive coalition model is taken up in Chapter Five.

The Rebirth of Managerialism: Management as Mediating Hierarchs

In her seminal work, *Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century*, Margaret Blair concludes that major reform of the US corporate governance system is unnecessary, principally because "US corporation law, contract law, and securities law readily accommodate most experiments in new organizational forms, many new governance structures are emerging on their own."¹⁸⁹ In a series of articles jointly written with Lynn Stout,¹⁹⁰ flesh is put on the bones of this argument. They argue that the law grants management discretion to allocate returns to the various constituencies in accordance with the extent of their firm-specific investment and contribution to production, thus avoiding costly rent-seeking among constituencies and helping to maintain trust and cooperation. The role of the board and its delegates in team production situations is to act as *mediating hierarchs* between the claims of all corporate constituencies, and in particular "to coordinate the activities of the team members, allocate the resulting production, and mediate disputes among team members over that allocation."¹⁹¹ As insiders they are uniquely well placed to observe the contributions of each constituency to the output of the productive coalition. Blair and Stout insist that their model is descriptive because company law as it currently stands revolves around a managerial conception of the corporation.¹⁹²

Managerial discretion becomes a gap-filling governance structure for incomplete contracts. The corporate form is a useful legal framework which guarantees the continued independence of this governance mechanism from interference by any corporate

¹⁸⁹ Blair, MM (1995) (*supra* note 3) at 277

¹⁹⁰ Blair, MM and Stout, LA (1999) (*supra* note 1), Blair, MM and Stout, LA, "Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law" (2000) *Georgetown University Law Center 2000 Working Paper Series in Business, Economics, and Regulatory Law Working Paper No. 241403* and Blair, MM and Stout, LA, "Director Accountability and the Mediating Role of the Corporate Board" (2001) *Georgetown University Law Center Working Paper Series in Business, Economics, and Regulatory Law*

¹⁹¹ Blair, MM and Stout, LA (1999) (*supra* note 1) at 251

¹⁹² *ibid* at 290-320. At 320 they argue that "The mediating hierarchy model we propose explains many important aspects of corporate law much more robustly than its alternatives, especially principal-agent theories premised on the notion that shareholders 'own' corporations." In addition, it "departs from those of the progressives because the[y] commonly argue that corporate directors do not take sufficient account of nonshareholders' interests and that changes in the law are required to make this happen...e.g. ...arguing that directors should operate as "neutral referees" and proposing legal requirements that employees be represented in the boardroom." (*ibid* at 286 fn 83)

constituency, allowing the participants to make credible commitments to each other, thereby creating the stability to develop organisational capabilities.¹⁹³

Blair and Stout's model treats the public corporation as a "nexus of firm-specific investments... in which several different groups contribute unique and essential resources to the corporate enterprise" rather than a "'nexus of contracts' (explicit or implicit)".¹⁹⁴ The vulnerability to opportunism of fellow investors, which arises from the lack of explicit contractual protection, is obviated by the grant of governance rights to management. Giving this role to management clearly contradicts the agency model of the firm, and implies that "*no one team member is a 'principal'* who enjoys a right of control over the team".¹⁹⁵ Rather, each team member has yielded control over their investment to management in the expectation that others will do likewise. In this remodelled managerialism, each corporate participant "agree[s] not to specific terms or outcomes (as in a traditional "contract"), but to participation in a process of internal goal setting and dispute resolution."¹⁹⁶ This incomplete contract reformulation contains no novelty as far as the shareholders are concerned: their residual claimant status is of course familiar from Chapter 1. The key difference lies in the recognition that employees are also dependent on management. Corporate residuals are then allocated according to the outcome of a "political game" in which the participants lobby management to grant them a larger share of the residuals on the basis of the value created by their inputs in the production process.

Blair and Stout recognise that the delegation of decision-making powers to this managerial hierarchy may lead to an increase in agency costs, but suggest that the facilitation of credible commitments between members of the team production system, lower levels of shirking, and a streamlined rent-seeking process should be sufficient to

¹⁹³ See Blair, MM, "Corporate Law and the Accumulation of Organizational Assets: Lessons from the 19th Century" (2003) *Georgetown University Law Center 2003 Working Paper Series in Business, Economics, and Regulatory Policy Working Paper No. 368100*. Blair claims at 50 that "the 'separation of ownership from control', far from being an infirmity of the corporate form, was one of the most important benefits of the corporate form."

¹⁹⁴ Blair, MM and Stout, LA (1999) (*supra* note 1) at 275

¹⁹⁵ *ibid* at 277, emphasis in original

¹⁹⁶ *ibid* at 278; this method of dispute resolution is both cheaper and more conducive to continued cooperation than more adversarial methods such as arbitration and litigation

outweigh these costs. While, at least in the short term, returns to shareholders will be likely to be lower, in the longer term, increased returns may accrue to shareholders as the company exploits the competitive advantage it derives from maintaining a network of firm-specific investments. In response to the inevitable arguments that management will tend to act in a self-serving way, Blair and Stout assert that developments in behavioural psychology suggest that there may be grounds for believing that, as a general rule, management tends to act in an intrinsically trustworthy manner, constrained by social signals and other variables.¹⁹⁷

The Impact of Adaptive Mechanisms on the Prospects of Mediating Hierarchy

We have seen that the law presently plays only a minor, facilitating role in systems of corporate governance. It pushes management to fulfil a mediating role, at least rhetorically, by imposing both fiduciary duties and a duty of care on management to act in the best interests of the legal person. However, these liability rules play only a minor role in making directors accountable, serving as a "backstop" for egregious wrongdoing and have limited enforceability;¹⁹⁸ the capital markets play the most important role in controlling managerial discretion, and of course focus on the interests of shareholders rather than employees.¹⁹⁹

One might ask whether the tools of shareholder value,²⁰⁰ stock options, the market for corporate control, short tenure for executives and earnings metrics, which push management to exercise their discretion to advance the interests of shareholders,

¹⁹⁷ Blair, MM and Stout, LA (2001) (*supra* note 190) especially at 44 *et seq*; see also Stout LA, "On the Proper Motives of Corporate Directors (Or, Why You Don't Want to Invite Homo Economicus to Join Your Board)" (*UCLA School of Law Law and Economics Research Paper 03-08*). While this argument may have been fatally undermined by subsequent revelations from, *inter alia*, Enron and Worldcom, it is possible to argue that "stock-based compensation... can encourage directors to take actions that can raise share price in the short run rather effectively, while harming the firm's long-run prospects. Accounting fraud provides an extreme example of this phenomenon." (*ibid* at 4 fn 9.) While stock-based compensation was originally intended to align management's interests with those of the shareholders, in the end, when combined with their inside information, it only served further to differentiate their interests from those of their "principals".

¹⁹⁸ See Mitchell's critique below.

¹⁹⁹ Blair, MM and Stout, LA (2001) (*supra* note 190) at 45 suggest that capital markets are not the only constraint on management: "even while directors enjoy enormous *legal* discretion in how they choose to manage and allocate corporate resources, as a practical matter this discretion is limited somewhat by *economic* pressures (the cost of capital, the availability of skilled workers, the demand for the firm's products)."

whatever the claims of other constituencies, undermine the operation *in practice* of Blair and Stout's model. They suggest that these mechanisms should be seen simply as "disparities...driven more by political power than by economic factors."²⁰¹ In making allocation decisions, the board simply has to meet the minimum demands of each team member (for a return at least equal to their opportunity cost) and to maintain sufficient reputation to continue recruitment to the team;²⁰² beyond that, they have an array of choices as to how to distribute surplus rents, and will make decisions according to the political pressure which a given group can impose on them. Two interpretations of the rationale for the more pro-shareholder allocation of surplus witnessed recently are advanced. First, that "the rise in the 1980s of institutional shareholders ... (which control sizeable blocks of shares in many firms) has tipped the balance of political power toward shareholders by reducing obstacles to collective investor action" at the expense of labour.²⁰³ Alternatively, the imperatives of capital market globalisation have led management to realise that "they must redirect some of the surplus produced by corporate team production from employees to shareholders in order to prevent the flight of capital and keep the coalition together."²⁰⁴

By treating the market's "adaptive responses"²⁰⁵ to managerialism as mere "political pressures" on management, Blair and Stout are able to continue to treat managerial responses to changes in market conditions as ultimately rational rather than sectional. They therefore remain opposed to "reform proposals designed to give stakeholders greater power over directors [which] are misguided if they are driven by efficiency concerns about the supposed inability of current law to protect nonshareholders' firm-

²⁰⁰ See Chapter One, "The Agency Model Beyond Company Law"

²⁰¹ Blair, MM and Stout, LA (1999) (*supra* note 1) at 283

²⁰² Millon, D, "New Game Plan or Business as Usual? A Critique of the Team Production Model of Corporate Law" (2000) 86 *Virginia Law Review* 1001 at 1024

²⁰³ Blair, MM and Stout, LA (1999) (*supra* note 1) at 325; one might add the decline in collective organisation as a further reason behind the reduction of employees' political weight in the coalition.

²⁰⁴ *ibid* at 326; it might be suggested that the reason for this change in allocation was that during the boom of the "new economy", management thought that technological change was reducing the importance of firm-specific investment by labour, and that more capital was needed for investment in information technology; this drove management to make an "appropriate and economically efficient response to changes in the underlying markets for capital and labor."

²⁰⁵ See Kahan, M and Rock, EB, "How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law" (2002) 69 *Uni Chi L Rev* 871

specific investments".²⁰⁶ Yet the assertion of managerial rationality may be questioned on the basis that the capital market's "high-powered incentives" force management into a coalition with the shareholders which marginalises the employees, encouraging them to exercise their discretion in a particular way regardless of the underlying economics of the situation. The focus on short term stock price brought about, *inter alia*,²⁰⁷ by the market's combination of "carrots" and "sticks" is likely to make management reluctant to allocate resources on the basis of employee investments.

Communitarian Critiques

Blair and Stout's interpretation of the doctrinal content of company law, which sees the board as a neutral constituency making trade-offs where the interests of the shareholders and the employees are in conflict, clearly contradicts the normative claims of the contractualists. However, from a communitarian perspective, Mitchell argues that this characterisation of the board cannot be sustained by reference to the doctrinal content of the law either: the basic structure of American corporate law "create[s] almost insurmountable incentives for corporate actors to look primarily, if not exclusively, to maximizing stockholder wealth in performing their functions, and to make any more balanced concept of their roles extremely difficult to pursue."²⁰⁸ In support of his contention he refers to various structural issues: only shareholders have the power to vote, an "inchoate power" which encourages directors to focus on shareholder wealth because "stockholders have the right to sell the corporation out from under the management to the highest bidder";²⁰⁹ only shareholders have standing to bring a derivative action on behalf of the company in respect of directors' breaches of duty, meaning that directors will tend to "behave" as regards the shareholders;²¹⁰ and although management is permitted by constituency statutes to take into account non-shareholder interests, these are not enforceable because of the limitations on derivative actions.²¹¹

²⁰⁶ Blair, MM and Stout, LA (1999) (*supra* note 1) 327 fn 206

²⁰⁷ See Millon, D (2002) (*supra* note 202)

²⁰⁸ Mitchell, LE (2001) (*supra* note 123) at 99

²⁰⁹ *ibid* at 107

²¹⁰ Of course, the use of derivative actions is more restricted in English law.

²¹¹ US constituency statutes are discussed in Chapter 4.

Millon also suggests that the mediating hierarch theory "implicitly assumes that the board's role is to validate existing, exogenously determined power relationships among employees, shareholders, and other stakeholders."²¹² Even worse, it "tacitly accepts the possibility that extralegal pressures might lead the board to behave no differently than it would if operating under the constraints of a shareholder primacy legal regime."²¹³ While the risk that management may only act in the interests of a given constituency where it also serves their own interests is a repeated concern whenever managerialism is discussed,²¹⁴ that risk becomes a near certainty where the incentives provided to management tilt the balance of likely decision-making firmly in favour of one constituency. Existing power structures, and the distribution of wealth, are reflected in the imposition of extralegal constraints.

Perhaps more importantly, the incentives and social norms, which drive management to concentrate on the share price, undermine the board's position of neutrality, and therefore the possibility of maintaining a productive coalition. Employees who have made firm-specific investment, Millon adds, will be in a weaker bargaining position than shareholders because of the cost of their exit option.²¹⁵ Diversified shareholders may more credibly threaten to exit because "no portion of their investment is firm-specific".²¹⁶ Millon also suggests that rent-seeking might reach such high levels that "aggregate net benefits to team members... could be less than they would be under a legal regime of shareholder primacy because the value of each person's share of the pie would be reduced by the costs required to obtain it."²¹⁷ He argues that the only way to avoid this rent-seeking fiasco is to provide management with insulation from political pressure, but doubts whether it is possible to "conceive of a set of legal rules capable of establishing this state of ivory tower autonomy".²¹⁸ Certainly, such rules would need to include some degree of protection against hostile takeover, or taming of the market for corporate

²¹² Millon, D (2000) (*supra* note 202) at 1027

²¹³ *ibid* at 1027

²¹⁴ The "classic" argument discussed in Chapter 2.

²¹⁵ Millon, D (2000) (*supra* note 202) at 1027-8: they are unable to make a credible threat of defection because it would imply forfeiture of their investment

²¹⁶ *ibid* at 1028.

²¹⁷ *ibid* at 1031

²¹⁸ *ibid* at 1032

control, as well as restrictions on remuneration based solely on share price. Millon ultimately falls back on the "classic argument", concluding that fiduciary duties are "ill-suited to situations in which a steward must figure out how to serve two masters at the same time."²¹⁹

Information and Consultation as Rights Guaranteeing Dialogue

Leaving these important critiques aside, Blair and Stout's mediating role for the board suggests a new economic rationale for information and consultation processes, located squarely between a contractual rationale, which posits that information and consultation are aimed at achieving contractual completeness, and a governance rationale, which posits that the process facilitates the establishment and operation of appropriate decision-making structures which allow adaptation to changed circumstances. Information and consultation might instead be seen as formalised processes guaranteeing employees access to management on a regular basis; this repeated interaction then becomes one of the political methods by which employees press their claims before the mediating hierarchs, allowing them to emphasise the importance of their firm-specific investment. The question that remains is whether information and consultation create a sufficiently powerful "political lobbying" mechanism, compared with the "high-powered incentives" provided to management to serve the interests of capital markets.

A Critique of the Productive Coalition Model

As we have seen, investments in human capital are difficult to quantify, and so they are either resisted by neoclassical contractualists on the basis that they cannot be proved to exist, or ignored altogether. They do not consider the potential role of employees in reducing agency costs by monitoring management for self-serving behaviour.²²⁰ The argument that employees should also be considered residual claimants because of the contracting problems they face must be answered systematically before the agency model can truly claim exclusive heuristic force.

²¹⁹ *ibid* at 1041

²²⁰ Mitchell, LE (2001) (*supra* note 123) at 131 argues that, in contrast to shareholders, employees have good knowledge about the business, the incentive to monitor management, and would tend to take a longer term view.

Moving beyond the empirical difficulties associated with demonstrating that employees make investments in firm-specific capital, economists like Lazonick and O'Sullivan have been somewhat critical of the productive coalition approach, although their analysis of corporate governance in terms of productive efficiency and generation of innovation also shares much common ground. O'Sullivan is very critical of the neoclassical contractual approach on the grounds that it is premised on exchange (static resource allocation) at the expense of organisational and production issues.²²¹ Its emphasis on exchange does not allow it to have any theory of production²²² or of organisational capability: since the market is the only form of governance considered, emphasis is placed on the ease with which assets may be redeployed to other uses. Of course, this takes no account of investments which cannot be redeployed easily or at all, irreversible commitment of investments being one of the key aspects of the innovative enterprise in the opinion of Lazonick and O'Sullivan.²²³ This is the defect in the neoclassical model which the concept of firm-specific capital is supposed to remedy. But this approach does not escape their critique either:

"to an extraordinary degree, given its centrality to their work, labour economists have failed to open the black box of firm-specificity to analyze where it comes from and, relatedly, why it makes sense to assume that it might be an important phenomenon in the economy."²²⁴

²²¹ O'Sullivan, MA (2000) (*supra* note 5) in particular at 43-52

²²² Pitelis, C, *Market and Non-Market Hierarchies - Theory of Institutional Failure* (1991) at 18-19 explains why neoclassical analysis can have no theory of production: if one does not follow Coase and Williamson's view of the market pre-existing the firm and being the "natural (or original) means of resource allocation, so that non-market institutions need to be explained", then one can see that "market exchanges are nothing but exchanges between existing firms, or between such firms and their customers. The reason for this is that exchange presupposes production. Markets do not produce. Firms (including single-person ones) do. It follows that conceptually the firm precedes the market and not vice versa."

²²³ O'Sullivan, MA (2000) (*supra* note 5) at 11; the other two are the organizational integration of human and physical resources and the strategic allocation of resources to alter market and technological conditions.

²²⁴ Lazonick, W and O'Sullivan, M, "Perspectives on Corporate Governance, Innovation, and Economic Performance" (2000) *Corporate Governance, Innovation, and Economic Performance in the EU*, European Institute of Business Administration (INSEAD) at 44; see also O'Sullivan, MA (2000) (*supra* note 5) at 56-8

According to O'Sullivan's critique, while the productive coalition model offers a more satisfactory account of the process of wealth creation, it "fails to go beyond the neoclassical preoccupation with static resource allocation."²²⁵ It omits organizational issues (the interaction of factors of production cumulatively to produce innovation) and strategic issues (the fact that the firm's environment is taken as given). While she recognises Blair's attempts to embed "stakeholder theories...in a framework of economic analysis",²²⁶ O'Sullivan describes Blair's notion of firm-specificity variously as a "black box"²²⁷ and a "*deus ex machina*."²²⁸ She charges Blair with over-reliance on exchange and therefore contract, so that the "returns to all participants (productive factors) in the enterprise - in such forms as wages, rent, and interest - remain strictly determined, as they are in the neoclassical model, by technological and market forces that are external to the operation of the enterprise and human control more generally."²²⁹ This means that Blair tends to underemphasise organisational processes, and so to treat firm-specific investment in a static rather than dynamic evolutionary manner:

"There are economists of innovation [like Lazonick] who have argued that the characteristic of firm specificity is an outcome of organizational learning processes through which resources are developed and utilized in the economy...the firm specific-skills that result from continued innovation are constantly evolving. Firm-specific skills that were at one time part of a process that enhanced economic performance may fail to do so in another era and may even retard it. To focus on firm-specific skills as the critical dimension of the process of wealth creation is to ignore the dynamics of the innovation process. Linked to a theory of governance, such a perspective may well encourage the entrenchment of the claims of economic actors who have participated in and benefited from wealth creation in the past, even when the integration of their skills is no longer a

²²⁵ O'Sullivan, MA (2000) (*supra* note 5) at 56

²²⁶ *ibid* at 53

²²⁷ *ibid* at 55, perhaps making an analogy with pre-Coasean theories of the firm.

²²⁸ *ibid* at 42

²²⁹ *ibid* at 56

viable basis on which the economy can generate the returns to meet these claims. That is, the stakeholder theory risks becoming a de facto theory of corporate welfare."²³⁰

As we have seen, Blair's work is not limited to simple exchange (in the Alchian-Demsetz sense, or even in the legal-contractual sense) but focuses on relational and incomplete contracts, often of long duration, which create pressure for the development of governance structures, and which should be considered organisational rather than purely "contractual" arrangements. It is submitted that once a contract is termed "relational" or "incomplete" then to label it simply as "exchange" is unhelpful. It is a "constitutive" contract, and the parties and their output are "endogenous" rather than static.²³¹ The specialisation of the factor of production is described as "an investment in firm-specific capital" because a contractual methodology has been adopted. Theories of company law and corporate governance which take into account employee investment in firm-specific capital recognise that one cannot know *ex ante* either the extent of the investment or the future returns attributable to it. Further, Blair is explicit that the value and extent of firm-specific capital, and the returns attributable to it, will grow as time passes and the employee becomes more specialised in the task. The ongoing interaction of the employee with the task may in time lead to a change in the nature of the task and consequential innovation. Certainly the absence of specialisation by the employee would appear to preclude any co-evolution of employee and task.

O'Sullivan's criticisms are made in the context of a focus on innovation, which she argues depends on more than the commitment and specialisation of productive resources. However, such a broad focus on innovation is less useful in terms of setting an agenda for the law. In particular, the constant change which innovation requires, particularly as regards matters of internal organisation, suggests that the law can have little role in laying down governance structures, which must evolve on a case-by-case basis. Yet if the law is not to play this role, then at the very least the innovative firm will be constantly

²³⁰ O'Sullivan, MA (2000) (*supra* note 5) at 56. It might be argued that O'Sullivan's entrenchment argument applies even more strongly to the doctrine of shareholder value, which underpins returns to unproductive shareholders who simply trade residual claims for the most part based on historically distant capital contributions.

hampered by transaction costs and rent-seeking as the organisational framework evolves through sequential adaptations. The productive coalition model can at least assist with the reduction of these costs.

Under O'Sullivan's approach, the crucial rights to determine resource and return allocation should be placed "in the hands of decision-makers who are integrated with the learning process that generates innovation...inherent in the process of innovation, in the need to commit to resources to undertake it and the uncertainty of returns from innovative investments, is a need for control of resources by the decision-makers who shape the innovation process."²³² Given that the identity of the "shapers" may change over time and across various aspects of the production process, and that those with decision-making power may be reluctant to transfer that power to the new "shapers", the law's task seems rather difficult. Haggling over the allocation of decision-making power seems likely to delay innovation. Perhaps their positions can be reconciled by viewing Blair's work as a preliminary step on the road to introducing a notion of productive innovation into company law and corporate governance through the proxy of firm-specificity. This view casts the role of the law as being to encourage the irreversible commitment of resources by employees as well as shareholders, leaving the other elements of innovation to flow from the interaction which constitutes the corporate governance process.

Conclusion

As we saw in Chapter 1, the essentially managerialist model of company law has been supplemented, or even transformed, by the provision of high-powered incentives to management in order to solve the "agency problem". By contrast, the political will to implement a political stakeholder model at the level of the company was found to be lacking during the 1970s, perhaps because its advocates did not make a more cogent economic case for its introduction. The failure of stakeholding to make an impact on company law, coupled with the shift to services and high value-added manufacture, has led to the development of the productive coalition model. Its prescriptions are less

²³¹ Bowles, S, "What Markets Can - and Cannot - Do" (1991) *Challenge* 11 at 13

²³² O'Sullivan, MA (2000) (*supra* note 5) at 60

determinate than those of either of the models which preceded it, but they are not completely indeterminate. It recognises that one-size-fits-all corporate governance is not likely to maximise efficiency. While there may be some firms which conform to the agency model, it is a methodological oversimplification to assume that employees never bear risk. Its more sophisticated conception of societal wealth generation carries important policy implications for company law and corporate governance. Productive coalitions play an increasingly important role in developed economies. However, they can only develop where appropriate institutional infrastructure is in place, and their continued existence depends on its continued support. If this support is not available, economic actors will be reluctant to specialise, allocative efficiency will suffer and the wealth of society will not be maximised. Managerialism was one such means of support, but has now been co-opted to the pursuit of shareholder value. Legal intervention may be appropriate, given the difficulties faced when attempts are made to draw together disparate groups into a productive coalition. The law could decree a return to managerialism, perhaps prohibiting various groups from offering incentives to management to serve their interests. Alternatively, it could provide members of the coalition more formalised procedural means to representation of their interests in the corporate decision-making process. In particular, full provision of information (even to the extent of informational board representation) and (perhaps) consultation fit well with all three models.

Part two of the thesis looks at the specific threat to the productive coalition posed by the hostile takeover mechanism, and the way in which the law supports and regulates that mechanism. It also suggests ways in which takeover regulation may be made more conducive to the development and support of productive coalitions.

Part Two:
Application of the Models
to Takeover Regulation

Chapter Four: Takeover Regulation in the United Kingdom and the United States

Introduction

The UK and US systems of corporate governance share many features, including a managerialist conception of company law; the strong normative influence of the agency model; wide dispersal of shareholders in public corporations; and a high level of market capitalisation by reference to GDP. This makes the differences in their systems of takeover regulation particularly striking. The UK system suspends the general company law rule of managerialism from the moment a bid is made, while the US system, which differs in its precise details from state to state, theoretically permits management a considerable degree of discretion to defend against hostile takeovers.

This chapter first examines the theoretical issues behind takeover regulation, then looks at its evolution in the UK and the US, comparing the two systems against the models of the company and identifying their underlying assumptions.

The Scope of Takeover Regulation

Takeovers occur where a bidder, most often a company, gains control of a company through the acquisition of a controlling shareholding in it.¹ Where control is already concentrated, as in many continental European jurisdictions,² takeovers normally take the form of a private sale of a shareholding. By contrast, a bidder seeking control of a widely-held corporation normally makes an offer directly to the dispersed shareholding public, inviting them to tender their shares in the corporation for a price set at a considerable premium above the market price, the offer being expressly conditional upon a set level of acceptance being achieved within a given time period.

¹ See for example, Roe, "Strong Managers, Weak Owners" (1994) at 151: "Takeovers coalesce ownership structures. If ownership were already coalesced, takeovers could not readily occur."

² See for example, Franks and Mayer, "Ownership and Control in Europe" in Newman, P (ed), *The New Palgrave Dictionary of Economics and the Law* (1998), 722

In the conventional view, takeover regulation is not concerned with the merits of a proposed takeover (including, but not limited to, its effects on industry structure and competition), but simply prescribes *the process by which offers are made and responded to*. A takeover bid is described as "hostile" if it is not "welcomed" by the board of the target company, and "friendly" where the board approves the bid.³ There are various reasons for which the incumbent board might not welcome a bid, and some regulatory systems attempt to distinguish between them. The board may not approve of the bidder's plans for the corporation, considering their own plans to be better. In that case, it might be argued that the board (with their superior inside knowledge) should be permitted to take steps to defend the target against takeover,⁴ or at least make their position known to the shareholders. Alternatively, they may consider the price offered to be too low, giving rise to an argument that the board should be obliged to seek additional bidders and hold an auction. Finally, the board may fear that the bidder is planning to replace them after the takeover has occurred,⁵ leading to an argument for board neutrality lest the board defend the takeover in order to entrench themselves.

Identifying the motive behind the board's defensive action is the main difficulty faced by takeover regulation, as may be seen from the different approaches taken by the various regulatory systems. In the UK, in the face of the common law's high cost approach of reviewing the board's motives in each case, shareholder interests succeeded *de facto* in outlawing defensive measures by the boards of publicly quoted companies altogether. In the most important US jurisdiction, Delaware, an intermediate standard of review was

³ Deakin, S and Slinger, G, "Hostile Takeovers, Corporate Law, and the Theory of the Firm" (1997) 24 *Journal of Law and Society* 124 at 146: "A hostile bid is...an offer for a controlling shareholding which is not welcomed by the incumbent management, whether or not the management later recommends the acceptance of that bid or another one." Similarly, "...the hostility emanates from target management. It is they who are antagonistic to the prospect of a change in ownership and control. In the face of such hostility the tender offer provides a means by which the outside suitor can go over the heads of target management and make an offer directly to the shareholders." (Cohen, "Tender Offers" in Newman, P (ed), *The New Palgrave Dictionary of Economics and the Law* (1998), 580 at 580.)

⁴ Lipton, M and Rosenblum, SA, "A New System of Corporate Governance: The Quinquennial Election of Directors" (1991) 58 *University of Chicago Law Review* 187 at 196: "antitakeover provisions can be a quite rational tool for a board of directors seeking to preserve the corporation in the face of an attempted takeover that is likely to be detrimental to the long-term health of its business."

⁵ Easterbrook, F and Fischel, D, *The Economic Structure of Company Law* (1991) at 162: "Managers of the target perceive bids as reflecting poorly on their service, since the bidders commonly propose to change the

adopted, in which the board is given discretion to defend, but is subject to review against the objective criterion of reasonableness in the circumstances of the particular bid. Other US jurisdictions are even more tolerant of defensive measures, theoretically allowing management a very broad discretion to take into account a range of "stakeholder" interests, although as an empirical matter, the introduction of "antitakeover" laws has not prevented takeovers and further corporate consolidation. In the next chapter we shall see that a recent piece of legislation in Germany allows defensive measures where they are authorised by the supervisory board, and makes no reference to the motivations of the board whatsoever. This is in stark contrast to the proposed EC takeover directive, discussed in the final chapter, which follows the UK approach and outlaws defensive measures altogether.

In line with the focus of this thesis, the analysis of takeover regulation here concentrates on the position of employees. Defensive measures by the board are one way in which the employees' position might be taken into account alongside the other interests of "the company". Alternatively, provision might be made for direct employee involvement in the form of information and consultation; there are no instances of co-determination by shareholders and employees of the outcome of takeover bids for the simple reason that in all the jurisdictions considered, the decision whether or not to sell their shares is for the shareholders alone.⁶ However, given the commercial and financial sensitivity of many deals, even apparently lower order procedural obligations, which have the potential to delay the bid, may have a significant effect on its outcome. The important point is that whether it restricts the board's ability to take defensive measures, or requires employees to be informed and consulted, interventionist takeover regulation represents a significant deviation from the general board-centred, managerialist view of company law.

way the target is run. Within three years of an acquisition, half of all the managers at targets are out of work."

⁶ With the limited exception of the "freezeout" rule, discussed below.

The Market for Corporate Control

Since the emergence of the Berle and Means corporation in the nineteenth century, the only rational recourse of dispersed individual shareholders, dissatisfied with the performance of management, has been to exit the firm by selling their shares. Their collective action problem prevents them from co-ordinating their actions to oust management in a proxy contest: other shareholders will "free ride" on the efforts and at the expense of those who initiate action. The market measures votes cast with their feet in this way, indicating shareholder dissatisfaction by a declining share price. Without more, however, a declining share price has little effect on underperforming management, who remain in their positions, unthreatened by rationally apathetic shareholders. To the extent that management relied upon issuing new stock to raise capital, or on debt financing, the lower share price would raise the firm's cost of capital. However, since most firms satisfied the bulk of their capital requirements through retained earnings,⁷ this imposed minimal constraints on management to maximise shareholder value.

Accordingly, agency-model economic analysis suggests that hostile takeovers can reduce agency costs and increase allocative efficiency where the Berle and Means corporation is dominant by constraining management to advance the shareholders' interests.⁸ This is necessary where there are no blockholders with the correct incentives to undertake monitoring activities.⁹ Henry Manne first suggested in 1965 that the market for corporate

⁷ O'Sullivan, MA, *Contests for Corporate Control: Corporate Governance and Economic Performance in the United States and Germany* (2000) at 154 notes that "From 1970 to 1989...retained earnings accounted for 91 percent of the net sources of finance for US non-financial corporations." Unger, RM, *Democracy Realized: The Progressive Alternative* (1998) at 46 and Stiglitz, JE, *Globalization and Its Discontents* (2002) at 128 note the minor importance of new equity for satisfying firms' capital requirements. See further the discussion of negative net equity issues in Chapter 3.

⁸ As Easterbrook, F and Fischel, D (1991) (*supra* note 5) say at 171, "tender offers control the agency costs of management. Their existence makes contractarianism on other subjects practical." Other benefits have been claimed for takeovers and mergers: synergy gains may be made when two formerly separate enterprises are combined, allowing them to rationalise non-productive aspects of their business such as administration, and mergers may also offer tax advantages. The use of takeovers in this way lies outside the scope of this thesis.

⁹ For discussion of the role of blockholders as an alternative mechanism for monitoring management see Roe, MJ, *Political Determinants of Corporate Governance* (2003). As Roe suggests, the direction of causality could be reversed, blockholders being prevented from selling their shares and diversifying by the absence of a market for corporate control, which means that they would not receive full value for their shares.

control is the key mechanism for the protection of shareholder interests,¹⁰ disciplining management through the threat, and occasionally the execution, of takeover bids. Certainly when compared with the managerialist norms of English and US company law, which emphasise "the interests of the company" and managerial discretion, the market for corporate control appears to considerably strengthen the norm of shareholder value.

Groups of potential bidders monitor managerial performance by comparing the current share price to its potential, identifying underperforming companies, and making tender offers for their share capital.¹¹ Managerial failure may take several forms. First, management may act in a self-serving way and direct too much corporate surplus to themselves. Second, they may engage in "empire building", or seeking power for power's sake, and fail to draw the line between the firm and the market correctly, employing capital for a return below that achievable elsewhere. Third (and another aspect of "empire-building"), the organisation may have become too large for management's decision-making capacity. Finally, management may pursue shareholder interests less than fully by making concessions to other corporate constituencies in order to enjoy more leisure.¹²

However, the market for corporate control operates primarily as a background threat, or a "stick"¹³ to encourage management to serve the interests of current shareholders by maximising profits.¹⁴ The capital markets demand that managers should only make "corporate investments in projects that can yield at least the same risk-adjusted rate of return that shareholders could receive elsewhere in the economy, or...redistribut[e]

¹⁰ Manne, H, "Mergers and the Market for Corporate Control" (1965) 73 *J. Pol. Econ.* 110 at 113: "Compared to this mechanism, the efforts of the SEC and the courts to protect shareholders through the development of a fiduciary duty concept and the shareholder's derivative suit seem small indeed."

¹¹ Easterbrook, F and Fischel, D (1991) (*supra* note 5) at 172-3.

¹² Manne (in Manne, HG and Wallich, HC, *The Modern Corporation and Social Responsibility* (1972) at 19) suggests that management can "use for their own purposes any rents produced by the corporation up to the amount it would cost to displace them from their positions." See also Romano, below note 73.

¹³ Lazonick, W and O'Sullivan, M, "Perspectives on Corporate Governance, Innovation, and Economic Performance" (2000) *Corporate Governance, Innovation, and Economic Performance in the EU*, *European Institute of Business Administration (INSEAD)* at 26; the "carrot" is, of course, the grant of stock options, which are intended to allow the "stick" to be used sparingly.

¹⁴ Manne, H (1965) (*supra* note 10) ; also Easterbrook, F and Fischel, DR, "The Proper Role of a Target's Management in Responding to a Tender Offer" (1981) 94 *Harvard Law Review* 1161 at 1169-73.

revenues to shareholders who can then reallocate these resources themselves in search of the highest available returns."¹⁵ Failure to comply with the capital market's demands will lead to a shareholder exit or even exodus, depressing the price of shares and rendering management vulnerable to would-be bidders. Where the threat does not work, and "the internal processes for change in large corporations are too slow, costly and clumsy to bring about the required restructuring or change in managers efficiently...",¹⁶ the hostile takeover is a "nuclear" mechanism of last resort.¹⁷

Hostile takeovers only become viable where agency costs in the target firm are higher than the sum of the transaction costs of launching a takeover and the payment of a premium over market price to the shareholders.¹⁸ A contest for control of the corporation takes place between the bidders and incumbent management, with the shareholders deciding the outcome by referendum. Its supporters claim that the market for corporate control redraws the boundary between the firm and the market in the correct position.¹⁹ A successful bid allows target shareholders to exit the scene (or to join the offeror company if shares in the bidder constitute part of the purchase price). The bidder then installs management who will prioritise the creation of shareholder value, which, according to the

¹⁵ Lazonick, W and O'Sullivan, M (2000) (*supra* note 13) at 25

¹⁶ Jensen, MC, "The Takeover Controversy: Analysis and Evidence" in Coffee, JC, Lowenstein, L, and Rose-Ackerman, S eds, *Knights, Raiders and Targets* (1988), 314 at 318; see also Bergström, C, Högfeldt, P, Macey, JR, and Samuelsson, P, "The Regulation of Corporate Acquisitions: A Law and Economics Analysis of European Proposals for Reform" (1995) *Columbia Business Law Review* 495 at 500: takeovers, especially hostile ones contribute to "improving performance by selling corporate assets to more specialized managers"

¹⁷ Becht, M, Bolton, P, and Rowell, A, "Corporate Governance and Control" (*ECGI Finance Paper No2, October 2002*) at 24 describe hostile takeovers as "a radical and spectacular mechanism" which "is highly disruptive and costly". The transaction costs of the takeover, in the form of professional fees may amount to a rather high percentage of the corporation's overall value. These high transaction costs suggest that it is desirable that the takeover mechanism be used sparingly, and *primarily pour encourager les autres* rather than as a routine asset allocation mechanism.

¹⁸ While a successful takeover bid may mean that the target shareholders collectively do not suffer loss compared with the current market price, if management have been underperforming for some time, there may still be a loss compared to the putative value of the corporation. This of course is the source of gains to offeror shareholders.

¹⁹ According to this logic, the market for corporate control should operate to prevent managers from empire-building because, if the empire they build does not produce synergy gains, and therefore a gain in the share price, the enlarged corporation will be vulnerable to takeover and break up. Of course, there is a danger that bidders may also be engaging in empire-building, but they too should be aware of the risk posed to their position by the market for corporate control. We can see from this that while the market for corporate control should allocate assets to where the capital markets value them most highly, this process of

agency model, maximises the wealth of society.²⁰ The gains made when new managers are installed who will serve shareholder interests more keenly (either because they are more competent or motivated) are shared between existing and new shareholders. Where there is a cash-only offer, the existing shareholders receive their premium and exit the scene before the efficiency gains are realised. The new shareholders get the benefit of a progressively higher market valuation of their shareholdings as new management implements shareholder value strategies.²¹ Where there is a share-for-share bid, both sets of shareholders must await the market's verdict on the new strategy.

Legal Implementation of the Market for Corporate Control

A market for corporate control cannot operate in a vacuum. It requires constitutive legal rules. Agency theoretical arguments have been very influential in normative debates about takeover regulation, both in terms of the mechanics of the bid and the role of management.

Shareholders will be unwilling to diversify their portfolios fully unless they are assured that even small shareholders will share in the control premium which accompanies a takeover bid.²² Takeover regulation frequently interferes with the bidder's normal freedom of action on the market in two ways. It may prohibit partial bids, effectively forcing the bidder to buy out the minority, and require equal treatment of shareholders, allowing all to exit on the same terms, whatever the size of their holding. The effect is that the control premium paid by the bidder is shared among all shareholders rather than

"creative destruction" will give rise to significant transaction costs as successive empire-building bidders are "rumbled" and their costly actions reversed.

²⁰ Jensen, (1988) (*supra* note 16) at 315 and 318 explains that the "corporate control market generates these gains [for society] by loosening control over vast amounts of resources and enabling them to move more quickly to their highest-valued use." Further, once management have paid out free cash flow to shareholders (which rational investors can then apply to its best use), management will be subject to capital market discipline when they want to raise funds for further activities, leading to "substantial changes in corporate strategy."

²¹ Some studies suggest that offeror shareholders are often worse off post-takeover: see the sources cited in Coffee, JC, "The Uncertain Case for Takeover Reform: An Essay on Stockholders, Stakeholders and Bust-ups" (1988) *Wisconsin Law Review* 435 at 438 fn 11 and 12.

²² Rajan, RG and Zingales, L, *Saving Capitalism From the Capitalists* (2003) at 160: "dispersed investors may find it prohibitively costly to enforce their rights; hence they need an organization like the SEC to represent them and laws to protect them."

being appropriated as a "private benefit" by those in control.²³ The counterpart of the minority's right to exit on change of control is a "squeeze-out" right which allows the bidder to compulsorily acquire the holdings of the minority shareholders that did not accept the tender offer. Yarrow suggests that compulsory acquisitions prevent free riding by minorities on efforts by would-be bidders and so are an essential support for the market for corporate control:

"The argument is that shareholders of the target company, believing their own actions have a trivially small effect on the probability of success of a particular bid, will have an incentive to decline the offer if they expect others to accept, since in this way they can participate in the post-raid improvement in performance of the firm...If all owners expect the bid to succeed then it will in fact fail."²⁴

Yarrow suggests that "the granting of rights to controlling interests to compulsorily acquire minority shareholdings...[is] a simple and elegant solution of the free rider problem."²⁵ In the absence of this rule, the market for corporate control would not produce the benefits claimed for it by agency theorists. The "squeeze-out" right constitutes another important interference with the normal operation of the market, denying individual shareholders the right to decide whether they wish to sell their shares, which instead becomes a matter for the majority to decide on a case-by-case basis.²⁶

In addition, calls are frequently made for prohibitions on defensive measures by management, which agency theorists treat as a device for entrenching incumbent management at the expense of shareholders, and an obstacle to the operation of the market for corporate control. If the board is permitted to take defensive measures, some bids will fail, increasing the costs of outside monitors, making their operations less viable

²³ *ibid* at 57

²⁴ Yarrow, GK, "Shareholder Protection, Compulsory Acquisition and the Efficiency of the Takeover Process" (1985) 34 *Journal of Industrial Economics* 3 at 3-4

²⁵ *ibid* at 4. For an example, see ss 429-30 Companies Act 1985, which sets the threshold at 90%.

²⁶ *ibid* at 12

and increasing agency costs across the economy as a whole.²⁷ Since monitoring is seen as a social good, the law is charged with ensuring that nothing is done to discourage a constant supply of potential monitors. There is unanimity among those viewing takeovers as a mechanism for reducing agency costs that this entails, *inter alia*, prohibiting management from taking defensive measures to oppose or delay bids.

The main point of contention among agency theorists is whether management should be encouraged or allowed to auction off the company. Easterbrook and Fischel consider that "managers should remain passive and let investors decide whether to tender."²⁸ This entails prohibitions on defensive measures and on soliciting other bidders with the aim of raising the bid price through auction. The reason is that losing bidders also incur the costs of pre-bid monitoring and making the bid, so auctions tend to discourage potential monitors. *In extremis*, the price demanded at auction may become so high that the target's shareholders appropriate all the gain arising from the bid, rather than sharing it with the bidder, leading to a situation where "no one has an incentive to monitor and make offers."²⁹ By contrast, Bebchuk argues that management should be permitted to solicit additional bidders in order to hold an auction, with the proviso that these rules should not discourage initial bids.³⁰ He argues that the encouragement of competing tender offers is "desirable both to targets' shareholders and to society"³¹ because they improve the flow of private information about companies.³² An auction rule would not deter first bidders since "the search costs that first bidders incur do not seem to be at all large."³³ Bebchuk

²⁷ Easterbrook, F and Fischel, D (1991) (*supra* note 5) at 174: "If managers pursue a path of 'independence'... there is no profit in being an outside monitor, hence all firms' stock price falls *ex ante*. Agency costs increase (and prices fall) to the point where further changes precipitate a change of control. Because investors prefer the wealth maximizing rule...the optimal legal rule prevents resistance unless expressly authorized by contract *ex ante*."

²⁸ *ibid* at 171

²⁹ *ibid* at 174. They also argue that the first bid reveals the knowledge of the monitor so an auction allows free-riding, and that maximising the wealth of target shareholders at the expense of the bidder is wasteful "shuffling" because of diversification: "Investors in targets (who are also investors in bidders) want the maximum value for stocks as a whole." (at 189)

³⁰ See for example, Bebchuk, LA, "The Case for Facilitating Competing Tender Offers" (1982) 95 *Harvard Law Review* 1028 and Bebchuk, LA, "The Case for Facilitating Competing Tender Offers: A Reply and Extension" (1982) 35 *Stanford Law Review* 23; see also Gilson, R, "A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers" (1981) 33 *Stanford Law Review* 819.

³¹ Bebchuk, LA (1982) (*supra*) at 1029

³² *ibid* at 1049-50

³³ *ibid* at 1036 for a breakdown of these costs

argues that auctions have the positive effect of encouraging the optimal amount of search. If premia are minimal and all gains go to the acquirer, then too much search may be performed.³⁴ Auctions increase "the likelihood that the target will be acquired by the firm to which its assets are most valuable,"³⁵ namely the bidder most likely to realise synergy gains rather than an asset-stripper. It may also discourage acquisitions which are prompted only by financial speculation or empire-building on the part of the bidder's management. An auction rule might even encourage the preservation of firm-specific investments, by selling firms more frequently to bidders who will keep the assets in their higher value current use.

Explanations of the "Deal Decade"

A particularly "vigorous" market for corporate control emerged during the 1980s in both the UK and the US. The phenomenon was so pronounced that the period has been widely termed the "deal decade", characterised by "the emergence of hostile transactions, the large size of the average target, and the unprecedented reliance on aggressive techniques to conclude transfers of corporate control."³⁶

The deal decade is important because widespread use of the hostile takeover reoriented corporate governance from managerialism to a single-minded pursuit of shareholder value. The only way in which managers could fend off unwanted suitors and preserve their positions was to concentrate on the share price. The deal decade also forms the political context in which many states enacted anti-takeover statutes.

Leaving aside the rather implausible hypothesis that all the takeovers were motivated by replacing ineffectual management,³⁷ two main competing explanations have been

³⁴ *ibid* at 1047

³⁵ *ibid* at 1048

³⁶ O'Sullivan, MA (2000) (*supra* note 7) at 161; Cook, J and Deakin, S, "Stakeholding and Corporate Governance: Theory and Evidence on Economic Performance" (1999) *ESRC Centre for Business Research, University of Cambridge Working Paper No ??* at 23 refer to "an increase in takeover activity from 1984-88 and then a decrease over the period 1989-93." Kelly, M, *The Divine Right of Capital* (2003) at 55 cites estimates that in 1990, one third of companies in the Fortune 500 were targeted for hostile takeovers.

³⁷ Coffey, JC (1988) (*supra* note 21) at 441: "managerial incompetence is hardly cyclical."

advanced for the enormous growth in takeovers during the deal decade. Which of the two explanations one accepts obviously colours one's view of the legitimacy of the regulatory regimes put in place in the UK and the US.

i) Deconglomeration

The most frequently advanced perspective within the financial economics literature builds on the theory of the market for corporate control, and explains corporate restructuring during the 1980s as a necessary response to new competitive pressures,³⁸ changes in technology³⁹ and growing demand for financial liquidity.⁴⁰ The competitive decline of many US and UK corporations in the face of challenges from, in particular, German and Japanese rivals is explained by reference to the agency problem described in chapter one and the bounded rationality problem described in chapter three.⁴¹ Management of the Berle and Means corporation, gradually freed from shareholders' oversight as those shareholders became more dispersed, either abused, or used incompetently, the wide discretion granted to them under Anglo-American systems of corporate governance. Corporate decision-makers satisfied their own preferences for prestige at the expense of creditors, who bore greater risk, and shareholders, who suffered

³⁸ Jensen, MC, "Takeovers: Their Causes and Consequences" (1988) 2 *Journal of Economic Perspectives* 21 at 24

³⁹ See Holmstrom, B and Kaplan, S, "Corporate Governance and Merger Activity in the U.S.: Making Sense of the 1980s and 1990s" (*MIT Department of Economics Working Paper 01-11 February 2001 available at http://papers.ssrn.com/paper.taf?abstract_id=261112*). The authors argue at 3 that "shareholder value became dominant in the 1980s and 1990s in part at least because capital markets have a comparative advantage in undertaking the kind of structural reforms that deregulation and technological change necessitated." Their hypothesis is that "Markets are more effective than managers when it comes to moving capital from declining industries to emerging industries." (23)

⁴⁰ O'Sullivan, MA (2000) (*supra* note 5) at 146-161 who notes in particular changes in savings and pension-provision patterns to favour investments in corporate equities: after restructuring, cash flow, which had until then been allocated by management, was paid out to shareholders who would then reinvest it in the stock market where it received the highest return, thus putting the assets to their most highly valued use. See also Dore, R, *Stock Market Capitalism: Welfare Capitalism - Japan and Germany Versus the Anglo-Saxons* (2000) who stresses the role of financial deregulation and tax incentives in increasing the flow of savings to the capital markets, and the corresponding pressure to return spare cash flow to shareholders.

⁴¹ Dore, R (2000) (*supra*) at 26-32 and 45-8 argues that the reasons for the competitive decline are more fundamental. He refers to differences in the underlying model of the firm, and argues that broad cultural or conventional (rather than legal) differences in systems of corporate governance, as well as differences in financial systems, create institutional interlock. Within a varieties of capitalism perspective, the finance-dominated Anglo-Saxon agency model undermines investments in firm-specific skills and incremental innovation, generating competitive advantage through radical innovation and lower wage costs: (*ibid* at 233 *et seq*, this point is taken up in more detail in Chapter 6).

from lower profitability.⁴² This unconstrained spree of hierarchy-building led to gargantuan inefficiencies as managers built and ran corporations which were too complex for them to monitor fully, and the allocation of resources within the firm became sub-optimal. Impatient capital seeking out the highest returns restored optimality.

Certainly in retrospect, the exponential growth of conglomerate (or "multidivisional") corporations from the beginning of the 1960s, which occurred through merger (hostile or friendly takeover), rather than organic growth, is striking. However, the conglomeration process had itself been justified in terms of allocative efficiency on the basis of two related arguments drawn from pre-transaction cost economics and "scientific management" theory. First, diversification into lines of business unrelated to the company's core business reduced its exposure to risk in product markets. Second, the loss of control on the part of top management, which one would expect in the event of such diversification, could be avoided by clear differentiation between strategic decision-making, which should occur at head office level, and administrative decision-making, at divisional level.⁴³ When it became clear that this "strategic segmentation" of operational and strategic decision-making did not work because the two areas were interdependent, and that management were accordingly not capable of managing the conglomerates which they had built, the obvious conclusion was that the companies in question needed to restructure or "deconglomerate". The market for corporate control, having originally constructed these gigantic corporations, would once again achieve efficiency by reallocating underperforming assets among competing purchasers.⁴⁴

⁴² Margaret Blair argues that the restructuring process "was largely fueled by the conflict among managers, financial institutions and shareholders about whose interests should take precedence." (Blair, "Financial Restructuring and the Debate about Corporate Governance" in Blair, MM (ed), *The Deal Decade* (1993), 1at 2)

⁴³ See O'Sullivan, MA (2000) (*supra* note 7) at 109-116; Williamson, OE, *The Economic Institutions of Capitalism* (1985) at 279-281

⁴⁴ Coffee, JC (1988) (*supra* note 21) at 445-6 points out that this reallocation thesis is not as clear-cut as its advocates would suggest: "the 'negative synergy' that a 'bust-up' liberates may stem from the possibility that there are persons who place a more optimistic valuation on each of the firm's operating divisions." Where the purchaser is optimistic, this simply constitutes a wealth transfer from bidder to target shareholders. It is only where they are actually more efficient users that there is a social gain.

The deconglomeration process received stimulus from the leveraged buy-out (LBO) mechanism, a device by which the bidder (often management) purchases the target's share capital with loan finance, secured against the target's assets and subsequently paid off by the target, either out of earnings or by selling off assets. Many previously public corporations were taken private in this way by a group of investors. The "junk bond" market, which of course demanded increased returns for the higher levels of risk assumed by participants, made the LBO more pervasive still. These financing mechanisms pushed corporations to assume massive levels of debt during the 1980s.⁴⁵ From a neoclassical perspective, the LBO mechanism was considered an improvement on the standard takeover for two reasons. First, LBOs had the effect of eliminating shareholder-management agency costs by once more reuniting ownership and control, as takeovers became increasingly characterised by "entrepreneurs taking over large and medium-sized companies (and less often large companies taking over small ones)."⁴⁶ Second, debt is considered a better device for disciplining managers because lender-borrower agency costs are lower than shareholder-manager ones.⁴⁷ Thus these new controllers bore some risk, and were further disciplined by the monitoring of debt-holders. As we shall see below, however, the massive increase in debt also led to widespread cost-cutting in order to keep up loan repayments, leading some commentators to argue that this undermined the productive coalition model of the firm.⁴⁸

O'Sullivan argues that since the market for corporate control both "served as a willing accomplice to a management fad"⁴⁹ (the process of conglomeration in the 1960s and

⁴⁵ Blair, (1993) (*supra* note 42) at 1

⁴⁶ Roe, "Takeover Politics" in Blair, MM (ed), *The Deal Decade* (1993), 321 at 344

⁴⁷ See for example, Jensen's argument that lenders are more equipped to take an active monitoring role in corporate governance. This opens into a broader agency theoretical argument that free cash flow in excess of what is required for investment should be paid out to investors: Jensen, MC, "Agency Cost of Free Cash Flow, Corporate Finance and Takeovers" (1986) 76 *American Economic Review* 323 at 323-9.

⁴⁸ In particular, Shleifer and Summers, "Breach of Trust in Hostile Takeovers" in Auerbach, AJ ed, *Corporate Takeovers: Causes and Consequences* (1988), 33. They argue at 43 that where a bidder has used a substantial amount of debt to finance the acquisition, this usually means that they will cut wages and lay off employees. This raises profitability, at least in the short term, and so "hostile takeovers designed to eliminate a firm's free cash flows are taken as paradigmatic cases of efficiency improving transactions." Their arguments are discussed in detail below.

⁴⁹ O'Sullivan, MA (2000) (*supra* note 7) at 173

1970s), and assisted with the reverse process of deconglomeration during the 1980s,⁵⁰ it is "inappropriate to elevate the market for corporate control to the status of corporate governance solution."⁵¹ Unless some kind of underlying productive change, or a change in the economic environment, can be pointed to, the dual role of the market for corporate control undermines its claims to produce efficient structures, particularly if one sets the transaction costs associated with corporate engineering against the temporal duration of the structures they created.⁵² It is also a clear illustration of the flip-side of the market for corporate control, that where the bidder is also a widely-held corporation, its management may be indulging in the very empire-building that the operation of the market for corporate control is supposed to prevent in targets, albeit on the back of a strong stock valuation.⁵³

ii) Wealth Transfer

In opposition to this, it is argued that takeovers often simply effect wealth transfers between corporate constituencies rather than create social value by improving allocative efficiency.⁵⁴ Coffee argued that hostile takeovers involve the breach of the implicit

⁵⁰ Similarly Gilson in Roe, (1993) (*supra* note 46) at 377 fn 124, citing Morck, R, Shleifer, A and Vishny, R, "Do Managerial Objectives Drive Bad Acquisitions?" 45 J Fin (1990): "the source of bust-up gains in the 1980s is the reversal of the unrelated diversification of the 1960s and 1970s. Hostile bust-up takeovers simply undo past conglomeration." Coffee, JC (1988) (*supra* note 21) also argues at 443-4 that, contrary to the efficiency interpretation of the market for corporate control, the discounting of corporate assets over the corporation's market price may not necessarily reflect managerial incompetence but rather "the market's preference for 'negative synergy'--that is, for a general downsizing and streamlining of the conglomerate firm in the belief that diversification makes more sense at the shareholder level than at the firm level." The fear may be raised that this is another market "fad", this time financial as opposed to managerial.

⁵¹ O'Sullivan, MA (2000) (*supra* note 7) at 172

⁵² It is frequently suggested that those in the financial engineering industries, who benefited greatly in terms of fees, did much to stimulate and sustain the takeover boom. Subramanian, G, "The Drivers of Market Efficiency in Revlon Transactions" (*Harvard Law School Public Law Research Paper, forthcoming in Journal of Corporation Law 2003* notes at 7 that "Transaction costs in corporate control transactions, including professional service fees and management opportunity cost, are typically 2-5% of deal value..."

⁵³ Advocates of the market for corporate control simply respond to this argument by citing the EMH: managers of a company with a strong stock price are performing well, and if they engage in empire-building, the stock price will suffer in consequence; critics refer to the various arguments against the EMH discussed below.

⁵⁴ See for example, Mitchell, LE, *Corporate Irresponsibility: America's Newest Export* (2001) at 177-8 who explains control premia as coming at the expense of "creditors who see the value of their debtholdings drop as leveraged acquisitions increase default risks, suppliers who see long-term relationships disrupted, employees who are laid off to cut costs." The source of these premia has not been conclusively demonstrated: O'Connor, M, "Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers" (1990) 69 *N.C.L.Rev.* 1189 at 1212. Stout, LA, "Stock

contracts between shareholders and managers, which were "an attempt to foster investment by managers in 'firm-specific' human capital. To encourage such investment, managers must be promised a form of quasi-tenure, because their 'firm-specific' capital will have limited value to the market."⁵⁵ Opportunistic breach of these contracts using the takeover mechanism potentially reduces overall social wealth. However, Coffee limits his theory to managerial employees, arguing (in terms familiar from Chapter 3) that "[l]ower echelon employees contract through other means and institutions (i.e., collective bargaining) and are not as exposed to opportunism because they do not invest in much 'firm-specific' capital or expect an ex post 'settling up.' The real contracting parties are chiefly managers and shareholders."⁵⁶ However, if we follow advocates of the productive coalition of the firm, such as Margaret Blair, and expand Coffee's analysis beyond the managers to include "non-managerial" employees within the category of those who invest in firm-specific capital on the basis of the arguments in Chapter 3, then it seems clear that employees may also suffer opportunistic breaches of implicit contract.

In their classic exposition of the expropriation explanation, Shleifer and Summers argue that takeovers involving breach of implicit contracts are "rent-seeking and not value-creating exercises," institutional changes which reduce social wealth through the destruction of non-redeployable investment.⁵⁷ Management is normally constrained to

Prices and Social Wealth" (*Harvard Law School Center for Law and Economics Discussion Paper No 301 (November 2000)*) suggests that while a small holding may be purchased at market price from fairly "pessimistic" investors, a bidder who wants to acquire a 51% majority must acquire shares from "optimistic" shareholders who will insist on an increasing premium over market prices as the bidder moves up the optimism scale. This interesting idea is not developed further in this thesis.

⁵⁵ Coffee, JC (1988) (*supra* note 21) at 447

⁵⁶ *ibid* at 449; in his footnote he adds that " In theory, the 'settling up' process is intended to compensate those employees whose contribution to the firm's productivity cannot be currently estimated...This category will rarely include lower-echelon employees."

⁵⁷ Shleifer and Summers, (1988) (*supra* note 48) at 42. In contrast, Williamson's comment (at 61 in Auerbach, AJ (ed), *Corporate Takeovers: Causes and Consequences*) on Shleifer and Summers' paper, emphasises changes in competitive conditions, such as reductions in barriers to entry, as important influences on the exercise of managerial discretion. Gilson, "The Political Ecology of Takeovers: Thoughts on Harmonizing the European Corporate Governance Environment" in Hopt, K and Wymeersch E ed, *European Takeovers: Law and Practice* (1992), at 72-3 asks whether any provisions were made in the implicit contract for changes in the company's competitive or technological environment. Romano, ("A Guide to Takeovers: Theory, Evidence and Regulation" in Hopt, K and Wymeersch E (eds), *European Takeovers: Law and Practice* (1992), 3 at 19) points out further empirical difficulties with testing their hypothesis: "we would need counter-factual data to test the labor expropriation hypothesis fully – we need to know how many workers would have been laid off of what the wage profile would have looked like if

honour their non-binding undertakings, either because they desire to build a reputation which will allow them to rely in future on implicit contracts,⁵⁸ or simply because they prefer to stand by their word and fulfil the trust which is placed in them. As the firm evolves in terms of capabilities, so these contracts become more fundamental in terms of underpinning productive capacity, and so "the shareholders deliberately choose as managers individuals for whom value maximisation is subordinate to satisfaction of stakeholder claims, and then surrender to them control over the firm's contracts."⁵⁹ According to this view, where the company wants to rely on implicit contracts, management must be accorded a degree of entrenchment and independence from shareholder control in order that they may make credible commitments to employees and others.⁶⁰ Some commentators even argue that the company's ability to rely on implicit contracts becomes an important asset.⁶¹

However, once put in place, this type of institutional arrangement obstructs shareholders' ability to maximise their share of the corporate income, for example by cutting the above-market wages of employees, which are the deferred portion of their remuneration, and paying employees just above their opportunity cost.⁶² Incumbent management, bound by

the firm had not been acquired." Of course, we cannot test the argument that takeovers enhance efficiency against counter-factual data either.

⁵⁸ Reputational protection of implicit contracts was discussed at length in Chapter 3.

⁵⁹ Shleifer and Summers, (1988) (*supra* note 48) at 40

⁶⁰ They give the example of allowing management to have control of the proxy machinery, and therefore succession.

⁶¹ In this regard, Gilson (1992) (*supra* note 57) at 74 argues that the "acquirer has no incentive to alter implicit contracts that remain efficient. If a hostile takeover really would dissipate a valuable corporate asset - namely, trust and reputation - why would an acquirer pay more for the target after the loss of this asset than the target was valued by the market in the hands of previous management? In settings where a hostile takeover would somehow unavoidably destroy important implicit contracts, we would expect to see only friendly transactions." Gilson's argument relies on the assumption (discussed below) that markets are able to identify and value implicit contracts despite the obvious informational asymmetries. One wonders whether the market is really able to distinguish between managers who do not bargain hard and managers who make implicit contracts. Where quasi-rents are being shared with employees, this leads to a reduction in "profitability" for shareholders, which should be reflected in a reduced rather than increased share price, unless the market can identify long-term benefits accruing to shareholders from the arrangement. Accordingly, a bidder could take advantage of the lower price to expropriate the employees' share of quasi-rents, undermining efficient arrangements but skewing distribution in his favour..

⁶² Alternatively, where "the employee is costing the company more than he is contributing *at the moment*...his dismissal is a gain to the shareholders" (Shleifer and Summers, (1988) (*supra* note 48) at 45, emphasis added). Alternatively, shareholders may want to free up cash flow and prevent overinvestment by management. Interrupting management's plans, or reducing their options, in this way may also involve

reputation or trust, insist on honouring the implicit contracts which they have made with the employees and will not consent to the redistribution of rents from employees to shareholders. This means that changing the institutional framework by "ousting the managers is a prerequisite to realizing the gains"⁶³ which may be made by breaching the implicit contracts. "Not surprisingly, then, takeovers that transfer wealth from stakeholders to shareholders must be hostile."⁶⁴ They must also come as a surprise to both management and employees, since if they could be anticipated, they would undermine the initial feasibility of implicit contracts.

Once a hostile takeover has taken place and management has been replaced by new managers who are willing to breach the implicit contracts, the new shareholders are able to capture the flow of rents. Leaving aside arguments that this expropriation is morally suspect because it arises out of a breach of trust, and that the justice of the resulting redistribution is questionable, this kind of rent-seeking is economically inefficient because it undermines the implicit contracting process, which has an adverse impact both on the firm in question, and on firms in general. As discussed in chapter 3, a company which breaches implicit contracts will damage its own reputation, and this may prevent it from relying on such contracts in the future. Of greater macro-economic significance are the "reputational externalities" which arise when hostile takeovers, or rather, the fear of them,⁶⁵ spreads through the economy. They cause employees as a class to be less willing to enter implicit contracts, leading either to the higher transaction costs associated with explicit contracting, or to "the need to pay them more now in return for their accepting uncertainty about future payments, or simply as forgone profitable trade. Whatever form this cost takes, it should *ultimately* show in the declining value of corporate equity."⁶⁶

"reducing the wealth of stakeholders, who did not count on changes in operations when agreeing to work for the firm." (ibid at 41)

⁶³ ibid at 41

⁶⁴ ibid

⁶⁵ The fear of hostile takeover may be greater than the actual risk as employees face uncertainty in identifying the types of firms which are at risk of hostile takeover. Since the share price appears to be the key determinant, and employees apparently have little or no influence over it, this may increase the fear that their future employment depends entirely on factors outside their control.

⁶⁶ Shleifer and Summers, (1988) (*supra* note 48) at 46, emphasis in original; the damage caused by breaches of implicit contracts may also be modelled in terms of a reduction of trust across the economy as a whole. As Shleifer and Summers conclude at 53, this "reorganization of the corporation into more of a spot

The explanation that takeover premia are, *inter alia*,⁶⁷ opportunistically expropriated from employees directly contradicts the efficiency hypothesis because where "rent transfers form a significant part of the takeover gains, the combined share price change of the target and the buyer vastly overstates the efficiency gains from takeovers."⁶⁸ Its effect on productive coalitions is particularly marked because of accounting practices, discussed in Chapter 3, which insist that supra-competitive wages, which often reflect investments in firm-specific capital, should be charged against income rather than capital expenditure. Outsiders cannot know the reason for these supra-competitive payments and so consider them inefficient uses of resources. This view is factored into the share price, reducing it and increasing the risk of hostile takeover.⁶⁹

Critiques of "Deal Decade" Explanations

Neither of these explanations of the deal decade is uncontested, and the conflict between the neoclassical and productive coalition models becomes particularly clear in this context. Within the neoclassical perspective, implicit contracts are often treated as a merely evidentiary problem, "a contract whose terms are observable to the contracting parties, but not to third parties, such as courts and hence are not verifiable."⁷⁰ Romano suggests that the concept is inappropriate where the contract is potentially explicit, for

market system can be socially very costly. To gauge this cost, however, would require an understanding of how trust facilitates contracting, which at this moment we do not have." In addition, corporate equity may decline in value over time as management "respond to capital market pressures by short-term strategies to bolster share prices, thereby sacrificing beneficial long-term projects and investments": Höpner, M and Jackson, G, "An Emerging Market for Corporate Control? The Mannesmann Takeover and German Corporate Governance" (2001) *Max-Planck-Institut für Gesellschaftsforschung MPIfG Discussion Paper 01/4* at 9

⁶⁷ Shleifer and Summers, (1988) (*supra*) at 53 accept that tax savings also contribute significantly, especially in LBOs. See also Blair, (1993) (*supra* note 42) at 3. Undervaluations of shares by the market may also be a source, but in that case, the takeover involves redistribution from current shareholders to the buyer.

⁶⁸ Shleifer and Summers, *ibid*

⁶⁹ It might therefore be suggested that firms with a high degree of firm-specific capital are more likely to be taken over. Where firms which rely on firm-specific capital are faced with a takeover, management should carefully scrutinise the bidder's plans to distinguish asset-stripping bids from those predicated on acquiring firm-specific skills *in situ*, and advise shareholders accordingly.

⁷⁰ Romano, (1992) (*supra* note 57) at 17

example, regarding employee pension entitlements,⁷¹ but accepts that “the level of development of firm specific capital is unlikely to be verifiable, and thus could be the basis of an implicit contract that a raider will breach.”⁷² Difficulties in demonstrating the existence of firm-specific investments lead neoclassical theorists to argue that the true motivation of management in making implicit promises to employees is that they are averse to adversarial bargaining, granting favourable terms to support comfortable relations between themselves and the company's employees, thereby ensuring corporate stability and increased leisure for themselves.⁷³ Agency costs like “empire-building” of course are at the heart of the neoclassical rationale for the market for corporate control.⁷⁴

The expropriation critique challenges the notion that the performance of management may be judged accurately on the basis of share price movements. A “fundamental premise underlying the market for corporate control”⁷⁵ is the “Efficient Markets Hypothesis” (“EMH”), which suggests that stock markets are informationally efficient and so stock prices represent an estimate, based on all publicly-held information,⁷⁶ of the

⁷¹ In the context of a complete contract, a failure to provide for something is consistent with the risk being left where it falls.

⁷² Romano, (1992) (*supra* note 57) at 17

⁷³ *ibid* at 18: “managers may be burdened with a reputation for weakness from past practices of capitulation to labor demands in order to make their jobs as managers more comfortable, and this affects their reputation as bargainers”; see also Holmstrom, B, “Comment” in Auerbach, A(ed), *Corporate Takeovers: Causes and Consequences*.

⁷⁴ As Roe, MJ (2003) (*supra* note 9) points out at 33-5, agency costs and employee preferences “fit well” with each other, in particular as regards risk-taking and job stability, while the preferences of *dispersed* shareholders are likely to differ significantly.

⁷⁵ Manne, H (1965) (*supra* note 10) at 112

⁷⁶ This is the “semi-strong” EMH, while the “strong” EMH suggests that prices reflect all publicly or privately-held information. Those with greater information, motivated by profit, drive prices to their correct levels through arbitrage: Manne (*ibid* at 112 fn 10) suggests that these arbitrageurs base their decisions on “their sense of what constitutes efficient management”. The effect of this insider action is in no way counteracted by those trading on an absence of reliable information because their trades will tend to be “randomly distributed and the effect will therefore be neutral.” By contrast, Shiller, (“Fashions, Fads, and Bubbles in Financial Markets” in Coffee, JC, Lowenstein, L, and Rose-Ackerman, S (eds), *Knights, Raiders and Targets* (1988), 56) argues that “fashions, fads and bubbles *do* importantly influence prices of speculative assets” as ordinary investors prevail over “smart money”. He argues at 65 that the EMH does not take into account psychological evidence which suggests that “there is sometimes excessive enthusiasm for certain financial assets and thus that other financial assets are sometimes ignored.” Others are less sanguine about the prospects for constant arbitrage: Rajan, RG and Zingales, L (2003) (*supra* note 22) suggest at 96-9 that, although an asset may be mispriced on the market, traders cannot always drive the price to its correct level by risk-free trading where their position has to be closed out in the future, because they must be wary of the danger that mispricing might increase before they close out.

present value of future dividends.⁷⁷ Managerial efficiency is reflected in the company's share price as monitors trade on the basis of their assessment of performance. Where a firm's competitiveness is based on the productive coalition model, its share price will often not reflect the added value created by firm-specific investment for two reasons. First, the precise contribution to productivity can only be ascertained by insiders, and so cannot be incorporated into the share price by those trading at arm's length. Second, rents paid to employees will tend to lower, rather than increase, the share price, as any reduction in returns to shareholders will be reflected in division of rents with employees.

This assumption is absolutely crucial because the market for corporate control reallocates assets solely on the basis of share price.⁷⁸ If share price movements fail to accurately reflect fundamentals, this opens the way to fads like conglomeration or the technology bubble. Even agency theorists implicitly admit that stock price is only a second-best proxy for measuring managerial performance: "Apart from the stock market, we have no objective standard of managerial efficiency."⁷⁹ More critical commentators suggest that the EMH faces more serious difficulties. O'Sullivan argues that financial economists rely exclusively on indirect evidence which is consistent with EMH, and that the deal decade may have witnessed a disjunction between stock valuations and institutional arrangements on the one hand, and changes in the productive economy on the other.⁸⁰ The difficulty for the EMH is that it "cannot, in fact, be empirically tested in isolation from assumptions about the way in which economic actors price securities."⁸¹ An initial drop in the share price of a corporation may reflect managerial failure as dissatisfied shareholders sell their shares. It may equally be driven by other considerations, such as a change in investment strategy by an institutional investor. However, once an initial downwards movement has started, the share price may continue to fall as other shareholders sell in response to the downwards movement. George Soros terms this the

⁷⁷ Any publicly available piece of information will tend to be exploited by investors in competitive capital markets: see Osterman, P, *Securing Prosperity* (1999) at 151-2.

⁷⁸ Easterbrook, F and Fischel, D (1991) (*supra* note 5) at 209: "Finance economists have devoted more effort in recent years to understanding tender offers than to any other subject."

⁷⁹ Manne, H (1965) (*supra* note 10) at 113

⁸⁰ O'Sullivan, MA (2000) (*supra* note 7) at 171-2; see also Shiller, RJ (*supra* note 76) at 56

⁸¹ Lazonick, W and O'Sullivan, M, "Maximizing Shareholder Value: A New Ideology for Corporate Governance" (*INSEAD Working Paper 2000, now published as (2000) 29 Economy and Society 13* at 29

"reflexivity" of markets.⁸² Share movements are further amplified by the operation of investment funds which track and respond to movements in the market, rather than trading on information about the underlying productive characteristics and prospects of the corporation in question. In turn, extreme variations in share price carry markets into "far-from-equilibrium territory"⁸³ and affect the "fundamentals" of corporations, as their cost of credit increases and they become vulnerable to takeover, or are able to launch their own takeovers. Shiller argues that in any given case, a firm may, as the neoclassical view suggests, be a takeover target because of inefficient management. Alternatively, it might have been "overlooked by ordinary investors"⁸⁴, or "the takeover premium may reflect an overvaluation by those who acquire the firm."⁸⁵

The EMH is under sustained pressure after the dot.com bubble and Enron and related scandals. Margaret Blair suggests that

"If one lesson of Enron and other corporate disasters in the last few years is that today's share price cannot be counted on to reflect the true underlying value of the equity of a corporation, then the rise in share prices in the short run after the announcement of a

⁸² See Soros, G, *Open Society: Reforming Global Capitalism* (2000), Chapter 3. Soros explains at 59-60 that the EMH "treats markets as a passive reflection of the fundamentals, and it treats decisions as if they could be based on information. I contend that participants in financial markets, instead of basing their decisions on rational expectations, cannot avoid introducing a bias in their decision-making...market participants are obliged to exercise an element of judgment. The important feature of biased judgments is that they are not purely passive: They affect the course of events that they are supposed to reflect. They are reflexive." So the way in which market participants act should (along with their rational expectations) also be factored into any understanding of share price movements. Also at 60-61: "In buying and selling financial instruments, market participants are not trying to discount fundamentals; they seek to anticipate the future prices of the selfsame financial instruments." At 78 he suggests that this herd-like behaviour of investors may contradict economic theory, an increase in prices actually giving rise to an increase in demand. While Soros' theory is broadly criticised for indeterminacy and failing to predict prices, it does contain echoes of Keynes' famous dictum (from *The General Theory of Employment, Interest and Money* (1936)) that professional investment resembles a beauty contest in which investors must pick "not those faces which he himself finds prettiest, but those which he thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view." In other words, we devote our intelligence to anticipating what average opinion expects the average opinion to be." For a discussion of reflexivity in terms of feedback loops, see Shiller, RJ, *Irrational Exuberance* (2000), in particular at 60-8.

⁸³ *ibid* at 64. Of course, corrections (or "inflections") inevitably follow, although one would expect the herd mentality to prevail here too.

⁸⁴ Shiller, RJ (1988) (*supra* note 76) at 57

⁸⁵ *ibid* at 65-6. For a comprehensive explanation of the periodic overvaluations of companies by public markets, see Shiller, RJ (*supra* note 82).

hostile tender offer cannot necessarily be interpreted as reflecting a true increase in value that would result from the takeover."⁸⁶

The UK System

The hostile takeover, in which management is bypassed in favour of a direct approach to shareholders, is a relatively recent phenomenon. Although friendly takeovers have been a familiar part of the corporate landscape, in the UK at least, since the end of the Second World War,⁸⁷ hostile bids were not considered "respectable" business practices and were very rare before the late 1950s.⁸⁸ Instead bidders relied on the practice of "negotiated merger", persuading incumbent management to recommend their bid to the shareholders.⁸⁹ This was uncontroversial, providing little reason for the courts to become involved, and, "in the financial press of the time, take-over bids were regarded as, on balance, a useful stimulus to efficiency."⁹⁰

Common Law Regulation of Takeovers

The common law did not have much opportunity to regulate hostile takeovers. By the time they emerged as a phenomenon worthy of regulation, the City Panel had already

⁸⁶ Blair, MM, "Directors' Duties in a Post-Enron World: Why Language Matters" (2003) 38 *Wake Forest Law Review* (forthcoming) at 12. In *Paramount v Time* (571 A.2d 1140, Delaware Supreme Court (1989)) at 1150 fn, the Delaware Supreme Court held that "it is not breach of faith for directors to determine that the present stock market price of shares is not representative of true value or that there may indeed be several market values for any corporation's stock."

⁸⁷ Before the war, the typical merger had been an agreed merger between the boards of the two companies in the same or similar lines of business: see Johnston, A, *The City Take-Over Code* (1980) at 8. The aim was either to take advantage of synergies or to gain greater market share. Shareholders were largely passive: their only role was to ratify the board's decision: see Cranston, "The Rise and Rise of the Hostile Takeover" in Hopt, K and Wymeersch, E (eds), *European Takeovers: Law and Practice* (1992), 77 at 78

⁸⁸ See generally Johnston, A (1980) (*supra* note 87) at 10-14: in December 1953, the Bank of England had warned the British Bankers' Association to be wary of lending where there was a "speculative element". The hostile bid emerged even later in the US. O'Sullivan, MA (2000) (*supra* note 7) at 162 notes that in the US until the 1970s, such bids remained the province of speculators while banks refused to finance them.

⁸⁹ See Hannah, L, "Takeover Bids in Britain before 1950: An Exercise in Business 'Pre-History'" (1974) 16 *Business History* 65. The board were often in possession of information to which the shareholders were not privy.

⁹⁰ Johnston, A (1980) (*supra* note 87) at 10

effected its own friendly takeover of the task from the courts.⁹¹ This is the reason for the stunted development of takeover regulation at common law, which comprises merely the "proper purpose" rule and a threadbare set of requirements where the board advises the shareholders on the merits of the bid.⁹² Cases concerning takeovers of publicly-listed corporations simply do not come before the courts, and therefore the common law rules are of little practical application.⁹³ Nevertheless, the way in which the common law regulated management's exercise of their powers in the takeover context provides both context for the emergence of the City Code in its legal context, and more importantly, clearly illustrates that the Code truncates managerialism as one interest group captures the regulatory process.

It is frequently claimed that the common law adapted an existing mechanism, the equitable duty of the fiduciary to use his powers for the purpose for which they were conferred, to the new task of controlling the actions of the board in the event of a takeover bid, recognising the takeover as an occasion when the interests of directors potentially conflict with those of the shareholders.⁹⁴ According to this understanding of

⁹¹ Although the writ had been issued in 1963, the decision in *Hogg v Cramphorn* (the first case to systematically consider the board's obligations in the event of a hostile takeover) was not delivered until 18th October 1967. On 20th September 1967, "the Bank of England publicly announced the intention of the City organizations to set up a Panel which would come into operation when the revision of the Rules had been completed." (Johnston, A (1980) (*supra* note 87) at 37) As a result, the rules laid out in *Hogg* were never widely applied to takeovers of public corporations. Whether the City Code was a response to the anticipated judgment must remain a matter of conjecture.

⁹² In *Re A Company* (1986) BCLC 382. Hoffmann J held, at a preliminary hearing for the striking out of a petition, that while the directors are not necessarily under a common law duty to advise the shareholders on the merits, if they decide to do so, "fairness requires that such advice should be factually accurate and given with a view to enabling shareholders (who, ex hypothesi, are being advised to sell) to sell, if they so wish, at the best price." While the case involved a private company, and therefore was not technically governed by the City Code, the court drew inspiration from it, seeing it as "a helpful guide to the City's views on fairness in similar circumstances." This suggests that the assumptions underlying the City Code might begin to feed back into company law and be felt more widely.

⁹³ With the rare exception of appeals to the Privy Council from other Commonwealth jurisdictions. The *Howard Smith* case (discussed below) demonstrates how the courts would have approached the issue in the absence of the City Code. Where companies are not publicly quoted, takeovers will occur by private sale and a different set of concerns, which are outside the scope of this thesis, arise.

⁹⁴ See, for example, Davies, "Defensive Measures: The Anglo-American Approach" in Hopt, K and Wymeersch E ed, *European Takeovers: Law and Practice* (1992), 195 at 208 who argues that the proper purpose rule became "an objective rule which, like General Principle 7 [of the City Code], shifts decision-making from the board to the shareholders." The clear implication of this is that the City Code merely codified the decisions of the courts. More neutrally, Parkinson, J, *Corporate Power and Responsibility: Issues in the Theory of Company Law* (1993) at 138 considers the proper purpose rule operates as a

the pre-City Code legal position, the onset of a takeover bid truncates the board's general power to manage the company and places decision-making in the hands of the shareholders. The directors will be using their powers for an improper purpose if they remove from the shareholders the power to decide on the outcome of a bid. The cases which came before the courts concerned the issue of shares in the face of a takeover bid, but the principle would theoretically apply equally to other defensive measures taken by the board using their fiduciary powers of management, such as crown jewels sales or poison debt. The reason such actions constitute a breach of duty is that "the directors' power to issue new shares was not one that had been conferred upon them by the articles to enable them to take away from the shareholders the power to decide on an offer for their shares."⁹⁵ However, it is suggested that, in contrast to this widespread view, the proper purpose rule did not in fact impose an absolute rule on management, instead focusing on the *purpose* for which the power was exercised (rather than its *effect*).

In *Hogg v Cramphorn Ltd*,⁹⁶ the board of Cramphorn Ltd, a public but unquoted company, received an unwelcome takeover bid from Baxter. The board advised the shareholders of their opinion that "it would have an unsettling effect on the staff"⁹⁷ and "avowedly formulated" a plan to respond to the "situation created by Mr Baxter's offer."⁹⁸ They created a trust for the benefit of the company's employees to which they allotted a number of shares, each of which carried the right to exercise ten votes on a poll vote. The trustees were to be nominated by the directors. The additional votes provided by these shares ensured that the directors retained control of the company through a combination of direct (their own shareholding) and indirect (the nominated trustees) means.

The parties agreed that establishing a trust for the employees was not *per se* an improper use of the board's powers⁹⁹ and it was also "common ground that the scheme of which

guarantee of constitutionality and argues that its role lies in "upholding the allocation of decision-making power made by the Companies Act and the articles."

⁹⁵ Davies, (1992) (*supra*) at 208-9

⁹⁶ (1967) Ch 254, (1966) 3 All ER 420

⁹⁷ (1966) 3 All ER 420 at 423

⁹⁸ *ibid*

⁹⁹ It is submitted, correctly, on the basis that this "prudential stakeholder" measure fell within their general power of management and is allowed under the *Hutton v West Cork Railway* ((1883) 23 Ch 654) principle

this allotment formed part was formulated to meet the threat, as the directors regarded it, of Mr Baxter's offer. *The trust deed would not have come into existence, nor would the 5,707 shares have been issued as they were, but for Mr Baxter's bid and the threat that it constituted to the established management of the company.*" Accordingly it was clear on the facts that "an essential element of the scheme, and indeed its primary purpose, was to ensure control of the company by the directors..."¹⁰⁰ and prevent the takeover. It was also clear that the directors honestly thought¹⁰¹ that *their keeping control* was in the company's best interests, in the sense that giving "the staff through the trustees a sizeable, though indirect, voice in the affairs of the company would benefit both the staff and the company."¹⁰² This unusual conjunction of facts has cast considerable obscurity over the precise scope of this case.

The board had acted primarily for an improper purpose, namely maintaining their control of the company, even if their bona fide ultimate goal had been to look after the company's best interest by treating the employees in an enlightened manner. Buckley, J accordingly asked whether "Was such a manipulation of the voting position a legitimate act on the part of the directors?"¹⁰³ He referred to a long-standing line of cases which established that directors breach their fiduciary duty where they issue shares "merely for the purpose of maintaining their control or the control of themselves and their friends over the affairs of the company, or merely for the purpose of defeating the wishes of the existing majority of shareholders."¹⁰⁴ Where such an improper motive was apparent from the evidence, the

of "cakes and ale... for the benefit of the company". The shares were funded by an interest-free loan out of the company's reserves, which although described as "Employees' Benevolent and Pension Fund" was the "absolute property" of the company. The position would now be covered by s309 Companies Act 1985, which requires the board to "have regard in the performance of their functions [to] the interests of the company's employees in general".

¹⁰⁰ (1967) Ch 254 at 266-7

¹⁰¹ In accordance with *Re Smith & Fawcett Ltd* (1942) Ch 304 which decided management were under a duty act "bona fide in the interests of what they consider - not what a court may consider - is in the interests of the company."

¹⁰² (1967) Ch 254 at 265

¹⁰³ *ibid* at 266-7, emphasis added

¹⁰⁴ Per Peterson, J in *Piercy v Mills* (1920) 1 Ch 77 at 85. Precedent stretched back as far as the 1864 decision in *Fraser v Whalley* 2 H & M 10, where (at 29) the evidence showed that the directors had "on the faith of this obsolete power entrusted to them for a different purpose...issued [shares] for the very purpose of controlling the ensuing general meeting." Similarly in *Punt v Symons & Co Ltd* (1903) 2 Ch 506, the board improperly used its fiduciary power to issue shares "for the express purpose of acquiring an unfair majority for the purpose of altering the rights of parties under the articles." (at 517)

court would intervene because it would not "permit directors to exercise [fiduciary] powers...in such a way as to interfere with the exercise by the majority of its constitutional rights."¹⁰⁵

In this line of authority, the court does not look beyond primary purpose. It is suggested that where the facts are that the board's *primary or sole purpose* is not to maintain control in the face of an unwelcome takeover bid, but rather is part of their normal management of the affairs of the company, their actions will not be caught by this precedent and will not constitute a breach of their fiduciary duty. There would arguably have been no breach of duty in *Hogg* if the board had acted to benefit "the company" by treating its employees well, as long as their *primary purpose* was not to ensure that they retained control. Indeed, Buckley, J confirmed that the fiduciary power to issue shares is not granted to the board for the sole purpose of allowing them to raise capital.¹⁰⁶ This makes the ratio of *Hogg* very narrow. *Hogg* only applies where, *as a matter of fact*, the board, aware of a bid, uses its fiduciary powers *for the primary purpose* of manipulating the voting position and frustrating that bid. Accordingly, the motive or purpose for which the fiduciary power is exercised is absolutely crucial to establishing whether there has been a breach of duty.¹⁰⁷

In *Howard Smith Ltd v Ampol Petroleum Ltd*,¹⁰⁸ the board, faced with two competing bidders, issued shares to their preferred bidder, reducing the previous controlling

¹⁰⁵ per Buckley, J at 268

¹⁰⁶ Based on *Punt v Symons & Co Ltd* (1903) 2 Ch 506 at 516 ("There may be occasions when the directors may fairly and properly issue shares in the case of a company constituted like the present for other reasons"); also *Piercy v S. Mills & Co Ltd* (1920) 1 Ch 77. Lord Wilberforce confirmed this in *Howard Smith* at 835-8 (discussed below).

¹⁰⁷ In each of the cases in this line of authority, the evidence before the court was unequivocal that the shares were issued for the "very" purpose (*Fraser* at 29), the "express" purpose (*Punt* at 517) or "solely" for the purpose (*Piercy* at 83). This narrow interpretation is confirmed by Megarry, J in *Gaiman and others v National Association for Mental Health* (1970) 2 All ER 362 at 374 who stated that the "issue of shares with the object...of affecting the balance of voting power, is thus an exercise of powers made with a purpose that is ulterior". Once it was clear that "it was an exercise of a fiduciary power with an improper motive... it was immaterial that the directors believed in good faith that the issue was in the interests of the company." See also the emphasis placed on the board's motive in *Bamford v Bamford* (1969) 1 All ER 969 and *Lee Panavision Ltd v Lee Lighting Ltd* (1992) BCLC 22

¹⁰⁸ (1974) AC 821, PC, (1974) 1 All ER 1126, a case on appeal to the Privy Council from the Supreme Court of New South Wales

shareholding to a minority interest and allowing an effective takeover offer to be made by their preferred bidder. This was held to be an improper use of their fiduciary powers.

As in *Hogg*, the propriety of the board's exercise of their powers was determined by a factual inquiry into their motivation. The facts are therefore very important. At first instance the board had argued that their primary purpose was to raise capital which was necessary to keep the company going. This was rejected on the evidence put before him by Street CJ, who found that, although the directors had not acted "to gain some personal advantage for themselves by way of retention of their seats on the board or by obtaining a higher price for their personal shareholding"¹⁰⁹, their actions had concerned the "majority bloc in the share register. Their intention was to destroy its character as a majority... The ultimate purpose was to procure the continuation by Howard Smith's of the takeover offer made by that company."¹¹⁰ The board's motivation had gone beyond "considerations of management, within the proper sphere of the directors."¹¹¹ This finding of fact was absolutely crucial to the outcome of the case.

On appeal to the Privy Council, the board sought to argue that Street CJ "should have considered whether the purpose of the majority directors in deciding to make the allotment to Howard Smith might not have been, at least in part, to secure the company's future as a going concern and to prevent its possible dismemberment."¹¹² However, the Privy Council rejected this submission on the basis that this argument had neither been advanced at first instance nor was it supported by evidence given at the trial. *Howard Smith* therefore has no bearing on the question of whether the board is entitled to issue shares to protect the company "as a going concern" from a predator who intends to break it up. The propriety of such action would be wholly dependent on the factual question of whether the board's primary purpose was to interfere with the shareholder's rights of voting, or to act in the "best interests of what they... consider to be the interests of the company as a whole."

¹⁰⁹ (1974) AC 821 at 831

¹¹⁰ *ibid* at 833

¹¹¹ *ibid* at 837

¹¹² *ibid* at 832

Lord Wilberforce referred to the need for a "wider investigation"¹¹³ into "the state of mind those who acted, and the motive on which they acted... collecting from the surrounding circumstances all the materials which genuinely throw light upon that question of the state of mind of the directors so as to show whether they were honestly acting in discharge of their powers in the interests of the company or were acting from some bye-motive, possibly of personal advantage, or for any other reason."¹¹⁴ This can only be avoided where there is "common ground between the parties". Lord Wilberforce suggested that it is impossible "define in advance exact limits beyond which directors must not pass".¹¹⁵ This reflects the law's general managerialist orientation and abstention from interference in matters of business judgement.

The ratio of the case is that "it must be unconstitutional for directors to use their fiduciary powers over the shares in the company *purely* for the purpose of destroying an existing majority or creating a new majority which did not previously exist. To do so is to interfere with that element of the company's constitution which is separate from and set against their powers."¹¹⁶ The use of the word "purely" is absolutely crucial. Where the board exercises their powers of management primarily for a proper purpose (which, Lord Wilberforce emphasised, cannot be defined in the abstract), they do not breach their fiduciary duty if they incidentally affect the shareholders' voting rights.¹¹⁷ Their duty is

¹¹³ *ibid* at 834

¹¹⁴ Lord Wilberforce approved this dictum of Viscount Finlay in *Hindle v John Cotton Ltd* ((1919) 56 Sc. L. R. 625 at 630-1

¹¹⁵ *ibid* at 835; here the court recognises that presentation of the directors' contracts with the company is impossible because of bounded rationality.

¹¹⁶ *Ibid* at 837; emphasis added

¹¹⁷ The notion that the directors' duties and powers of managing the company may continue even in the face of a takeover bid is confirmed by *Dawson International plc v Coats Patons plc* (1988) 4 BCC 305 (Court of Session (Outer House)). In this case, the pursuers sought to recover the wasted costs of their abortive takeover bid. Lord Cullen emphasised that "The interests of the company and of the shareholders as prospective sellers might well diverge." He did "not accept as a general proposition that a company can have no interest in the change of identity of its shareholders upon a take-over. It appears to me that there will be cases in which its agents, the directors, will see the take-over of its shares by a particular bidder as beneficial to the company. For example, it may provide the opportunity for integrating or obtaining additional resources. In other cases the directors will see a particular bid as not in the best interests of the company..." He concluded that "The directors are not normally the agents of the current shareholders... This must not be confused with their duty to consider the interests of the shareholders in the discharge of their duty to the company... Directors have but one master, the company." One might therefore conclude that at common law, and subject to factual evidence, the board is free to issue shares to a potential

only broken if they act solely or primarily for the purpose of affecting the shareholders' voting rights.¹¹⁸

Both *Hogg* and *Howard Smith* are authority for the proposition that the question of purpose must be established before the question of the effect of the decision on the shareholders' rights is addressed. Since many actions taken in the ordinary course of management may have an effect on shareholder rights, their effect only becomes relevant where the board's primary purpose was the improper one of interfering with their rights. If the board's action was primarily referable to their general task of managing the company, any effect on shareholder rights is irrelevant. In neither case was it in any doubt on the evidence that the board's motivation had been improper. But in every case the question of propriety will be a matter of fact and of evidence. The fact that a takeover bid is either imminent or known to the board is not decisive of the legality of the action in question; it is merely part of the evidentiary matrix to be weighed alongside other issues in finding the facts.

Therefore, the common law rules emphatically do not deprive the board of its powers of management in the event of a takeover. These cases impose an evidentiary burden on the claimant to show that the *primary* purpose for which the directors used their powers was an improper one, for example because they were directly motivated by maintaining their positions. This is clearly not an unbearable evidential burden, but it is a burden nonetheless. In a given case, it may be easily discharged. Where an aggrieved shareholder is able either to produce evidence that the board had acted primarily to prevent the takeover and maintain control, or to persuade the court that what the board knew of the offeror's plans made preventing the takeover their most likely primary purpose, the action

bidder if they consider that that bidder's plans for the company are in the interests of the company as a whole.

¹¹⁸ The leading Australian case of *Mills v Mills* (1938) 60 CLR 150, HCA, provides some indication of the route the common law might have taken in dealing with multiple motivations on the part of the board. Dixon J referred to "the substantial object, the accomplishment of which formed the real ground of the board's action...if, except for some ulterior and illegitimate object, the power would not have been exercised, that which has been attempted as an ostensible exercise of the power will be void, notwithstanding that the directors may incidentally bring about a result which is within the purpose of the power and which they consider desirable." This is generally interpreted as requiring an impermissible purpose to be "causative" of the exercise of the power in order for it to be voidable.

would be likely to be held in breach of duty. More generally, the absence of similar initiatives in the past to act "in the best interests of the company as a whole" by, for example, benefiting the employees, would open up a strong argument that preventing the takeover was the real reason behind the initiative. Similarly, in situations where the board knows about a bid, the conflict of interest to which they were exposed would also weigh heavily in the evidential balance. It might even lead the court to develop a rebuttable presumption that, once the board has notice of a bid then they should prove that any exercise of their powers was for a primary legitimate purpose. Once the claimant has established a prima facie case, it would be for the board to produce contrary evidence. For example, if the board were able to produce evidence that they had discussed, but not carried out, the establishment of a trust for the employees *before the bid was imminent* then the claimant's burden would become rather more difficult to discharge.

Understood in this way, the way in which the common law regulated managerial conduct during takeover bids is unsurprising. It is entirely consistent with its general policy of defending managerial decision-making autonomy against the demands of shareholders.¹¹⁹ The business judgement rule is the law's recognition that the courts should not, as a general rule, interfere with the way in which the board exercises its discretion to run the business. That discretion is limited only by general fiduciary principles, which do not apply any differently simply because a takeover bid has been made. Defences against takeovers are therefore permitted at common law as long as they can be justified as forming part of the bona fide exercise of the board's general powers of management.¹²⁰ This reading of the operation of the proper purpose rule suggests that it would have operated in a manner broadly similar to the modified business judgement rule applied to takeovers in Delaware.

In terms of models of the company, the hands-off approach to managerialism taken by the courts conforms with a productive coalition model, with management as mediating

¹¹⁹ Originating with *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cuninghame* (1906) 2 Ch 34, CA.

¹²⁰ Compare this conclusion with that of Parkinson, J (1993) (*supra* note 94) at 138-9 that "a plea by the directors that they have acted only in accordance with what they considered to be the company's interests will necessarily be misconceived."

hierarchs. The courts refused to equate the "interests of the company" in the takeover context with the immediate interests of the current shareholders in selling their shares at a premium. The board may consider the interests of future shareholders in the continuation of the company's business and the interests of the employees, at least as long as this may potentially result in some benefit to the company in the long run, a test which seems easily satisfied.¹²¹ Whether s309 of the Companies Act 1985 would allow the board to consider the interests of the employees regardless of any benefit to the company is not clear.¹²² While the question may appear to be a moot point in most cases, given the breadth of the concept of benefit to the company, the answer may be crucial in a situation where the business continues to generate quasi-rents for the employees in the form of above-market wages, while profits for shareholders are non-existent.

However, this remains mere conjecture. The advent of self-regulation by the City denied the courts appropriate litigation in which to refine their approach. Nevertheless, there is no doubt that the proper purpose rule is not especially encouraging of takeover activity. While it is likely that in most cases, a motivational nexus could be easily established, any challenge to the board's exercise of their fiduciary powers involves an element of evidentiary risk which renders the outcome unpredictable. More importantly from the perspective of the market for corporate control, this rule makes the obligations of the board in the event of a takeover bid less than clear, and the consequent delay pending review by the courts risks having a general dampening effect on takeover activity and discouraging monitors.

¹²¹ It seems that the courts will only interfere where there cannot conceivably be a future benefit to the shareholders; in *Hutton* itself, the company was about to be wound up.

¹²² Villiers, "Section 309 of the Companies Act 1985: Is it time for a reappraisal?" in Collins, H, Davies, P, and Rideout, R (eds), *Legal Regulation of the Employment Relation* (2000), 593

The Emergence of Self-Regulation and the City Code

i) Historical Background

The first attempt at self-regulation¹²³ of the takeover process, the "Notes on Amalgamations of British Businesses", produced by the Issuing Houses Association in 1957 at the request of the Bank of England, had a profound influence on all subsequent attempts at self-regulation.¹²⁴ The Notes set out principles and procedures to deal with the then normal practice of "agreed merger" between two boards.¹²⁵ They aimed to prevent interference with the free market in shares and securities of companies; guarantee shareholders free choice in the disposition of their shares; and oblige the board to provide shareholders with sufficient information to enable them to make that choice. The Notes encouraged bidders to approach the shareholders through the board of the offeree company, which was then under an obligation to notify the shareholders within a reasonable time. Since the aim was to protect the interests of all shareholders, offers were supposed to be made for the entire share capital of the company, with partial bids being considered exceptional and to be achieved by making a *pro rata* offer to all shareholders. The Notes were supplemented by a Board of Trade initiative, the "Licensed Dealers (Conduct of Business) Rules" which defined a takeover as an offer to acquire securities with the aim of acquiring "control", in the sense of the right to exercise majority voting power. This concept remains key in the modern regime of self-regulation. The Rules also prohibited the board from disposing of the whole or substantially the whole of the corporation's assets without shareholder approval.

¹²³ Sir John Donaldson MR (in *R v Panel on Takeovers and Mergers, Ex parte Datafin Plc* (1987) 1 QB 815 at 826), described self-regulation as "a system where a group of people, acting in concert, use their collective power to force themselves and others to comply with a code of conduct of their own devising. This is not necessarily morally wrong or contrary to the public interest, unlawful or even undesirable."

¹²⁴ This section is drawn from Johnston, A (1980) (*supra* note 87), Ch 3

¹²⁵ Hannah, L (1974) (*supra* note 89) at 71-2 notes that the bidder was dependent upon support from the board both because they had access to information which was not publicly available (so alone could gauge the adequacy of a bid) and because of "the absence of power to enforce the purchase of minority holdings when it had succeeded in purchasing more than 50 per cent of the shares. They were more likely to achieve something approaching total ownership (which might be desirable for reasons of management and finance) if they had the directors' support." Accordingly, the directors were often offered a large cash payment or a place on the new board. Similarly, the shareholders tended generally to be loyal to the board because they also relied on them for advice.

ii) The Emergence of Hostile Takeovers

This early self-regulatory system appears to have been reasonably effective in protecting the interests of shareholders, but proved inadequate to deal with the emergence of the hostile takeover. During the post-war period, takeovers had become increasingly common, perhaps because many listed companies were undervalued compared with their cash and asset holdings.¹²⁶ As the 1960s wore on, and suitable targets became rarer (or the number of bidders increased), the profile of the typical takeover changed. It became common for two or more bidders to be competing for control of the target. More hostile bids were made, perhaps motivated by a desire to bypass increasingly obstructive corporate boards. The emergence of a class of "corporate raiders", many of whom were "outsiders" who did not feel bound by the convention of approaching the incumbent board and began to approach the shareholders directly, has been described as "perhaps the most important factor" in the emergence of the hostile bid.¹²⁷

Hostile bids raised new concerns. First, competing bidders often bought up large quantities of shares on the open market before a bid was announced, causing those shareholders who sold at the market price in ignorance that a bid was planned to lose out on the premium which was later offered. Second, some takeover bids only benefitted those shareholders who acted quickly (considered "coercive" bids), or who held large blocks of shares, leaving the others contemplating a reduced offer price and perhaps consequently a future as a minority.¹²⁸ Third, the share-for-share offer raised concerns that shareholders may not be receiving adequate consideration for their shares.¹²⁹ It could also be used to coerce the shareholders: cash would be offered to early acceptors of the tender offer, shares to those who hesitated. Finally, hostile bids put management in a position of conflict of interests where they feared a change of control would cost them

¹²⁶ Cranston, (1992) (*supra* note 87) at 79; he also refers to improvements in accounting standards. Hannah, L. (1974) (*supra* note 89) at 75 refers to the role of the Companies Act 1948 in improving the public disclosure of information and making undervalued companies easier to identify.

¹²⁷ Cranston, (1992) (*supra* note 87) at 82

¹²⁸ Until the middle of the 1960s, public takeover bids generally took the form of a cash offer to shareholders. The bidder's ability to raise cash obviously imposed limits on the scope of the bid.

¹²⁹ The share-for-share offer meant that the takeover mechanism was no longer limited to those corporations which had spare cash. Its emergence gave a further push to the movement towards corporate

their jobs. Where two or more bidders were competing for control, this gave the board the opportunity to favour the one they preferred (which tended to be the one that did not threaten their position).¹³⁰

iii) The City Code

In order to maintain its reputation among investors, and given the delays inherent in the courts' investigative approach, the City responded to the unprecedentedly intense period of merger and acquisition activity between 1961 and 1968 by instituting a more comprehensive scheme of self-regulation. In 1967, the Chairman of the Stock Exchange and the Bank of England agreed that a "Panel", consisting of representatives of various City institutions,¹³¹ would be established to oversee the operation of a new "Code".¹³² The Code itself was published on 27th March 1968 and was essentially an extension of its predecessors, based around seven general principles and thirty five rules. It responded to the concerns which had accompanied the emergence of hostile takeovers. In particular, the board's actions were to be limited: any action which could frustrate an offer required advance approval from the general meeting. Various revisions followed, including the introduction of a mandatory bid requirement in 1972, to protect minority shareholders where control was acquired (the Panel considered a purchase of 30 per cent of shares to constitute a change of control whatever the distribution of the remaining shares). In 1974, the Code was amended to require the bidder to disclose his intentions as regards the continuance of the business and future employment within the company. This anomalous provision is discussed below.

The Code has the status of "soft law",¹³³ and sanctions for breach are imposed not by the courts but by "self-policing"¹³⁴ within the financial services industry.¹³⁵ The imposition

conglomerations discussed above. Tax incentives deriving from the 1965 introduction of Capital Gains Tax and Corporation Tax also favoured the use of paper in acquisitions.

¹³⁰ See Johnston, A (1980) (*supra* note 87), Ch2

¹³¹ *ibid* at 37

¹³² To date, the Takeover Panel remains a non-statutory body which wields "immense power de facto". For further discussion see the judgment of Sir John Donaldson, MR, in *Datafin* (below note 123) at 825-6.

¹³³ Deakin, S, Hobbs, R, Nash, D, and Slinger, G, "Implicit Contracts, Takeovers, and Corporate Governance: In the Shadow of the City Code" (2002) *ESRC Working Paper No 254* at 6

of sanctions has been recently formalised by the involvement of the Financial Services Authority (a statutory body) which has endorsed the City Takeover Code as an instrument of self-regulation.¹³⁶ By virtue of this endorsement, the FSA is entitled to punish violators of the Code by withdrawal of their authority to carry on investment business. In the absence of FSA involvement, and if the Panel does not report a violation to another body, the Panel may privately reprimand the wrongdoer or publicly censure them.¹³⁷

Its supporters claim that self-regulation offers flexibility of application and interpretation, that its rules may be changed inexpensively and relatively frequently, and that those who administer the Code are intimately familiar with City practice.¹³⁸ Government intervention in the regulatory process is considered unlikely while the system continues to produce these benefits.¹³⁹ Johnston argues that the Panel's actions are essentially apolitical, and the City Code simply operates within the scope permitted to it by Parliament, which retains control over the public policy issue of whether takeovers are desirable.¹⁴⁰ The City Panel "imposes restrictions in what it conceives to be the public interest",¹⁴¹ defining this in terms of public confidence in the operation of capital markets. While intellectual support for this definition of the public interest could be found in the claims of the agency model that maximising returns to shareholders maximises the wealth of society, this argument is not made explicitly by the Panel.

¹³⁴ Johnston, A (1980) (*supra* note 98) at 5

¹³⁵ In the first version of the Code and its predecessors, the only sanction for breach was public censure. The second version of the Code, produced in 1969, envisaged stronger sanctions, which related to depriving a wrongdoer of his access to the Stock Exchange, as well as sanctions from other City institutions where appropriate. Now the Stock Exchange's "Yellow Book" includes compliance with the Code among the "continuing obligations" of a listed company.

¹³⁶ Under the Financial Services and Markets Act 2000, s143, which means that "the FSA may, at the request of the Panel, take enforcement action against a person authorised under the FSMA who contravenes the Code or a Panel ruling. Such action can include public censure, fines, the removal of authorisation, the imposition of injunctions and orders for restitution. In addition, the FSA may, again at the request of the Panel, take enforcement action against an individual who is an "approved person" (eg a director of an authorised firm)." (Takeover Code Introduction para 1(c))

¹³⁷ Takeover Code Introduction paras 3(d)(1) and (2)

¹³⁸ Johnston, A (1980) (*supra* note 87) at 4

¹³⁹ These benefits have also inspired the spirited opposition against the proposed EC takeover directive, which was perceived as being excessively legalistic (see further, Chapter 6).

¹⁴⁰ Johnston, A (1980) (*supra* note 87) at 8

¹⁴¹ *ibid* at 7.

Instead, their actions are explained as neutral and technocratic, impartial "experts" taking into account all relevant interests with a view to "securing higher ethical standards than can be secured by legal regulation".¹⁴² The Panel's advocates argued in *Datafin* that "no one can survive in the market without the confidence of others, and that [self-regulatory] rules ultimately serve the public interest."¹⁴³ This market-integrity conception of the public interest appears to have been accepted by the Court of Appeal, which stated that it was "content to assume for the purposes of this appeal that self-regulation is preferable in the public interest"¹⁴⁴ and that the Panel's "raison d'être [sic] is to do equity between one shareholder and another."¹⁴⁵ Accordingly, only limited judicial review lies against determinations by the Panel.¹⁴⁶

The Current Version of the City Code

i) Aim and Scope

The introduction to the Code states that its aim is "principally to ensure fair and equal treatment of all shareholders in relation to takeovers...."¹⁴⁷

The Code applies to all "listed and unlisted public companies (and, where appropriate, statutory and chartered companies) considered by the Panel to be resident in the United

¹⁴² *ibid* at 5.

¹⁴³ *Datafin* (*supra* note 123) at 820

¹⁴⁴ *ibid* at 827. The substance of the Panel's conception of the public interest, and the issue of whether the Code has an impact on non-shareholder constituencies, were not considered: "The principal issue in this appeal, and only issue which may matter in the longer term, is whether this remarkable body is above the law. Its respectability is beyond question. So is its bona fides. I do not doubt for one moment that it is intended to, and does, operate in the public interest and that the enormously wide discretion which it arrogates to itself is necessary if it is to function efficiently and effectively." (*Datafin* at 827 per Sir John Donaldson, MR).

¹⁴⁵ *ibid* at 838

¹⁴⁶ In its *Datafin* decision at 842, the Court of Appeal undertook only to review the Panel's decisions *ex post* on a declaratory basis against the requirements of natural justice.

¹⁴⁷ Introduction to the City Code, para 1(a). General principle 1 states that "All shareholders of the same class of an offeree company must be treated similarly by an offeror." This principle is fleshed out in Rules 6, 14 and 16. Rules 6.1 and 6.2 require that all shareholders of the same class be offered the highest price paid for shares in the company during the three months before the bid is announced or during the currency of the bid.

Kingdom, the Channel Islands or the Isle of Man.”¹⁴⁸ It applies to “takeover and merger transactions, however effected, of all relevant companies; these include partial offers, offers by a parent company for shares in its subsidiary and certain other transactions where control of a company... is to be obtained or consolidated.”¹⁴⁹ “Control” is defined as “a holding, or aggregate holdings, of shares carrying 30% or more of the voting rights... of a company, irrespective of whether the holding or holdings gives de facto control.”¹⁵⁰

ii) Minority Protection

“Control” is also a central concept in the Code's scheme of minority protection, which underpins the operation of a market for corporate control. Rule 9.1 requires a mandatory bid for the whole share capital of the company where a person (including any persons acting “in concert” (co-operating) with him) crosses this threshold. The bid must be for the entire share capital, and offers for different classes of shares must be “comparable” (not necessarily identical). Rule 9.5 requires that the offer “be in cash or be accompanied by a cash alternative at not less than the highest price paid by the offeror or any person acting in concert with it for shares of that class during the offer period and within 12 months prior to its commencement.” This rule underpins portfolio diversification by guaranteeing minority shareholders the right to share in the premium paid to majority shareholders, and the right to exit with that premium in cash. In its absence, they would be likely to remain minorities, as many bidders would only purchase sufficient shares to ensure control, leaving the minority vulnerable to oppression (or the cost of bringing proceedings to prevent this). The counterpart to this scheme of minority protection is found in sections 429 and 430 of the Companies Act 1985, which allow a bidder who has

¹⁴⁸ Code introduction para 4(a); the Panel “will normally consider a company to be resident only if it is incorporated in the United Kingdom, the Channel Islands or the Isle of Man and has its place of central management in one of those jurisdictions.”

¹⁴⁹ Code introduction para 4(b); Rule 36 states that partial offers will normally be consented to where they do not result in the offeror holding more than 30% of the voting rights in the company.

¹⁵⁰ See Definitions Section of the Code.

acquired 90% of the share capital of a company following a tender offer to issue a notice and compulsorily acquire the remainder at the offer price.¹⁵¹

iii) The Role of the Board under the Code

a) As information and advice providers

The board has a duty to provide sufficient information to the shareholders to enable them to make an informed decision.¹⁵² The principle of equality also applies here.¹⁵³ The board should communicate the bidder's statement of "intentions with regard to the continued employment of the employees of the offeree company and of its subsidiaries",¹⁵⁴ and also "circulate its views on the offer, including any alternative offers".¹⁵⁵ Given their potential conflict of interest, the board's advice should be accompanied by "the advice given to it by the independent advisers".¹⁵⁶ In any event, the advice proffered by the board should consider "the shareholders' interests taken as a whole, together with those of employees and creditors."¹⁵⁷ While this provision appears to recognise that the interests of employees may be affected by takeovers, employees are wholly excluded from the takeover process by the Code and must rely on the shareholders taking their interests into account when deciding whether or not to sell their shares at a premium over the market price.

Rule 25.2 requires that the "board of the offeree company should, *insofar as relevant*, comment upon the statements in the offer document regarding the offeror's intentions in

¹⁵¹ Under s430A, a remaining minority shareholder can also require to be bought out. See the discussion above about the role of the "squeeze-out" rule in the operation of the market for corporate control.

¹⁵² General Principle 4. This duty, which is fleshed out in rule 23 of the Code, also applies to the board of the offeror company. All announcements or advertisements made in connection with the takeover process, whether made by offeror or offeree, must fulfil the highest standards of accuracy (rule 19.1) and contain an explicit statement that the directors accept responsibility (rule 19.2). It is not clear that this imposes a higher standard than the duty of care in negligence, but the acceptance of responsibility should certainly be sufficient for tortious liability under *Hedley Byrne & Co v Heller & Partners Ltd* (1964) AC 465.

¹⁵³ Rule 20.1 of the Code states that information "must be made equally available to all shareholders as nearly as possible at the same time and in the same manner."

¹⁵⁴ Under Rule 24.1.

¹⁵⁵ Rule 25.1(a)

¹⁵⁶ *Ibid*; Rule 3.1 states that "The board of the offeree company must obtain competent independent advice on any offer and the substance of such advice must be made known to its shareholders."

respect of the offeree company and its employees made pursuant to Rule 24.1."¹⁵⁸ It is not clear what "relevant" means in this Rule. General Principle 9 suggests that comment should be made as part of the board's advice, but rule 25.2 limits this to circumstances in which the comment is relevant. This presumably means "relevant" to the shareholders' decision, and will therefore only apply where the offer consists wholly or partly of shares, and the shareholders will accordingly have a continuing interest in the company which might be adversely affected by the new incumbents' industrial relations strategy.

The board's obligation to act in an impartial manner¹⁵⁹ does not prevent it from commenting adversely on the bid and making the case for the company's continued independence. In particular where there is a share-for-share offer, the board's analysis may go beyond comparing the offer price with anticipated dividend yield; the bidder's plans for the company may be scrutinised to see whether alleged synergies are likely to be achieved, as well as the bidder's past record of success in integrating acquisitions. The shares which are being offered could also be scrutinised by accountants to ensure whether they provide good value in terms of share price performance compared with the shares of the target or the market as a whole. Finally, where the bidder admits to planning large-scale lay-offs, and the employees have invested heavily in firm-specific capital, the incumbent board may use the destruction of this source of rents as an argument in favour of continued independence.¹⁶⁰

b) Not to take defensive measures

General Principle 7 states that:

"At no time after a bona fide offer has been communicated to the board of the offeree company, or after the board of the offeree company has reason to believe that a bona fide

¹⁵⁷ General Principle 9

¹⁵⁸ Emphasis added.

¹⁵⁹ General Principle 9: "Directors of an offeror and the offeree company must always, in advising their shareholders, act only in their capacity as directors and not have regard to their personal or family shareholdings or to their personal relationships with the companies."

¹⁶⁰ However, as we shall see below, such admissions in offer documents are rare.

offer might be imminent, may any action be taken by the board of the offeree company in relation to the affairs of the company, without the approval of the shareholders in general meeting, which could effectively result in any bona fide offer being frustrated or in the shareholders being denied an opportunity to decide on its merits."

This Principle is elaborated in rule 21.1:

"During the course of an offer, or even before the date of the offer if the board of the offeree company has reason to believe that a bona fide offer might be imminent, the board must not, except in pursuance of a contract entered into earlier, without the approval of the shareholders in general meeting:

- (a) issue any authorised but unissued shares;
- (b) issue or grant options in respect of any unissued shares;
- (c) create or issue, or permit the creation or issue of, any securities carrying rights of conversion into or subscription for shares;
- (d) sell, dispose of or acquire, or agree to sell, dispose of or acquire, assets of a material amount; or
- (e) enter into contracts otherwise than in the ordinary course of business."¹⁶¹

This broad prohibition of defensive measures on the part of the board rules out many of the measures adopted in a takeover situation by their US counterparts, including "crown jewel sales", "poison pills", sales of unissued shares to a "white squire" etc.¹⁶² The prohibition may even kick in before the board are informed, if they have "reason to believe" that an offer is imminent. Only narrow exceptions to these rules are permitted.¹⁶³

¹⁶¹ Rule 21.1 also requires that the notice of the meeting at which approval of the shareholders is sought should include information about the offer or anticipated offer. Thus a shareholder meeting is unlikely to be called about an offer which is merely "anticipated". In any event this rule may raise issues of confidentiality and insider dealing if the offer is merely anticipated.

¹⁶² US defensive measures are discussed below. While the board might attempt to put a poison pill in place before a bid is imminent, their ability to do so is likely to be limited by broad company law requirements of shareholder consent and their fiduciary duties to act in the best interests of the company: see Armour, J, Deakin, S, and Konzelmann, S, "Shareholder Primacy and the Trajectory of UK Corporate Governance" (2003) *ESRC Centre for Business Research, University of Cambridge, Working Paper No. 266* at 4.

¹⁶³ Where management had, before the bid came to their attention, discussed the allocation of shares to a third party, but taken no formal action, Rule 21.1 obliges the board to obtain the Panel's consent to proceed.

The effect of this rule is considerably wider than the rule in *Hogg*, because the prohibitions it contains are absolute (in the absence of shareholder approval), rather than dependent upon the purpose for which management acts. It has the effect of making the board's power to take significant managerial decisions conditional upon advance shareholder approval when a bid is imminent. This is a significant deviation from the normal position where the law protects the board's power to manage, and constitutes an essential underpinning for the market for corporate control. The closer a corporation is to takeover, the more the powers of management are withdrawn from the board and made subject to shareholder approval.

The Evolution of the Provisions of the Code Relating to Employees

From the Code's narrow aim of ensuring fairness to shareholders, one would not expect to see many mentions of the interests of employees in the Code; the introduction to the Code suggests that the protection of employees in the takeover situation is a matter of public policy for Parliament, or presumably for different self-regulatory mechanisms such as collective bargaining.

However, since 1974 the offeror has been obliged to disclose their intentions for the offeree company. The Panel stated in its Annual Report of 1972/73 that:

"The Panel is concerned that this provision...is not adequately observed by some offerors. Not only is it essential that offerors fulfil their obligations in this respect, but it is the duty of directors of offeree companies, in the case of agreed take-overs or mergers, to insist that they do so."¹⁶⁴

Since the Panel's remit was limited to procedural matters, changes were made to the Stock Exchange Rules to require a bidder to include a statement in his offer document about his policy for "the continuance of the business of the offeree company", including

This would cover a situation similar to the one in *Hogg* where the board had planned to create a trust of shares for the benefit of the employees.

¹⁶⁴ Cited in Johnston, A (1980) (*supra* note 87) at 231

"for the continued employment of the existing employees of the offeree company, setting out the extent of any steps to be taken towards ceasing such employment."¹⁶⁵ In 1974, these requirements were added to Rule 15, which had previously been limited to a more general statement of the offeror's intentions. In 1976, a requirement was added that the board of the offeree company should comment on these statements of intentions as part of an attempt to "secure more precise statements about future intentions".¹⁶⁶ Rule 24.1(d) of the current Code, which evolved out of what the former Rule 15, requires the offeror to disclose "its intentions with regard to the continued employment of the employees of the offeree company and of its subsidiaries".

This rule was introduced during the 1970s when demands for industrial democracy were being made across the whole of Europe. The provisions requiring disclosure of the bidder's intentions as regards employment might be seen as a CSR measure, driven by the growing influence of the political stakeholder model, in particular in its voluntaristic form. However, the general aims of the Code suggest that the rule's rationale lies instead in facilitating informed decision-making by shareholders. As the Panel suggested in 1972/3:

"The intentions of the offeror as to the future conduct of the offeree's business, and the likely effect of any such intentions on the future livelihood of the offeree company's employees, may be a significant factor for shareholders in deciding whether or not to accept an offer."¹⁶⁷

The bidder's statement should not affect the shareholders' decision where the bid is all-cash, as their interest in the company will cease at the moment of sale. By contrast, where at least part of the bid is on a share-for-share basis, the employer's intentions towards the employees may be relevant for various reasons to the offeree shareholders, who will simply transfer their interests to the combined corporation. Widespread layoffs may lead to an industrial relations disaster with consequences for stock price. The offeror's ability

¹⁶⁵ *ibid* at 84

¹⁶⁶ *ibid* at 231-2

to realise synergy gains will also be crucial to the prospects of the corporation after the takeover. If the offeror has good ideas for the employees (whether in cost-cutting terms or in terms of improving productivity) this is likely to influence the shareholders in favour of the offeror. By contrast, if the offeror is unable to demonstrate clear plans, this may be one aspect of the bid which incumbent management might challenge without falling foul of the prohibition on defensive measures: it gives them a ground on which to advise the shareholders not to accept.

While the provision offers advantages in theory, in practice the requirement is "easily satisfied by a boiler-plate formula",¹⁶⁸ frequently amounting to no more than "window dressing"¹⁶⁹ and not fulfilling its shareholder information purpose. Coupled with the Code's insistence that the public policy aspects of mergers are for government, it is difficult to see why these toothless provisions should continue to be included in the Code. It might be suggested that the provision is simply an attempt to head off government public-policy intervention on the grounds that steps are already taken by the Code. Indeed, the Panel claims that this provision has a non-instrumental employee protection rationale after all, stating in its 1997-8 Annual Report that:

"It has always been a Code principle that the interests of employees should be considered in addition to those of shareholders."¹⁷⁰

¹⁶⁷ Annual Report 1972/3, cited in Johnston, A (1980) (*supra* note 87) at 231

¹⁶⁸ Deakin, S, Hobbs, R, Nash, D, and Slinger, G (2002) (*supra* note 133) at 8. They suggest that "In practice... the bidder simply undertakes to observe the employees' pre-existing legal rights, something which is little more than a statement of the obvious in this particular context." Slinger, G and Deakin, S, "Company Law as an Instrument of Inclusion: Re-Regulating Stakeholder Relations in the Context of Takeovers" (1999) *ESRC Centre for Business Research, University of Cambridge Working Paper No 145* point out at 15-16 that "It says nothing about the protection of implicit but legally unprotected formulations."

¹⁶⁹ Button, M (ed), *A Practitioner's Guide to The City Code on Takeovers and Mergers 2002/2003* (2002) at 192: "This last requirement is quite often met, particularly in contested bids, with the rather anodyne statement that the employment and other rights of employees will be "safeguarded.""

¹⁷⁰ "The Takeover Panel 1997 - 1998 Report on the year ended 31 March 1998", available at <http://www.thetakeoverpanel.org.uk>. Compare the statement of a former Deputy Director-General of the Takeover Panel: "The Panel has nothing to say about the merits of an offer. It is almost solely the offeree company's shareholders whose interest the code has at heart." (Lee, TP, "Takeover Regulation in the United Kingdom" in Hopt, K and Wymeersch, E, *European Takeovers: Law and Practice* (1992) at 136)

This bold statement is undermined by the absence of any employee rights to information and consultation about the bid. The Panel only allows employees to receive information and to be consulted when the bid has been made public, in order to preserve "the utmost confidentiality and secrecy in order to prevent insider dealing and false markets."¹⁷¹ The Panel suggests that it is willing to make an exception where the company "wishes simultaneously to announce significant restructuring or rationalisation"¹⁷² or in other circumstances. Of course, given the level of disclosure made in offer documents, this is unlikely to occur at the time the bid is made public.

The US System

Introduction

Takeover regulation in the United States co-exists at federal and state levels. A minimal federal framework was put in place in 1968 by the Williams Act amendments to the Securities Exchange Act 1934. The federal framework was then supplemented by a series of bursts of legislative activity by the individual states, which required the federal courts to resolve the extent to which action by the individual states had been pre-empted by the Williams Act. The general development of the US system is considered here before a fairly detailed consideration of Delaware's system of takeover regulation, which is of particular practical importance because so many of the largest US corporations are incorporated there.¹⁷³

¹⁷¹ Button, M (2002) (*supra* note 169) at 36: "The Panel will normally permit consultation with a very restricted number of employee representatives before an offer is publicly announced if there is to be significant restructuring or rationalisation."

¹⁷² This may of course give rise to obligations to inform and consult under EC directives, discussed briefly in Chapter 6. The Panel states that "it will normally be permissible to do so, subject to certain conditions. These include (i) that the information will only be disclosed to specific individuals and on a confidential basis; and (ii) that, if there is a leak, an immediate public announcement will be made." See further, "The Takeover Panel 1997 - 1998 Report on the year ended 31 March 1998", *supra* note 170.

¹⁷³ The latest figures suggest that over half of all publicly traded companies are incorporated in Delaware, including 58% of Fortune 500 companies, and 50% of NYSE companies: see Delaware Division of

Federal Regulation: The Williams Act

In 1968, Congress made the Williams Act amendments¹⁷⁴ to the Securities Exchange Act 1934 in response to the growth of hostile takeover bids.¹⁷⁵ The Act was "intended to protect investors...But it is also crystal clear that a major aspect of the effort to protect the investor was to avoid favoring either management or the takeover bidder."¹⁷⁶ The Williams Act regime is minimalist, simply imposing certain procedural requirements with a view to ensuring investor choice with full information.

Where an acquisition of shares in a publicly traded company takes a purchaser's total shareholding across the 5 per cent threshold,¹⁷⁷ this gives rise to an obligation on that purchaser to disclose certain information to the company, to the relevant stock exchange and to the Securities and Exchange Commission. The purchaser must disclose the background and identity of the beneficial owners, the source and amount of the funds or other consideration, whether their purpose is to acquire control of the issuer or make any other major changes, and the structure of their share ownership.¹⁷⁸ The importance of these informational obligations is that they must be complied with before a tender offer may be lawfully made.¹⁷⁹

Corporations, available online at <http://www.state.de.us/corp>. In addition, some 308,000 companies are currently incorporated there.

¹⁷⁴ Public Law 90-439, 82 STAT. 454, 15 U.S.C. 781

¹⁷⁵ Easterbrook and Fischel (1991) (*supra* note 5) at 224; it will be noted that this was the same year as the judgment in *Hogg* and the creation of the City Code. For a discussion of the growth in hostile takeovers in terms of a change social norms, see Eisenberg, MA, "Corporate Law and Social Norms" (1999) 99 *Columbia Law Journal* 1253 at 1287-91.

¹⁷⁶ Per White, J in *Edgar v Mite* 457 U.S. 624 (1982) at 633; the Supreme Court also noted that Congress had been convinced that takeovers provide "a check on entrenched but inefficient management." Roe, (1994) (*supra* note 1) at 156 describes it as "mildly antitakeover"; Easterbrook, F and Fischel, D (1991) (*supra* note 5) at 224 suggest that the Act allowed managers to take defensive measures by imposing delay and disclosure.

¹⁷⁷ The Williams Act had originally set the limit at 10% (s13(d)(1)), but in 1970 Congress lowered this threshold to require disclosure of an acquisition of more than 5% of a company's stock (see Act of Dec. 22, 1970, Pub.L. No. 91-567, § 3, 84 Stat. 1497, 1497). The disclosure must be made within ten days of the acquisition (s13(d)(1)). The aim of this provision is to limit the extent of secret purchases in advance of a bid and has the clear aim of fairness among shareholders generally: see Bebchuk, LA (1982) (*supra* note 30) at 1054. Disclosure rules of this kind limit the number of shareholders who sell in ignorance of the pending offer, thereby losing out on the premium offered by the bidder.

¹⁷⁸ §13(d)(1) A-D; the SEC is entitled to prescribe further particulars. Any subsequent changes to this position should also be notified according to SEC rules (§13(d)(2)).

¹⁷⁹ § 14(d)(1)

The Williams Act then sets out a timetable for tender offers.¹⁸⁰ Shareholders tendering their shares are entitled to withdraw them at any time up to seven¹⁸¹ days after the publication of the offer, and "at any time after sixty days from the date of the original tender offer".¹⁸² Additional regulations made by the SEC require that offers remain open for at least 20 days.¹⁸³ The Act also requires shareholders to be treated equally by the bidder. Where the bid is for less than the whole share capital, and the bidder is offered, within ten days of the tender offer, more shares than they are willing or able to take up, the bidder is bound to take them up *pro rata* from the tendering shareholders.¹⁸⁴ Similarly any post-bid increase in the consideration offered should be extended to all tendering shareholders.¹⁸⁵ Like their counterparts in the City Code, these provisions protect minority shareholders by preventing bidders from acting freely on the market.¹⁸⁶

State Antitakeover Statutes

Both before and after the enactment of the Williams Act, individual states had begun to introduce a "first generation" of antitakeover laws. Virginia introduced the first such statute some four months before the Williams Act,¹⁸⁷ requiring the disclosure of certain information to shareholders, and regulating the duration of bids. This type of action by the states raised the question of the extent to which the Williams Act pre-empted the

¹⁸⁰ § 14(d)(4) permits the SEC to supplement the Williams Act rules "as necessary or appropriate in the public interest or for the protection of investors."

¹⁸¹ Amended by the SEC to 15 business days.

¹⁸² § 14(d)(5)

¹⁸³ 17 CFR §240.14e- 1(a) (1986). Lipton and Panner ("Takeover Bids and United States Corporate Governance" in Prentice, DD and Holland, PRJ (eds), *Contemporary Issues in Corporate Governance* (1993), 116) criticise this provision on the basis that it provided bidders with "the ability to employ a wide variety of techniques which coerced shareholders into tendering into an offer rapidly or risk being deprived of much of the value of their shares."

¹⁸⁴ SEC rules have elaborated the requirements of equality of treatment of all shareholders.

¹⁸⁵ § 14(d)(7)

¹⁸⁶ It is, however, notable that only Maine and Pennsylvania have mandatory bid rules: see Berglöf, E and Burkart, M, "European Takeover Regulation" (2003) *Economic Policy* 172 at 188

¹⁸⁷ VA. CODE ANN. §§ 13.1-528 to 13.1-541 (1973). See Lipton, M and Rowe, PK, "Pills, Polls and Professors: A Reply to Professor Gilson" (2002) 27 *The Delaware Journal of Corporate Law* 1 at 4-5; also Romano, R, "The Future of Hostile Takeovers: Legislation and Public Opinion" (1988) 57 *University of Cincinnati Law Review* 457 at 458. In its judgment in *Edgar v Mite* at fn6, the Supreme Court notes that the legislative history of the Williams Act does not show that congress was aware of state antitakeover statutes, but that when "the Williams Act was enacted in 1968, only Virginia had a takeover statute. The Virginia statute...became effective March 5, 1968; the Williams Act was enacted several months later on July 19, 1968." The Virginia statute was repealed in 1989.

individual states' discretion to regulate takeovers. §28(a) of the Securities Exchange Act 1934, which was amended by the Williams Act, provided that the jurisdiction of the states was not pre-empted "insofar as it does not conflict with the provisions of this title or the rules and regulations thereunder."¹⁸⁸ Accordingly, in the absence of the Williams Act, and subject to the Commerce Clause of the Constitution, corporate law, and corporate governance more generally, would have remained entirely a matter for the individual states.

In *Edgar v MITE Corp.*,¹⁸⁹ the Supreme Court considered a challenge to the Illinois Business Take-over Act, which required the offeror to notify the Secretary of State and the target company¹⁹⁰ of its intent to make an offer, and of the terms of that offer, 20 days before the offer was to take effect. During that period, the offeror was not allowed contact the shareholders, but the offeree company was allowed to circulate information about the offer to the shareholders. In addition, the Secretary of State was entitled to hold a hearing during the 20-day period into the fairness of the proposed offer as concerns the shareholders, and could deny registration of the offer if he considered that it failed to give adequate disclosure or was inequitable.

The majority held¹⁹¹ the statute unconstitutional¹⁹² for violating the Commerce Clause because its effects on inter-state commerce were excessive compared with the local state

¹⁸⁸ 48 Stat. 903

¹⁸⁹ 457 U.S. 624 (1982)

¹⁹⁰ The statute adopted a very wide definition of "targets": any corporation in which Illinois residents held 10% of the shares which were the subject of the bid would be caught by the Act. Similarly, any corporation where two of the following three criteria were met: "the corporation has its principal executive office in Illinois, is organized under the laws of Illinois, or has at least 10% of its stated capital and paid-in surplus represented within the State."

¹⁹¹ The majority opinion is contained in Part VB of the judgment of White, J, which was shared by four other justices. There was also a plurality opinion to the effect that the obligation to give advance notification, as well as the power of the Secretary of State to hold a hearing (which the board as shareholders might even have a right to demand), frustrated the Williams Act's aim of striking a balance between board and bidder. The plurality accordingly decided that the state's action was pre-empted by Congress because it gave the board time to take defensive measures. A "plurality" opinion does not represent the views of the majority (Part III of White, J's opinion was shared by two other justices) and is not binding: see *CTS* at 81. Posner, J relied on the plurality opinion in the Court of Appeals in the *CTS* case to strike down the Indiana Statute, but his decision was reversed by the Supreme Court on the facts, leaving the exact status of the plurality opinion uncertain.

¹⁹² And accordingly the legislation of some 36 other states: Roe, (1994) (*supra* note 1) at 158

interests protected by the statute.¹⁹³ In particular, the court was influenced by the argument that the Statute hindered the reallocative function of the market for corporate control and weakened the "incentive the tender offer mechanism provides incumbent management to perform well so that stock prices remain high is reduced."¹⁹⁴ However, by deciding the case on this point, the Court left the states a modicum of flexibility in regulating tender offers to protect their interests.¹⁹⁵ Although agency model considerations were decisive in this particular case, this would not always be the outcome where the court applied the balancing test.

The "deal decade" of the 1980s saw the emergence of a "second generation" of state anti-takeover statutes which tested the limits of the *MITE* decision. States adopted a variety of restrictive takeover regulations,¹⁹⁶ including control-share provisions, which, in the absence of shareholder approval, denied voting rights to those acquiring a certain percentage of a company's share capital, and corporate constituency provisions, which either permitted or obliged¹⁹⁷ the board to take into account a broader range of interests than simply those of the shareholders. Ultimately, a "third generation" of "corporate combination" antitakeover statutes emerged which sought to prevent mergers unless approved by the board or pending the elapse of a period of several years from the change

¹⁹³ *MITE* at 646. Comparing its effects with the interests sought to be protected, the court emphasised the statute's "nationwide reach" (at 643), while deeming the shareholder protection argument "speculative", and reasoning that takeovers did not concern the "internal affairs" of corporations (at 645-6).

¹⁹⁴ *MITE* at 643. The Court cited, and was clearly influenced by, the work of Easterbrook and Fischel, including, inter alia, Easterbrook, F and Fischel, DR (1981) (*supra* note 14)

¹⁹⁵ See, for example, the judgment of Powell, J at 646. He referred to the frequently observed inequalities of resources between offeror and target which characterised the conglomerate era, and the damage which would be done to states where corporate headquarters are relocated out of state.

¹⁹⁶ For a summary of the different methods of takeover regulation put in place by the states, see Orts, EW, "Beyond Shareholders: Interpreting Corporate Constituency Statutes" (1992) *George Washington Law Review* 14

¹⁹⁷ Of all the states to have enacted constituency statutes, only Connecticut mandates consideration of non-shareholder interests: *ibid* at 29.

in control.¹⁹⁸ The Supreme Court has not yet ruled on these, although it seems unlikely, given the following judgment that they will be found to be pre-empted.¹⁹⁹

In *CTS Corp v Dynamics Corp of America*,²⁰⁰ the Supreme Court considered and upheld the Indiana Control Share Acquisitions Act. This is a particularly strong example of a control share statute, denying hostile buyers who pass certain shareholding thresholds²⁰¹ the right to vote their shares indefinitely until the acquisition is approved by a majority of pre-existing disinterested shareholders.²⁰² The Act applied to all Indiana corporations which did not opt out of it.²⁰³ The test applied by the Supreme Court states that state law is only pre-empted where it either makes compliance with both federal and state regulation "a physical impossibility",²⁰⁴ or "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."²⁰⁵ Concluding that the Indiana Act did not make compliance impossible, the Court then asked whether the statute frustrated the purposes of the Federal legislation. It found that the statute actually furthered the Williams Act's purposes by enabling the shareholders to vote as a group in the event of a takeover attempt, circumventing their collective action problem.²⁰⁶ Such a

¹⁹⁸ Delaware's statute (§203, 8 Del Code Ann (1991)), which allows firms to opt out of it in their articles, permits the directors to refuse to approve the transfer of control to a substantial shareholder, subject to contrary approval by 85% of shareholders. Lipton, M ("Pills, Polls and Professors Redux" (2002) 69 *Uni Chi L Rev* 1037) describes this at 1050 as "a statutory pill that can be neutered by a tender offer that attracts 85 per cent of the shares."

¹⁹⁹ By 1995, third-generation statutes had been adopted by 28 States: Davids, RS, "Constituency Statutes: An Appropriate Vehicle for Addressing Transition Costs?" (1995) 28 *Columbia Journal of Law and Social Problems* 145 at 164

²⁰⁰ 481 US 69 (1987); the Supreme Court overturned the federal court of appeals (794 F.2d 250) which had held at 264 that "Even if a corporation's tangible assets are immovable, the efficiency with which they are employed and the proportions in which the earnings they generate are divided between management and shareholders depends on the market for corporate control - an interstate...market that the state of Indiana is not authorised to opt out of, as in effect it has done in this statute." (cited in Roe, (1993) (*supra* note 46)) Agency model assumptions clearly underlay the federal court of appeals' judgment.

²⁰¹ The thresholds were set at 20%, 33 1/3%, or 50%.

²⁰² Although the acquiror does have a right to call a meeting of shareholders by following certain procedures.

²⁰³ It asserted a far narrower jurisdiction than the Act considered in *MITE*.

²⁰⁴ *CTS* at 79, citing *Florida Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132, 142-143 (1963)

²⁰⁵ Citing *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941) and *Ray v. Atlantic Richfield Co.*, 435 U.S. 151, 158, (1978).

²⁰⁶ *CTS* at 81 and 83.

statute would only be pre-empted if it created unreasonable delays, which was not the case here.²⁰⁷

Nor did the legislation in question violate the Inter-State Commerce Clause, because it did not "prohibit any entity--resident or nonresident-- from offering to purchase, or from purchasing, shares in Indiana corporations, or from attempting thereby to gain control. It only provides regulatory procedures designed for the better protection of the corporations' shareholders."²⁰⁸ The Court noted that the states have long used their right to make laws regulating corporate governance. Since these laws frequently have the effect of "prohibiting certain transactions, and regulating others, such laws necessarily affect certain aspects of interstate commerce."²⁰⁹ The Court justified state laws on the basis of concession theory: since corporations are creatures of the states,²¹⁰ the states are entitled to "prescribe their powers, and to define the rights that are acquired by purchasing their shares. A State has an interest in promoting stable relationships among parties involved in the corporations it charters, as well as in ensuring that investors in such corporations have an effective voice in corporate affairs."²¹¹ In response to the respondent's argument that state legislation should support the crucial role played by tender offers in the functioning of the market for corporate control, the Court held that "The Constitution does not require the States to subscribe to any particular economic theory. We are not inclined 'to second-guess the empirical judgments of lawmakers concerning the utility of legislation."²¹²

²⁰⁷ The Court reasoned (at 86) that "the possibility that the Indiana Act will delay some tender offers is insufficient to require a conclusion that the Williams Act pre-empts the Act. The longstanding prevalence of state regulation in this area suggests that, if Congress had intended to pre-empt all state laws that delay the acquisition of voting control following a tender offer, it would have said so explicitly."

²⁰⁸ *ibid* at 93

²⁰⁹ *ibid* at 90

²¹⁰ *ibid* at 90. The Court said that "state regulation of corporate governance is regulation of entities whose very existence and attributes are a product of state law." The Court approved Chief Justice Marshall's famous dictum that "A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly, or as incidental to its very existence. These are such as are supposed best calculated to effect the object for which it was created." (*Trustees of Dartmouth College v. Woodward*, 4 Wheat. 518, 636, 4 L.Ed. 518 (1819))

²¹¹ *ibid* at 91; the Court added at 93-4 that "The very commodity that is traded in the securities market is one whose characteristics are defined by state law. Similarly, the very commodity that is traded in the "market for corporate control"--the corporation--is one that owes its existence and attributes to state law. Indiana need not define these commodities as other States do."

²¹² *ibid* at 92. The Court (at 92 fn 13) was not prepared to view tender offers as an unqualified good: "No one doubts that some successful tender offers will provide more effective management or other benefits

Thus a piece of legislation which removed coercion from the tender process was a legitimate use of the state's discretion in this field.

On a broad reading of *CTS*, the decision transcends the agency approach to takeovers, and allows the states' systems of company law and corporate governance to take into account a range of interests going beyond shareholders.²¹³ The Court's use of concession theory is notable: since state law constitutes the corporation, it has a considerable margin of appreciation in defining the rights and duties of corporate constituencies, limited only by the requirement that it should not regulate the bidding process (which is pre-empted by federal legislation) or discriminate against non-resident shareholders (which would interfere with the inter-state Commerce Clause).

Corporate Constituency Statutes

Pennsylvania was the first state to include corporate constituency considerations in its corporate statute.²¹⁴ Many states followed its lead.²¹⁵ The Pennsylvania statute is considered here by way of example. The constituency statute forms part of a panoply of anti-takeover provisions, including a "profit disgorgement" clause (obliging a bidder to hand over short-term profits made post-bid) and control-share restrictions.²¹⁶ The

such as needed diversification. But there is no reason to assume that the type of conglomerate corporation that may result from repetitive takeovers necessarily will result in more effective management or otherwise be beneficial to shareholders. The divergent views in the literature--and even now being debated in the Congress--reflect the reality that the type and utility of tender offers vary widely."

²¹³ This may be seen as support for a system of regulatory competition, according to which states compete for corporate charters. In a long-running debate on the effects of inter-state competition for charters, two main positions may be discerned. The first, elaborated by Cary, W, "Federalism and Corporate Law: Reflections upon Delaware" (1974) 83 *Yale LJ* 663, suggests that there will be a "race to the bottom" from the shareholders' (and efficiency's) perspective as states offer incorporation on terms which will appeal to management, i.e., which allow them to exploit shareholders. The second, elaborated by Winter, RK, "State law, Shareholder Protection, and the Theory of the Corporation" (1977) 6 *Journal of Legal Studies* 251, suggests that management must compete for investments on capital markets, and so must put in place arrangements which favour investors as well as themselves.

²¹⁴ 15 PA. CONS. STAT. See Wallman, SMH, "The Proper Interpretation of Corporate Constituency Statutes and Formulation of Directors' Duties " (1991) *Stetson L Rev* 163 at 163; Robilotti, MG, "Codetermination, Stakeholder Rights, and Hostile Takeovers: A Reevaluation of the Evidence from Abroad" (1997) 38 *Harvard International Law Journal* 536 at 542; Davids, RS (1995) (*supra* note 199)

²¹⁵ Davids, RS (1995) (*supra* note 199) notes at 158 that 28 states, including the commercially important New York, had enacted such measures by 1995.

²¹⁶ Where a given corporation opts out of §515, §516, the original constituency provision, will, per §511(b), provide an "alternative standard".

constituency clause gives the board wide latitude to define "the best interests of the corporation" without requiring them "to regard any corporate interest or the interests of any particular group affected by such action as a dominant or controlling interest or factor."²¹⁷ The board is permitted to take into account a wide range of constituencies²¹⁸ and to consider the "short-term and long-term interests of the corporation, including benefits that may accrue to the corporation from its long-term plans and the possibility that these interests may be best served by the continued independence of the corporation."²¹⁹ This is clearly aimed at allowing the board to take defensive action against a takeover precisely where it threatens a productive coalition.

These far-reaching clauses clearly permit a variety of defensive measures as long as they can be justified by reference to the "best interests of the corporation", as defined by the board under the business judgement rule.²²⁰ The business judgement rule does not apply any differently in a takeover situation.²²¹ Corporate constituency statutes reiterate the law's rhetorical commitment to managerialism.²²² Action taken by management to frustrate a bid will, in the absence of contrary evidence, be presumed not to be in breach of fiduciary duty.²²³

²¹⁷ §515(b)

²¹⁸ 15 Pa.C.S.A. § 515(a)(1), entitled "Exercise of powers generally"

²¹⁹ §515(a)(2). The board is also entitled under §515(a)(3) to consider the "resources, intent and conduct (past, stated and potential) of any person seeking to acquire control of the corporation".

²²⁰ This is confirmed by §515(d), which provides that "Absent breach of fiduciary duty, lack of good faith or self-dealing, any act as the board of directors...shall be presumed to be in the best interests of the corporation."

²²¹ §515(d) provides that the normal business judgement rule applies in the takeover situation: "there shall not be any greater obligation to justify, or higher burden of proof with respect to, any act as the board of directors...relating to or affecting an acquisition or potential or proposed acquisition of control of the corporation than is applied to any other act as a board of directors...." The presumption will even apply where some board members have an interest in the outcome of the takeover, as long as "a majority of the disinterested directors shall have assented...."

²²² As Wallman, SMH (1991) (*supra* note 214) points out at 166, "a few corporation codes specify that the directors owe a fiduciary duty to the corporation and its shareholders, not a single state statute specifies that the directors owe a fiduciary duty solely to the shareholders." He refers to the *Revlon* case (below) as a rare example of jurisprudence which articulates a rule imposing duties on management to shareholders.

²²³ As Davids, RS (1995) (*supra* note 199) argues at 148, these statutes constitute a "a potentially radical break with the orthodox view that corporations should confine themselves to activity that maximizes the wealth of their shareholders. At stake may be a rethinking of the scope and function of corporation law and, at a deeper level, a new vision of what corporations are -- broad, interdependent networks of relationships rather than merely shareholder-management agency contracts -- and their role in our society."

Defences at the Level of the Individual Corporation

The freedom permitted to management under US law means that a wide range of company-level takeover defences has developed.²²⁴ The "poison pill"²²⁵ appears to be the most important defensive measure in practice.²²⁶ It is a low transaction-cost measure adopted unilaterally by management and comes in many varieties. The most common variety, the "flip-in" poison pill, is a right issued to shareholders as a dividend. Where a bidder acquires a certain percentage of the company's shares without the board's approval, the pill is triggered and the other shareholders become entitled to buy extra shares in the company at a discount.²²⁷ The company then becomes indigestible to the would-be predator because the value of his shareholding is drastically reduced by this issue of new shares, and the cost of acquiring control correspondingly higher.²²⁸ Depending, of course, upon their individual terms, pills frequently lapse once a bidder acquires a certain amount of stock, e.g., 80%. The target board is normally able to redeem the rights at a nominal price before the triggering percentage is reached, and they will do this where they consider that the bid is in the best interests of the company. Where this is the case, the pill simply prevents hostile takeovers and encourages the negotiation of friendly takeovers with the board.²²⁹

The pill is criticised by those who take a neoclassical contractual perspective of the corporation because management may adopt and redeem it unilaterally. They argue that

²²⁴ Such as lock-ups, crown jewels sales, white knights, staggered boards, greenmail, the pac-man defence etc. A full discussion of these exotically-named measures lies beyond the scope of this thesis, but brief details are given in the text where they arise. More detailed descriptions and discussions of takeover defences may be found in Lipton and Panner, (1993) (*supra* note 183) and elsewhere.

²²⁵ For a history of the poison pill, originally termed the "Warrant Dividend Plan", see Lipton, M (2002) (*supra* note 198). The poison pill is normally referred to in the case law as a "shareholder rights plan".

²²⁶ The poison pill has been adopted by most large US companies. Lipton, (ibid) at 1058 fn 79 states that "the pill has been adopted by thousands of public companies and has become an essential, commonplace element of the fabric of corporate governance, with no adverse effect on share prices or merger activity."

²²⁷ See Davies, (1992) (*supra* note 94) at 210 for more details. By contrast, the "flip-over" pill allows shareholders of the target company to buy shares in the bidder company at a discount after the takeover, encouraging them not to tender their shares.

²²⁸ Armour, J, Deakin, S, and Konzelmann, S (2003) (*supra* note 162) at 3 describe poison pills generally as "pre-commitments to engage in some activity or restructuring if a hostile bid succeeds that will destroy any value the bidder would obtain from the firm."

²²⁹ Davies, (1992) (*supra* note 94) at 215

the pill increases agency costs at the shareholders' expense by undermining the disciplining effect of the market for corporate control. The increased difficulty of taking control will deter potential bidders, making the displacement of underperforming management less likely. Finally, the pill does not satisfy a hypothetical bargaining test because the shareholders would not have agreed to it. By contrast, supporters of the pill, and managerialism more generally, argue that the pill benefits shareholders precisely because it is redeemable by the board. It allows the board to negotiate the best deal possible for shareholders, using their greater time resources and inside information about the value of the company's assets, opportunities and business plan.²³⁰ The pill also gives the board more time to respond to the bid than the twenty days provided by the Williams Act. The pill should therefore increase the premia paid to target shareholders,²³¹ and therefore fit with a hypothetical bargaining model (in which the shareholders have full information).

Finally, the poison pill may support the productive coalition model by allowing management to make (and keep) credible commitments to other corporate constituencies. The pill means that the company does not have to carry on business under a permanent "for sale" notice; since any sale will be negotiated, this will allow at least temporary protection of the expectations of managers and employees, at least where this is in the long-term interests of the shareholders.²³² The existence of a pill demonstrates *ex ante* to employees that management will retain a say in the company's future direction, and therefore that their implicit contracts will not necessarily be threatened by a hostile bid.²³³

Refusal by the board to consent to the proposed takeover and redeem the pill does not necessarily mean the end for the proposed takeover. There are two possible ways for a

²³⁰ As we saw in the previous chapter, critics such as Bebchuk, LA, "The Case Against Board Veto in Corporate Takeovers" (2002) 69 *University of Chicago Law Review* 973 at 988 *et seq* argue that their conflict of interests is so great that the board "do not have the best incentives".

²³¹ Lipton, M (2002) (*supra* note 198) at 1041, 1053 fn 59 and 1058 fn 81; Easterbrook, F and Fischel, D (1991) (*supra* note 14) argue at 189 that this amounts to "wasteful shuffling" where investors are diversified.

²³² Lipton, M (2002) (*supra* note 198) at 1039

²³³ However, the prevalence of "adaptive mechanisms" means that the board will be likely to redeem the pill where it suits their interests as shareholders. This is discussed below.

bidder to get around a refusal by the board. First, if the company in question is incorporated in Delaware, the shareholders may be able to challenge management's actions under the intermediate standard of review. This is discussed in detail below. If this is not possible, either because the corporation is incorporated elsewhere, or because the Delaware court holds that management's decision is well-founded, the hostile bidder, who has already acquired a base shareholding position, may be able to take control of the board through a proxy fight.

In a proxy fight, the bidder qua shareholder solicits the transfer of the proxy votes of other shareholders from the incumbent board to the bidder, with a view to replacing the board and ultimately redeeming the pill. The proxy fight is essentially a debate about the way in which incumbent management are running the company and the reasons for their rejection of the bid.²³⁴ By giving shareholders a vote about whether or not to reactivate the market for corporate control, shareholder choice remains at the centre of the takeover process.²³⁵ The proxy fight may become more complex where there is a staggered board.²³⁶ Company constitutions often provide that only one third of the board may be replaced in any one year, with the consequence that a bidder who controls the majority of the shares has to wait at least a year before their nominees would control the board. Such provisions are now very common,²³⁷ and where they are combined with a pill, the bidder must begin a proxy fight in the usual way. The difference is that the fight will take more than a year, since normally only 1/3 of the board may be replaced each year. Agency theorists obviously oppose such a combination of measures because of their dampening effect on the market for corporate control and consequent reduction of shareholder value.²³⁸ Lipton's managerialist perspective suggests that such a combination enhances

²³⁴ Lipton, M (2002) (*supra* note 198) at 1058 fn 81

²³⁵ *ibid* at 1037: "It was and is a fundamental aspect of the pill that a proxy fight is the only way in which a raider can override a well-founded decision of the board to reject and block a takeover bid."

²³⁶ These have long been allowed by state law: Orts, EW (1992) (*supra* note 196) at 64

²³⁷ See Kahan, M and Rock, EB, "How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law" (2002) 69 *Uni Chi L Rev* 871 at 885 noting that over 60% of public corporations have this type of provision in their constitution. As evidence of the unpopularity among shareholders, Kahan and Rock note at 911 that shareholder resolutions calling for the elimination of staggered boards are on the rise.

²³⁸ See the sources listed in Maher and Andersson, "Corporate Governance: Effects on Firm Performance and Economic Growth" in McCahery, JA, Moerland, P, Raaijmakers, T, and Renneboog, L *Corporate Governance Regimes: Convergence and Diversity* (2002), 386 at 409.

the board's ability to resist an offer which it considers inadequate and therefore raises the premia paid to target shareholders.²³⁹ From a productive coalition perspective, this combination of measures could be considered to give a greater degree of temporal protection to implicit contracts than the pill on its own by preventing the removal of management for at least one year.

Delaware's Intermediate Approach to Takeover Regulation

Delaware's approach differs from that of the states discussed above and from the approach of the City Code. Delaware reviews management conduct on a case-by-case basis, and does not impose absolute prohibitions on conduct. The parallels with the now-redundant *Hogg* test are striking.²⁴⁰ Delaware's approach offers the advantage of allowing management, with their inside knowledge of the company's prospects, to make decisions based on long-term considerations, while limited review undermines objections based on the "classic argument" that under a system of pure managerialism the board becomes unaccountable and tends to act for the purpose of self-entrenchment.

Generally, courts in common law jurisdictions refuse to second-guess the board's decisions,²⁴¹ on the basis that there are no appropriate "criteria by which the courts can assess the merits of an exercise of business discretion."²⁴² Delaware corporate law operates a general presumption that the directors "acted on an informed basis, in good

²³⁹ Lipton, M (2002) (*supra* note 198) at 1058.

²⁴⁰ In each of the Delaware cases discussed in this section, the court emphasises that "a meaningful decision upon review turns upon a complete understanding of the factual background" (Cheff at 497) and the "factual background of this matter bears a significant relationship to its ultimate outcome" (*Unocal* at 949).

²⁴¹ Davies, (1992) (*supra* note 94) at 208: in the UK, this general rule is implicit in the subjective terms in which director's duties are cast.

²⁴² Parkinson, J (1993) (*supra* note 94) at 108. Given the range of possible courses of action and the bounded rationality of management, which together make "what the market wants" unclear, ex post review would clearly be inappropriate: see further Stone, "Public Interest Representation: Economic and Social Policy Inside the Enterprise" in Hopt, KJ and Teubner, G (eds), *Corporate Governance and Directors' Liabilities* (1985), 122 at 137. In addition, Strine has argued that "the stockholders have a weak claim that they should be protected by judicially intrusive action to override the results generated by the internal processes of organizations whose shares they voluntarily purchased. Equally important, corporate boards will not function well (it is reasonably feared) if their every decision is subject to relatively unconstrained judicial review. Such easy second-guessing is likely to have a paralyzing effect, and diminish risk-taking, to the larger detriment of stockholders." (Strine, LE, "Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle" (2002) *57 Business Lawyer* 1371 at 1376)

faith and in the honest belief that the action taken was in the best interests of the company" when they took the decision in question.²⁴³ The burden is on anyone alleging breach of duty on the part of the board to produce evidence to rebut this presumption. However, the business judgement rule is modified in the context of hostile takeovers, to create a "middle ground"²⁴⁴ between an absolute prohibition on defences and absolute managerialism. An ex-Vice-Chancellor of the Delaware Supreme Court, Leo Strine considers that the modified rule simply amounts to the court deciding whether "corporate decisions have been made in a...[sufficiently trustworthy] manner".²⁴⁵ The rationale for the rule lies in the board's conflict of interest and the court's desire to ensure that the board are not using their powers of management for the purpose of entrenchment.²⁴⁶ The modified rule subjects management decision-making to "enhanced scrutiny", requiring management to justify any defensive measures²⁴⁷ by reference to "reasonable grounds for believing that a danger to corporate policy and effectiveness existed",²⁴⁸ and to show that the defensive measure was "reasonable in relation to the threat posed".²⁴⁹ This effectively reverses the burden of proof of the general business judgement rule²⁵⁰

²⁴³ *Aronson v. Lewis*, 473 A.2d 805 at 812 (1984).

²⁴⁴ Lipton, M (2002) (*supra* note 198) at 1046

²⁴⁵ Strine, LE (2002) (*supra* note 242) at 1376; thus it involves analysis of the role of independent directors and the shareholders in the taking of the decision.

²⁴⁶ See *Cheff v. Mathes* 199 A.2d 548 Delaware Supreme Court (1964) where the court permitted greenmail (the purchase by the company of its own shares at a premium from a likely predator) subject to proof by the board of their "true motives".

²⁴⁷ Whether taken in response to the bid or put in place before the bid, such as a poison pill.

²⁴⁸ *Cheff* at 555; affirmed in *Unocal Corp. v Mesa Petroleum Co.*, 493 A.2d 946 (1985). In *Unocal*, the Court upheld a rights issue plan (poison pill) put in place in response to fears of a specific takeover by a known predator. In *Moran v Household International, Inc.*, 500 A 2d 1346 (1985), the Delaware Supreme Court also upheld the right of the board to adopt the poison pill as a general corporate antitakeover defence on the basis that "pre-planning for the contingency of a hostile takeover might reduce the risk that, under the pressure of a takeover bid, management will fail to exercise reasonable judgement." (at 1350) However, any decision to create a poison pill, as well as any decision not to redeem it, would be reviewed against the *Unocal* rule. Subsequent developments in the Delaware case law have made clear that this tolerance does not extend to measures which deprive shareholders of their right to remove the board, or any new board of their right to manage. It is notable that the court refused to censure the unequal treatment of the undesirable shareholders.

²⁴⁹ *Unocal* at 955. In *Unitrim, Inc. v American General Corp* 651 A.2d 1361 (Del Sup Ct 1995), the Court emphasised at 1385-7 that the question was not whether the decision was a perfect one but a reasonable one, and in assessing this, the court should look at the overall response, the justification given and the results achieved. In that case the board had put in place a variety of defensive measures.

²⁵⁰ The Pennsylvania provisions discussed above technically require a challenger to produce evidence of breach of duty, although where a board's actions seem disproportionate or unreasonable, it will be easier to produce evidence that the action in question is aimed at entrenchment rather than the best interests of the company. Accordingly, the difference between Pennsylvania and Delaware is merely one of the burden of proof.

The first limb requires the directors to show good faith and reasonable investigation.²⁵¹ The second limb requires "an analysis by the directors of the nature of the takeover bid and its effect on the corporate enterprise."²⁵² The "corporate enterprise" is understood in a broad, pluralistic sense, and the board are entitled to take into account a range of factors in assessing the threat, including "inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on "constituencies" other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), the risk of nonconsummation, and the quality of securities being offered in the exchange."²⁵³ In a recent case, the Delaware Supreme Court emphasised that "a board of directors, while always required to act in an informed manner, is not under any *per se* duty to maximize shareholder value in the short term, even in the context of a takeover."²⁵⁴

This pluralistic conception of the "corporate enterprise" is only suspended where a sale of the company becomes "inevitable" (for example, where the board holds an auction among competing bidders).²⁵⁵ In that case, the board comes under a duty to obtain the highest price possible for shareholders. Management's plans for the business cease to be relevant and "concern for non-stockholder interests is inappropriate" because "the object no longer is to protect, or maintain the corporate enterprise, but to sell it to the highest bidder."²⁵⁶

²⁵¹ The opinion of non-executive directors will be crucial in establishing the purpose of the action under challenge. The Court in *Unocal* stated at 955 that "such proof is materially enhanced, as here, by the approval of a board comprised of a majority of outside independent directors who have acted in accordance with the foregoing standards."

²⁵² *ibid*

²⁵³ *ibid*. Kahan, "Jurisprudential and Transactional Developments in Takeovers" in Hopt, KJ, Kanda, H, Roe, MJ, Wymeersch, E, and Prigge, S (eds), *Comparative Corporate Governance: The State of the Art and Emerging Research* (1998), 683at 684 considers this burden easily discharged ("no Supreme Court case has ever invalidated a board's defensive action under *Unocal*"), and argues that, as applied by the Delaware courts, "the *Unocal* test demands for a rejection of a tender offer little more than the backing by the board's independent directors and an investment banker's opinion stating that the price offered is inadequate." Lipton, M (2002) (*supra* note 198) at 1061 disagrees, referring to the large amount of economic evidence which has been placed on the court record in some cases.

²⁵⁴ *Paramount v Time* 571 A.2d 1140 Delaware Supreme Court (1989) at 1150

²⁵⁵ *Revlon, Inc. v MacAndrews & Forbes Holdings, Inc.*, 506 A 2d 173 (Del Sup Ct, 1986).

²⁵⁶ *Ibid* at 182. Jensen criticises this from an agency perspective: "If the business judgement rule is applied to conflicts over control rights between principals and agents, the courts are effectively giving the agent the right to change the control rights unilaterally. In the long run, this interpretation of the contract will destroy

Although in *Revlon* itself it was "apparent to all that the break-up of the company was inevitable",²⁵⁷ identifying an "inevitable" sale may pose practical difficulties in other cases. A company moving into "Revlon mode" is both "ambiguous and commonplace, since its occurrence may be difficult to pinpoint in a hostile takeover, and yet it must arise in every friendly acquisition."²⁵⁸ The difficulties of interpretation faced by the courts may be seen from the different judgments delivered in two factually rather similar cases.

In *Paramount Communications Inc. v. Time, Inc.*,²⁵⁹ the Court found that Time's board had "steadfastly maintained it was not placing itself up for sale",²⁶⁰ planning a merger with Warner which would allow them to retain control over the joint governance structure (which would preserve Time's "culture" of "journalistic integrity"), and which "offered a greater long-term value for the stockholders".²⁶¹ On these facts, the board's mandate to manage subsisted and included "authority to set a corporate course of action, including time frame, designed to enhance corporate profitability." It was open to the directors to determine that "the present stock market price of shares is not representative of true value or that there may indeed be several market values for any corporation's stock."²⁶²

By contrast, in *Paramount Communications, Inc. v. QVC Network, Inc.*,²⁶³ the Court distinguished *Time* on the basis that the proposed sale to Viacom involved a change of control, and so the company had entered *Revlon* mode. This meant the board had to

the possibility of such cooperative agreements, because it will leave principals with few effective rights." Jensen, MC (1988) (*supra* note 16) at 43

²⁵⁷ *Revlon* at 182. The board had redeemed a poison pill in order to facilitate a bid by their preferred bidder, and subsequently proposed to introduce further defensive measures to discourage an undesired rival bidder.

²⁵⁸ Gilson, R and Kraakman, R, "What Triggers Revlon?" (1990) 25 *Wake Forest L Rev* 37 at 38

²⁵⁹ 571 A.2d 1140 Delaware Supreme Court (1989)

²⁶⁰ At 1145

²⁶¹ at 1149

²⁶² at 1150, footnote added. See also *Smith v Van Gorkom* 488 A.2d 858 (1985 Del Sup Ct) at 875. The Court said there that "A substantial premium may provide one reason to recommend a merger, but in the absence of other sound valuation information, the fact of a premium alone does not provide an adequate basis upon which to assess the fairness of an offering price." There the assessment was made on the basis of the company's "historically depressed" market price.

"secure the best value reasonably available to the stockholders"²⁶⁴ and the various defensive measures taken against QVC's bid were unlawful. The Court explained that *Revlon* does not require "inevitable...break-up"; a change of control is sufficient to oblige the board not to prefer one bidder over another.²⁶⁵ In this case, control of the corporation, which had been "vested in the fluid aggregation of unaffiliated stockholders" would be transferred to the bidder.²⁶⁶ This had important economic implications for existing shareholders because they would "have no leverage in the future to demand another control premium."²⁶⁷ The *Time* case was distinguished on the basis that control of *Time* remained vested in the aggregation of market shareholders.

Accordingly, subject to these procedural safeguards, the business judgement rule keeps managerialism at the heart of Delaware corporate law, even in the takeover context.²⁶⁸ In *Unocal*, the court referred to the board's "fundamental duty and obligation to protect the corporate enterprise" and emphasised that "in the broad context of corporate governance, including issues of fundamental corporate change, a board of directors is not a passive instrumentality."²⁶⁹

However, the court in *Revlon* suggested that this principle of managerialism is limited to "enlightened shareholder value":

"A board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders."²⁷⁰

Such a limitation on the board's discretion is not made explicit in *Unocal*. It may well be that the court assumed implicitly that corporate law, as a general rule, requires

²⁶³ 637 A.2d 34 (1993 Del Sup Ct)

²⁶⁴ *ibid* at 37

²⁶⁵ *ibid* at 46

²⁶⁶ *ibid* at 43

²⁶⁷ *ibid*

²⁶⁸ *Unocal* at 954

²⁶⁹ At 954; this appears to be a guarded rejection of the agency model in the takeover context. The Court added at 958 that "If the stockholders are displeased with the action of their elected representatives, the powers of corporate democracy are at their disposal to turn the board out."

²⁷⁰ at 182

managerial action to be aimed at producing future gains for shareholders. However, it repeatedly used the formulation that the board should consider whether an offer is "in the best interests of the corporation and its shareholders."²⁷¹ With its refusal to consider the board a "passive instrumentality" of the shareholders, the court seems to recognise a corporate interest independent from the shareholders.²⁷² Most of the time, of course, this will not be a significant distinction because shareholder interests and the "corporate interest" will coincide, at least in the long run.²⁷³ Both the *Unocal* and *Revlon* formulations allow a board which intends to maintain a company's independence to take into account investments by employees in firm-specific capital in making allocation decisions, on the basis that such investments might be expected to produce enhanced returns to current and future shareholders in the longer term. The *Revlon* formulation suggests that such an entitlement would cease in the narrow situation where the employees' investments continue to generate rents for themselves in the form of super-competitive salaries, but no longer generate profits for the shareholders, *and* are not expected to do so in the future. Under the *Unocal* formulation, it is arguable that the board's entitlement to consider the interests of employees in formulating the "best interests of the corporation" would subsist in this situation, although the continued absence of profits might entice the shareholders to exercise their democratic rights to remove the board.²⁷⁴

Finally, Delaware has a "short form merger" rule which allows a parent company to "squeeze out" minority shareholders when it acquires 90% of the share capital, regardless of their consent.²⁷⁵ By contrast, it does not have a mandatory bid rule, allowing bidders to purchase only the shares they want during a takeover. It might be argued that this configuration of rules is coercive for tendering shareholders.

²⁷¹ *Unocal* at 954

²⁷² Teubner, G, "Enterprise Corporatism: New Industrial Policy and the "Essence" of the Legal Person" (1988) 36 *American Journal of Comparative Law* 130, Teubner, "Company Interest: The Public Interest of the Enterprise 'in Itself'" in Rogowski, R and Wilthagen, T (eds), *Reflexive Labour Law* (1994), .

²⁷³ See Wallman, SMH (1991) (*supra* note 214) at 183-187

²⁷⁴ See *Unocal* at 958 where the Court drew attention to the shareholders' right to remove the board where they are not happy with its performance.

²⁷⁵ Under §253 Del Code Ann. A dissatisfied shareholder may seek an appraisal remedy.

Theoretical Perspectives on UK and US Takeover Regulation

i) UK

Although communications from the Panel and those involved in the self-regulatory process do not explicitly adopt the language of agency theory, the UK model is widely praised for its role in supporting an active market for corporate control and reducing agency costs.²⁷⁶ This is not surprising, given the rationale for its introduction and the identity of its promoters, and agency theory assumptions are immanent in the Code. Its rule of managerial passivity limits the board's ability to impose agency costs on shareholders because of their desire to remain in their posts. Mandatory bid provisions support and protect dispersed minority shareholders by allowing all to exit on the same terms and share in the control premium, while "squeeze-out" rules ensure that existing shareholders are unable to free ride on the efforts made by corporate monitors. This ensures a supply of willing bidders. These rules constitute important modifications to the operation of capital markets and managerialist company law which underpin the operation of a market for corporate control and make shareholder value the dominant norm of corporate governance.

By contrast, when viewed through the productive coalition lens, the UK model's suspension of managerialism during takeovers becomes more controversial. Where agency theory does not recognise any adverse effects for other corporate constituencies, the productive coalition model sees the wasteful destruction of networks of implicit contracts. The position of employees in the City Code is undertheorised at best, incoherent at worst. If one assumes that an articulation of employee interests during the takeover process is unnecessary because they are fully protected by their contracts, the City Code's provisions dealing with employees appear redundant because they do not enhance the quality of shareholder decision-making. Absent this assumption, the Code's provisions do not adequately protect the interests of employees in the modern corporation from expropriation. Despite the Panel's claims that the Code takes into account employee

²⁷⁶ See, for example, Bebchuk, LA (2002) (*supra* note 230) and Easterbrook, F and Fischel, D (1991) (*supra* note 5), whose prescriptions for US takeover law conform very closely to the City Code.

interests and recognition that takeovers may affect the "future livelihood" of employees, employees must rely on the board making a good argument to the shareholders to consider the employees' interests (in maintaining their firm-specific investments or otherwise), and hope that their interests either coincide with those of the shareholders, or that the shareholders act altruistically. Relying on dispersed shareholders taking the employees' contractually unprotected interests into account and not selling their shares to the highest bidder appears to be an unlikely route to protection.

As an example of capture of the regulatory process by sectional interests, the City Code constitutes an anomalous but very important deviation from the common law's managerialist approach, effectively replacing it with shareholder value in the context of takeovers. However, the Code's effects extend well beyond the takeover situation and the destruction of existing productive coalitions. As management's focus is constantly directed towards the share price in order to ward off hostile takeovers, any possibility of management assuming a neutral stance among the various constituencies is undermined. Management is unwilling to take any steps which might adversely affect the share price, including making long-term commitments to employees. This focus on shareholder value undermines the prospects for the emergence of new corporations based on a trust-based productive coalition model or the adoption of such a strategy by existing companies.

ii) Non-Delaware US

The criticisms of the non-Delaware US model run in precisely the opposite direction. The *CTS* decision in particular is often blamed for the "epidemic-like"²⁷⁷ spread of antitakeover laws.²⁷⁸ State antitakeover laws are widely criticised as measures of political choice, enacted at the behest of management and increasing agency costs for

²⁷⁷ Coffee, JC (1988) (*supra* note 21) at 436

²⁷⁸ See Roe, (1993) (*supra* note 46) at 337. Georgakopoulos, NL, "Corporate Defense Law for Dispersed Ownership" (2001) 30 *Hofstra Law Review* 11 at 27 argues that 25 other states enacted similar legislation in response to this decision. By mid-1995, this had increased to some 41 states per Robilotti, MG (1997) (*supra* note 214) at 536. For a contrary view on cause and effect, see Lipton's comment on Roe's article in Blair, MM, *The Deal Decade* (1993) at 353-357. Lipton argues that the "explosion of state antitakeover moves" did not follow the *CTS* case; rather the states' response began immediately after the *MITE* decision.

shareholders, while offering little in the way of additional protection to employees.²⁷⁹ Political expediency trumps economic good sense as losses suffered by management and employees reverberate politically in state elections, and corporate constituencies based in the state of incorporation rationally lobby their elected representatives to protect their interests.²⁸⁰ In comparison, the dispersed shareholders of US public corporations face a collective action problem. Their losses are felt over a range of companies across many jurisdictions²⁸¹ and diversification makes it irrational for them to incur costs lobbying or co-ordinating shareholder action in the first place. Critics further charge that antitakeover legislation does not mitigate the social impact of hostile takeovers, and simply gives management discretion to serve the interests of that group which most closely coincide with their own.²⁸² Similarly, the poison pill, which is adopted unilaterally by managers, does not fit with a contractual model because shareholders would not have agreed to it, yet is tolerated by state courts.

²⁷⁹ As Roe, MJ (2003) (*supra* note 9) says at 45, "One might cynically see these laws as made by and for managers, who wanted freedom to oppose hostile takeovers and, once they had it, offered employees little more." Roe, (1994) (*supra* note 1) at 160-1 argues that managers lobby for state legislation in order to circumvent the shareholder voting process. See also Robilotti, MG (1997) (*supra* note 214) at 544. Jensen, MC (1988) (*supra* note 16) at 45-6 argues that these statutes are "another example of special interests using the democratic political system to change the rules of the game to benefit themselves at the expense of society as a whole. In this case the special interests are top level corporate managers and other groups who stand to lose from competition in the market for corporate control." Of course, as we saw above, a political stakeholder or productive coalition perspective would make this very criticism of the City Code. Robilotti, MG (1997) (*supra*) at 542 explains constituency statutes by reference to "the tremendous social and economic dislocation caused by takeovers, along with the perception in state legislatures that Wall Street reaps its huge financial gains off the back of Main Street." Similarly, Orts, EW (1992) (*supra* note 196) at 25 confirms that, although the Pennsylvania Chamber of Commerce sponsored that state's antitakeover legislation, it was later sustained by a broader coalition. Davids, RS (1995) (*supra* note 199) at 154 confirms that "it appears that it was the involvement of labor and other interests, rather than the business community, which was decisive in the bill's enactment."

²⁸⁰ Roe, (1993) (*supra* note 46) at 330-1. Orts, EW (1992) (*supra* note 196) at 23 argues that "the more persuasive view is that state legislatures passed antitakeover statutes largely in response to *their* constituents, many of whom perceived hostile takeovers negatively." Romano, R (1988) (*supra* note 187) at 461-2 emphasises the role of large local corporations, which are vulnerable to hostile takeover, in the political process leading to legislation.

²⁸¹ Similarly, any "efficiency gains are spread through the economy. Dispersed winners do not even know they have won." (Roe, (1993) (*supra* note 46) at 331)

²⁸² For use of the "classic argument" in this context, see Bechuk, L and Ferrell, A, "Federalism and Corporate Law: The Race to Protect Managers from Takeovers" (1999) 99 *Columbia Law Review* 1168; Davies, P, "The Board of Directors: Composition, Structure, Duties and Powers" (2000) *OECD Paper Presented at Conference "Company Law Reform in OECD Countries A Comparative Outlook of Current Trends": 7-8 December 2000* at 17 comments that the position of stakeholders is unlikely to be improved by these regulations "unless the courts adopt a bold and interventionist stance when reviewing management's choice among the conflicting stakeholder interests...In both cases, entrenchment of incumbent management is likely to be the largest effect of such rules."

It appears to be not the element of political choice which these commentators find objectionable, but the fact that the resultant legislative output does not conform with their notions of efficiency. Their criticisms are based on agency model assumptions, and accordingly, only the shareholders can have residual claims. Reasoning backwards from an assumption that the market for corporate control maximises the wealth of society, takeover regulation which tolerates defensive measures must be motivated by private benefit rather than economic efficiency.²⁸³ The UK rules, which conform very well to an agency model of the company, but are also the result of political choice, are not subject to a similar bombardment of criticism. Commentators also argue that these laws are anticontractual. Since antitakeover and constituency statutes could be put in place at the level of individual companies, their imposition by state law is only necessary because shareholders would not consent to them.²⁸⁴ If these commentators adopted productive coalition assumptions, they could instead seek to justify imposition at state level as a public good: these laws save transaction costs by providing the terms that "almost everyone [involved in a productive coalition] would want to adopt".²⁸⁵ The assumptions of the agency model transform transaction cost saving measures into inefficient regulatory interference with the operation of the market for corporate control.

Moving beyond the political choice argument, constituency statutes might be evaluated against the productive coalition model by asking to what extent they allow management to act as "mediating hierarchs", freed from the tyranny of the hostile takeover mechanism to establish nexuses of implicit contracts and build high-skill, high-productivity businesses. Perhaps because of the broad way in which constituencies are defined, these measures are rarely considered as part of a productive coalition model.²⁸⁶ The classic

²⁸³ See for example, Easterbrook, F and Fischel, D (1991) (*supra* note 5) at 167: "For contracting to work optimally, the markets must be completely free." Note however, the distortion of the market's normal operation by the "freeze out" rule.

²⁸⁴ See Roe, (1994) (*supra* note 1) at 160-1

²⁸⁵ Easterbrook, F and Fischel, D (1991) (*supra* note 5) at 34-5

²⁸⁶ Although Orts, EW (1992) (*supra* note 196) notes at 19 that they "harbor potential for positive change...[they] may enable American corporations to emulate corporate governance configurations followed in competing nations within the world economy, such as Germany, Japan, and the nations of the European Community... [which] already seem to operate in a manner that constituency statutes promote--to take seriously corporate interests beyond those of shareholders."

argument about managerial unaccountability aside,²⁸⁷ constituency statutes certainly give management *legal* freedom to take into account non-shareholder interests, and therefore form the basis for an imperfect productive coalition model.²⁸⁸ The difficulty with this argument is that market adaptations have occurred which reinforce shareholder value and bypass state antitakeover laws. These adaptations are discussed below.

iii) Delaware

The Delaware courts' controversial decision to supervise managerial decision-making in the takeover context reflects their commitment to managerialism. Corporate governance becomes analogous to representative democracy.²⁸⁹ The *Unocal* decision affirms the board's role as government, including, within the limits of review, "the power to decide whether or not to accept a takeover bid."²⁹⁰ The company gains the benefit of the board's expertise and inside information about the true value of the firm and its prospects.²⁹¹ The shareholders' role as voters is limited to the right to elect a board which shares their views, and if they are "dissatisfied with a board decision to reject a takeover, their proper response is to elect another board."²⁹² The employees merely have the status of election

²⁸⁷ For an argument that management of a productive coalition may be relied on to act in a trustworthy manner, see Blair, MM and Stout, LA, "Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law" (2000) *Georgetown University Law Center 2000 Working Paper Series in Business, Economics, and Regulatory Law Working Paper No. 241403*.

²⁸⁸ See the discussion of Blair and Stout's "mediating hierarchs" model in Chapter 3.

²⁸⁹ Kahan, M, "Paramount or Paradox: The Delaware Supreme Court's Takeover Jurisprudence" (1994) 19 *J. Corp. L.* 583

²⁹⁰ *ibid* at 685. See also *Unocal* at 958.

²⁹¹ However, Strine, LE (2002) (*supra* note 242) points out at 1399 that the popular argument that the board know more about the corporation's business than the shareholders may be undermined by the events at Enron: "The parade of Enron executives and directors who went before the Congress to plead guilty to ignorance about key financial issues is arguably difficult to reconcile with the ideal of paternalistic and all-knowing directors acting as the faithful market intermediaries for the stockholders." This may simply undermine the weight to be attached to the opinion of independent directors in applying the *Unocal* test. However, it might have more far-reaching implications, undermining the Delaware jurisprudence because "Without a credible basis to believe that the directors generally know best, articulators of the corporate law will not be as well positioned to permit directors to, in essence, make such fundamental investment decisions for owners of securities." If both constituencies are equally ill-informed, it does, of course, make economic sense to give decision-making power to the constituency which bears the risk, and in mainstream corporate governance debate, that is always the shareholders. But, as Strine points out at 1400, the Enron affair also cuts against the EMH, where the "marketplace [is] dominated by speculators, caught up in a frenzied desire to Boogie Board on the big wave, rather than by careful investors whose investments follow a careful examination of fundamental drivers of long-term corporate performance."

²⁹² Kahan, (1998) (*supra* note 289) at 685

observers. The courts will not interfere with government decision-making except where it impinges upon this division of power or is motivated by bad faith.

Lipton and Rowe emphasise the beneficial effects of this managerial orientation and partial rejection of the EMH in protecting "shareholders, corporations, and directors from pressure to respond immediately to short-term dislocations in the stock market."²⁹³ The board's ability to defend against takeovers in these circumstances was particularly valuable during the recent boom and bust in technology stocks where the dislocation was particularly pronounced. Looked at in terms of a productive coalition model, Delaware's takeover rules provide a more reliable underpinning for a nexus of incomplete contracts by assuring some continuity of managerial personnel. By requiring the board to be able to produce economic evidence backing up their resistance to a given bid, the rules reduce the possibility of action aimed at entrenchment and ensure that management will use their mediating hierarch role in an economically rational manner rather than simply to favour client groups. This method implicitly recognises that one-size-fits-all regulation of the takeover process will not be optimal for all companies.

By contrast, Roe offers a more pragmatic, political explanation of Delaware's jurisprudence, but recognises that there is a "public-regarding dimension to antitakeover legislation."²⁹⁴ He argues that Delaware's original stance towards takeovers was fairly neutral, fearing that federal intervention might follow attempts to protect managers. When this fear proved unfounded, Delaware took a more antitakeover stance with the aim both of retaining corporations already present there, whose management were being tempted to reincorporate by states offering more antitakeover regimes, and of attracting corporations incorporated elsewhere.²⁹⁵ The inefficient outcome of inter-state competition for corporate charters seems to be resolvable only by federal legislation.²⁹⁶

²⁹³ Lipton, M and Rowe, PK (2002) (*supra* note 187) at 27.

²⁹⁴ Roe, (1994) (*supra* note 1) at 167

²⁹⁵ *ibid* at 163-6 and Roe, (1993) (*supra* note 46) at 340-9; similarly Bechuk, L and Ferrell, A (1999) (*supra* note 282) at 1173.

²⁹⁶ As recommended by Cary, W (1974) (*supra* note 213), calling for "federal standards of corporate responsibility" to prevent this particular "race to the bottom", a position supported recently by Bechuk and Ferrell.

Adaptive Responses by the Market to Takeover Regulation

Whatever the precise rationale for their enactment, it is clear that Delaware's takeover rules (like those of the other states) have not prevented takeovers from occurring.²⁹⁷ Analysis of takeover regulation in the abstract might lead to the conclusion that the movement back towards managerialism in many states means that the US system of corporate governance is less driven by agency theory than the UK system. Such a suggestion requires reconsideration in the light of what Ronald Dore terms the "capitalist-manager's counter revolution":²⁹⁸ the alignment of managerial interests with those of shareholders through their remuneration packages. This adaptive response to regulatory permissiveness makes takeovers more friendly and consensual by contracting away managerial opposition. A board whose interests have been correctly aligned²⁹⁹ with those of shareholders is only likely to adopt defensive measures where this furthers the interests of target company shareholders (for example, by holding an auction or increasing the bid price). Stock options have been performing the hostile takeover's role since its disciplining effects were undermined (and its costs increased) as a result of the wider availability of defensive measures.

The exponential growth of stock options is clearly referable to the spread of constituency statutes.³⁰⁰ Like the hostile takeover mechanism, these high-powered market incentives align the interests of management and shareholders through the medium of the share price, but replace the threat with an appeal to self-interest. Management's attention

²⁹⁷ Kahan, M and Rock, EB (2002) (*supra* note 237) note at 879 that the year 2000 saw over 10,000 takeover deals worth more than \$1.285 trillion, an increase on 1988 of over 400% in dollar terms and 300% in the number of deals.

²⁹⁸ Dore, R (2000) (*supra* note 40) at 12

²⁹⁹ Correct alignment requires that their interests qua shareholder should considerably outweigh their interests qua employee.

³⁰⁰ Even the relatively mild Delaware takeover laws provoked this type of market response, including "significant changes in the structure of compensation contracts...with features such as accelerated vesting upon a change of control. Such compensation devices provide substantial incentives to managers to accept an unsolicited bid...managers in companies with antitakeover provisions receive more valuable options, and managers of companies with large blockholders receive fewer options." (Kahan, M and Rock, EB (2002) (*supra* note 237) at 896-7) Millon, D, "Why is Corporate Management Obsessed with Quarterly Earnings and What Should Be Done About It?" (2002) 70 *George Washington Law Review* 890 at 906 notes that "During the 1990s, the number of options outstanding increased from 5 to 15 percent of all outstanding shares. Options now account for 60 percent of a typical CEO's compensation package." In the UK, their spread must be attributable to their lower transaction costs, compared with hostile takeovers.

remains fixed on the share price, not as before through fear of displacement, but because any action which harmed the company's share price would affect their remuneration. These changes to remuneration structure had their desired effect as, after a dip around 1990, takeover activity during the 1990s once more approached its 1980s peak, but this time without the hostility. "Shareholder value became an ally rather than an enemy"³⁰¹ of management following the changes. The new coalition between management and shareholders rested on an understanding that management would be remunerated in proportion to the value they generated for shareholders (or more accurately, in line with the share price).³⁰² State laws giving management back their discretion to act in a more pluralistic manner accordingly had little effect.

Stock options are only one of a number of mechanisms adopted by the capital market in response to the retreat of the hostile takeover to the corporate governance background. Other adaptive mechanisms like the progressive reduction of managerial tenure and improved corporate metrics, in particular quarterly earnings targets, discussed in Chapter one, wield enormous influence over management. Severe consequences follow failure to achieve expected earnings per share, while a "predictability premium" is awarded to companies which produce regular increments in earnings. These factors have induced the "management" (or "smoothing") of corporate earnings to maximise beneficial share price effects.³⁰³ Further dispersal of shareholders increased the power of institutional investors who "promote the Anglo-American model with a vengeance",³⁰⁴ their focus on financial and share price performance leading to high portfolio turnover. A growing number of day

³⁰¹ Holmstrom, B and Kaplan, S (*supra* note 39) at 3

³⁰² Millon, D (2002) (*supra* note 300) notes at 909 that "A recent study finds abnormal declines in stock prices just prior to issuance of options...These findings support the view that executives who are compensated by stock options allow their own self-interest to influence exercise of their managerial authority." Such incidents demonstrate the difficulty of measuring the creation of shareholder value where the EMH does not hold. Similarly, Stout LA, "On the Proper Motives of Corporate Directors (Or, Why You Don't Want to Invite Homo Economicus to Join Your Board)" (*UCLA School of Law Law and Economics Research Paper 03-08* at 4 fn 9 points out that "stock-based compensation... can encourage directors to take actions that can raise share price in the short run rather effectively, while harming the firm's long-run prospects. Accounting fraud provides an extreme example of this phenomenon."

³⁰³ See further Millon, D (2002) (*supra* note 300) at 897. This might involve, for example, setting aside reserves against notional contingent liabilities, which are then declared not to have arisen when the time is right. Millon suggests at 900 that "Earnings management, like earnings inflation, is symptomatic of a corporate culture emphasizing current stock prices over creation of longer-term value."

³⁰⁴ Mitchell, LE (2001) (*supra* note 54) at 171

traders turn over a high proportion of their shares simply on the basis of these metrics. Neither group has the resources or the incentive to observe the underlying businesses of the corporations in which they invest. Further, social norms of shareholder value and the 'financialisation' of executives contribute to an increasing focus on accounting matters and the disjunction of management from the underlying productive business.

The constant focus on share price driven by these mechanisms undermines the viability of the productive coalition model just as much as the hostile takeover did. Management now have strong incentives not to take into account employee interests, and employees have no countervailing political power to exert over management. Where investors rely solely on the share price and its supporting metrics as a proxy for the creation of shareholder value, this, coupled with the reflexivity of markets, causes severe difficulties for companies which want to make investments in training with a view to developing the firm's future competencies. Without detailed knowledge of an individual company's circumstances, it is impossible for investors to attach a precise value to these investments.³⁰⁵ Even if it were possible, it would require an investor to go "against trend" in his market activities, a course of action which is unlikely to be sustainable for institutional investors who are judged against benchmarks like stock market indices over shorter time horizons,³⁰⁶ and a very risky one for small investors who have to close out their position within a limited time span.³⁰⁷

To allow the capture of the board's mediating power by one constituency through the provision of incentives to serve that constituency's interests would appear to contradict the managerialist notion that the board serves the company as a whole rather than simply the shareholders. This issue is of particular salience for the law in the wake of the Enron debacle. The policy question now being faced by regulators is whether to try to introduce

³⁰⁵ See Osterman, P (1999) (*supra* note 77) at 152. He points out that even institutional investors "do not seem to develop the kind of in-depth knowledge that might lead them to support human resource investments that are shunned by more conventional analysts." The problem is, of course, with free riders, as even institutional investors do not hold large enough stakes to justify the necessary monitoring.

³⁰⁶ See Mitchell, LE (2001) (*supra* note 54) Ch 7. Mitchell also notes at 170 that fund managers are remunerated on the basis of how much money they make, "a fact which focuses his attention on the short-term performance of his portfolio corporations."

³⁰⁷ See Rajan and Zingales' critique of the EMH, *supra* note 76.

still more measures which will force the board to maximise shareholder value, for example, by defining shareholder value more clearly or by improving external monitoring.³⁰⁸ Alternatively, the increasing intensity of adaptive mechanisms means that legal support for companies based on a productive coalition model requires more than just reform of takeover regulation. Managerial insulation from capital market pressures needs to be restored, but must not result in diminished accountability. Breaking the link between managerial remuneration and short term stock price is necessary, and reform of accounting standards to reflect the changing nature of capital is essential, but unlikely, particularly given the level of opposition to reform of the treatment of stock options. Regulators might consider reforming monitoring structures to involve other constituencies, such as employees, as a way of improving managerial accountability. Similarly, information and consultation may serve useful articulative functions if the intensity of adaptive mechanisms is somewhat reduced. More explicit guidance for the board about when to take into account other constituencies might be helpful; voluntary statements of CSR, such as codes of conduct, may play an important role in setting out management's game plan and maintaining confidence of the various constituencies in the corporate decision-making process. Similarly, social accounting may convey useful information to the various corporate constituencies. More research is needed on ways in which managerial insulation could be enhanced without leading to unaccountability.

Conclusion

While the differences between US and UK systems of takeover regulation are striking, in particular as regards the role of managerialism, takeover regulation is only one among several influences on the prominence and dynamism of the takeover mechanism. It is suggested that hostile takeovers originally undermined managerialism, but that shareholder value is now underpinned by a more complex mix of aligned incentives and other market mechanisms, with the hostile takeover relegated to the background, standing by in case managerialism should once more rear its head. Management are now unlikely to oppose takeovers where they stand to gain from their share options. This suggests that

³⁰⁸ See for example, the recent "Review of the Role and Effectiveness of Non-Executive Directors"

in jurisdictions where shareholder value has strong roots, the precise configuration of takeover regulation is only one of a number of factors competing for influence.

While unlikely to have a causal effect on its own, a rule of strict management neutrality may contribute to undermining the viability of the productive coalition model - lack of managerial entrenchment undermines their ability to make credible commitments and act as mediating hierarchs. The firm-specific investments which are the basis of the productive coalition model are fragile, and are unlikely to be made without a legal framework.³⁰⁹ Allowing management to take some defensive measures appears to be more compatible with a productive coalition model, although there is the well-publicised risk that they will act in a self-serving way.

Where either model is pursued, regulatory interventions may be justified in pursuit of a specific notion of efficiency. The debate about takeover regulation revolves around which model of the company should prevail, which notion of efficiency is more appropriate, and ultimately, whose interests should take precedence. The "political conflict over takeovers...divides shareholders and stakeholders, and thus transcends the usually narrow concerns of corporate law."³¹⁰ This conflict is, of course, an aspect of the broader debate about corporate governance and the model of the company which should be pursued in order to enrich society. Each legislator must decide whether to concern themselves with "the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment"³¹¹ or with developing "mechanisms that give the firm the power to provide incentives to human capital."³¹²

produced by Derek Higgs for the DTI in January 2003.

³⁰⁹ See the argument of Sadowski, D, Junkes, J, and Lindenthal, S, "Labour Co-Determination and Corporate Governance in Germany: The Economic Impact of Marginal and Symbolic Rights" (*Quint-Essenzen Nr 65, August 2001, IAAEG* in favour of legal intervention to this end, discussed in Chapter 3.

³¹⁰ Coffee, JC (1988) (*supra* note 21) at 440

³¹¹ Shleifer, A and Vishny, RW, "A Survey of Corporate Governance" (1997) *52 Journal of Finance* 737 at 737

³¹² Rajan and Zingales, "The Governance of the New Enterprise" in Vives, X (ed), *Corporate Governance: Theoretical and Empirical Perspectives* (2000), 201 at 203

Chapter Five: Takeover Regulation in Germany

Introduction

In this chapter I look at takeover regulation in Germany. This forms an instructive counterpoint to the UK and US regulatory systems because the German system of corporate governance as a whole is rather different from the Anglo-American one. It is often categorised as the paradigmatic example of an 'insider' system of corporate control, "with small numbers of quoted companies, concentrated share ownership and comparatively low levels of takeover activity," in contrast to Anglo-American 'outsider' systems, which are characterised by "large equity markets, dispersed ownership and active markets in corporate control."¹ Corporate constituencies, rather than the market, tend to monitor the actions of corporate managers.² Since shareholdings are, on the whole, concentrated, the collective action problem and rational apathy do not arise because large shareholders receive the benefits of their efforts and do not have the ready exit option enjoyed by dispersed shareholders in the Anglo-American system. Block shareholders monitor both formally through their representatives on the supervisory board, and notably, informally through "out-of-the-boardroom shareholder caucuses and meetings [with] managers",³ committees and long-standing relational networks. In large corporations, employees also play a monitoring role through their representatives on the supervisory board.⁴

¹ See for example, Franks, JR and Mayer, C, "Ownership and Control of German Corporations" (2001) *CEPR Discussion Paper No 2898, July 2001* at 1

² It is often argued that blockholders in this system perform the same role as the market for corporate control does in the UK and the US. Bergström, C, Högfeldt, P, Macey, JR, and Samuelsson, P, "The Regulation of Corporate Acquisitions: A Law and Economics Analysis of European Proposals for Reform" (1995) *Columbia Business Law Review* 495 argue that, as a result of "unique historical economic conditions", banks only exercise vetoes rather than actively monitoring and demanding US-style restructuring. Banks are often both equity and debt holders, and so have a preference for a lower level of risk-taking, and so do not pressurise management to maximise shareholder value exclusively.

³ Roe, MJ, *Political Determinants of Corporate Governance* (2003) at 72

⁴ However, where blockholders adopt informal monitoring mechanisms, this may have the effect of "sapping" the supervisory board's power: Roe, MJ (2003) (*supra*) at 72. This may be seen as an adaptive response on the part of blockholders to mandatory co-determination.

However, 'insider' systems of corporate governance like the German model are widely considered to be under pressure⁵ because of globalisation and, in particular, liberalisation of capital markets, increased competition in product markets, and the corresponding cultural diffusion of norms of shareholder value⁶ and "marketisation."⁷ 'Progress' in a more market-orientated direction is being hindered both by structural factors and the legal model of corporate decision-making. This chapter first considers the structure of German corporate governance and the laws relating to corporate decision-making as they apply to employees. It then analyses their effect on hostile takeovers. Finally, it discusses the evolution of takeover regulation and the new German Takeover Law which came into force in 2002, analysing it in terms of the models of the company and in terms of its place in the broader system of German corporate governance.

Structure and Operation of German Corporate Governance

The dominance of large shareholders means that the Berle and Means corporation is not prevalent in Germany. Banks dominate the German system of corporate governance. Some surveys have found banks controlling up to 95% of the shares in large public corporations.⁸ Along with insurance companies, they are committed long-term shareholders who hold large shareholdings in enterprises, as well as directorships on the supervisory board.⁹ A high level of holding clearly puts them in a strong position to

⁵ The pressure on the co-determination model has been increased by the current economic downturn in Germany. The *Financial Times* reported on Friday, 20th June 2003 that 58.3 per cent of Lufthansa shareholders had adopted a resolution condemning the supervisory board vice-chairman and head of the Verdi trade union, Frank Bsirske, for encouraging strikes. Critics of co-determination use this to support their argument that co-determination institutionalises conflict rather than co-operation within the corporation. For a more nuanced discussion of the relationship between conflict and co-determination, see Pistor, K, "Codetermination: A Sociopolitical Model with Governance Externalities" in Blair, MM and Roe, MJ (eds), *Employees & Corporate Governance* (Brookings Institute, Washington DC, 1999)

⁶ Lane, C, "Changes in Corporate Governance of German Corporations: Convergence to the Anglo-American Model?" (2003) *ESRC Centre for Business Research, University of Cambridge Working Paper No 259* at 10

⁷ Dore, R, *Stock Market Capitalism: Welfare Capitalism - Japan and Germany Versus the Anglo-Saxons* (2000) at 171

⁸ See Jürgens, U and Rupp, J, "The German System of Corporate Governance - Characteristics and Changes" (2001) *INSEAD Paper forming part of Corporate Governance, Innovation and Economic Performance in the EU Research Project* at 5-6 for an English language review.

⁹ Although Hopt, "The German Two-Tier Board: Experience, Theories, Reforms" in Hopt, KJ, Kanda, H, Roe, MJ, Wymeersch, E, and Prigge, S (eds), *Comparative Corporate Governance: The State of the Art and Emerging Research* (1998), 227 at 253 notes that there may be a trend toward banks withdrawing from

monitor management without vulnerability to the free-rider problem. However, it should not be assumed that banks monitor solely with a view to ensuring shareholder value.¹⁰ The traditional explanation of the banks' role in corporate governance has been that their long-term relational ties mean that their "interests as creditors took precedence over their interests as shareholders."¹¹ Their role as house banks involves long-term credit links and gives them "deep insight into the credit-taking corporation."¹² In addition, social and cultural factors may lead banks to "feel they have obligations to other stakeholders such as employees and managers."¹³

Generally, the *Hausbank* model, where a bank has close relational ties with a particular company through a combination of interconnections, is considered to be of decreasing importance as competition in financial markets increasingly pushes banks to adopt a model of investment banking. While the banks' most visible role in corporate governance may be declining as they are driven to sell off their long-held core shareholdings, many other links, both financial and more broadly relational, continue to tie them to large corporations. For example, banks retain considerable indirect influence in corporate governance through their shareholdings in large insurance companies.¹⁴ More importantly, their voting rights are boosted by the depository system (*Depotstimmrecht*), whereby banks vote the shares which are placed on deposit with them by dispersed

their supervisory board positions. Jürgens, U and Rupp, J (2001) (*supra*) at 24 confirms this, although the speed of change is hardly dramatic and the starting point for the decline is at a very high level: "between 1986 and 1993, private banks reduced the number of seats held on the supervisory boards of the 100 largest German companies from 114 to 99."

¹⁰ This is the view of agency theorists who argue that the agency problem arises between depositors and the bank rather than between shareholders and management.

¹¹ Davies, P, "Employee Representation and Corporate Law Reform: A Comment from the United Kingdom" (2000) 22 *Comp. Labor Law & Policy Journal* 135 at 141; Beinert, D, *Corporate Acquisitions and Mergers in Germany* (2000) points out at 70 that "German companies rely heavily on debt finance and the banks are often the largest creditors of the target."

¹² Hopt, "Common Principles of Corporate Governance in Europe?" in McCahery, JA, Moerland, P, Raaijmakers, T, and Renneboog, L (eds), *Corporate Governance Regimes: Convergence and Diversity* (2002), 175 at 186; per Dore, R (2000) (*supra* note 7) at 175, "their ties with the firms they serve have been multistranded, covering insurance, securities underwriting, and trading and business consulting as well as the usual commercial credit and longer-term finance."

¹³ Franks and Mayer, "Bank Control, Takeovers, and Corporate Governance in Germany" in Hopt, Kanda et al (1998)(*supra* note 9), 641 at 642. This factor may be expected to diminish with increasing liberalisation of financial markets and the growing involvement of lenders not bound by such social norms.

¹⁴ Thanks to Dieter Sadowski for this point; banks and insurance companies frequently hold long-term cross-shareholdings

shareholders.¹⁵ In the absence of specific instructions on how to vote (which is usually the case), the banks must clearly state to shareholders how they will vote. In fact, they usually vote with management, subject to a legal duty to act in the interest of the client.¹⁶

Despite recent changes to capital gains tax rules (discussed below) which allow corporations to divest themselves of corporate cross-holdings without incurring huge capital gains tax liabilities, many corporations continue to hold large shareholdings in other companies. Corporate cross-shareholdings are in fact the most prevalent form of shareholding in the German economy.¹⁷ In firms where banks do not hold large shareholdings, this form of cross-shareholding may be particularly important in maintaining long-term relationships between firms, since "ownership strongly overlaps with a variety of other commercial relations."¹⁸ Although they may be shareholders, cross-shareholding corporations take a long-term productive view of their relationship with each other.

There are also many personal links between companies. Like banks, as noted above, many companies (including, in particular, insurance companies) provide each other with board members, both at the supervisory and management board levels.¹⁹ Since the priority of these representatives is generally the maintenance of long-term stable relations, their widespread presence is likely to prevent the pursuit of shareholder value becoming the corporation's dominant aim, at least in the short term, as "interlocking directorates and direct and indirect reciprocal personal links create interdependencies

¹⁵ Beinert, D (2000) (*supra* note 11) at 70: "It is estimated that the five largest banks in Germany own about 15 per cent of the country's listed shares and that the banks control an additional 20 per cent by way of proxy votes." A similar arrangement applies to associations of shareholders which may control sizeable chunks of company stock.

¹⁶ Hopt, (2002) (*supra* note 12) at 186-7

¹⁷ Dore, R (2000) (*supra* note 7) at 175; Jürgens, U and Rupp, J (2001) (*supra* note 8) at 7 note that in 1999 non-financial companies held 29.3% of shares in DAX30 companies compared to 13.5% held by banks.

¹⁸ Höpner, M and Jackson, G, "An Emerging Market for Corporate Control? The Mannesmann Takeover and German Corporate Governance" (2001) *Max-Planck-Institut für Gesellschaftsforschung MPIfG Discussion Paper 01/4* at 6

¹⁹ Prigge, "A Survey of German Corporate Governance" in Hopt, Kanda et al (1998) (*supra* note 9), 943 at 959

among their members that might result in an atmosphere of mutual consideration at the expense of shareholders."²⁰

In addition to this combination of bank and other corporation holdings, large family holdings should also be mentioned for their contribution to the concentration of ownership of many corporations.²¹

Barriers to Hostile Takeovers

This degree of concentration of ownership, coupled with the small number of public corporations,²² means that targets for hostile bids have been hard to find.²³ The large but private GmbH, which makes up 44% of the companies subject to "quasi-parity" co-determination,²⁴ is normally controlled by large shareholders, meaning it is a step removed from the model of the Berle-Means corporation and not an appropriate target for a hostile bid. Similarly, public AGs,²⁵ which "represent a significant but not dominant part of the German economy", and make up the rest of the co-determined companies, also tend to have a concentrated ownership structure, dominated by the large stakes held by the groups discussed above.²⁶ Further, even if a suitable target can be identified, a bidder faces the further obstacle of having to identify and locate smaller shareholders, since most shares are bearer shares, and notification requirements only apply above 5, 10, 25,

²⁰ *ibid* at 961

²¹ See for example, Prigge (1998) (*supra* note 19) at 975 who notes that in 1992, 18.9% of the shares of the largest 500 companies were held by families.

²² Per Beinert, D (2000) (*supra* note 11) at 67, "there are only about 870 German corporations listed on a German stock exchange, a large number of which are in turn affiliated with other companies, i.e., not really publicly held. Notwithstanding the increasing number of listings in recent years, it is estimated that the number of candidates suitable for a tender offer does not currently exceed about 100."

²³ The hostile bid is a rare phenomenon in Germany, with only a handful since 1945. See for example Prigge, (1998) (*supra* note 19) at 992 and Franks and Mayer, (1998) (*supra* note 1) at 642. Recently there have been tentative signs of an upturn in activity, such as Vodafone's successful hostile bid for Mannesmann in 2000 (see further Höpner, M and Jackson, G (2001) (*supra* note 18)) and Krupp's unsuccessful 1997 hostile bid for Thyssen (one of the rare widely held companies) which came to a negotiated settlement. See also Franks and Mayer, "Ownership and Control in Europe" in Newman, P (ed), *The New Palgrave Dictionary of Economics and the Law* (1998), 722, vol. II, 722 at 722 and 727

²⁴ Prigge, (1998) (*supra* note 19) at 951

²⁵ In February 1997 there were 4088 of them: Hopt, (1998) (*supra* note 9) at 257

²⁶ The exact pattern of ownership is complex: for detailed analysis see e.g., Prigge, (1998) (*supra* note 19) at 968-978. One striking illustration of the degree of concentration is that the stake of the largest shareholder at 65.4% of listed AGs in 1983 was over 50%.

50 and 75% thresholds. Smaller shareholders must initially be sought through the media, but once a bid has been launched, the depository banks are obliged to disclose the identity of the depositors.

The long-term perspective which many large shareholders take leads to fewer conflicts of interest between their representatives and the representatives of employees on the supervisory board, where decisions are almost always made by consensus. This aspect is discussed further below. Further, this identity of interests also plays a role in discouraging hostile bids, and while these positions are maintained, "there may be little that a strict neutrality rule, or any other rule of corporate law, can do to facilitate an active market for corporate control..."²⁷

These factors have contributed significantly to the virtual absence to date of hostile takeovers in the German marketplace. In addition, a period of industrial prosperity has coincided with popular (and managerial) opposition to hostile takeovers. Many shares never reach the market in the first place, and where they do, the sellers are likely to be influenced in their choice of buyer by their additional interests (beyond maximising their gain on their shareholdings).

The lack of liquidity in stock markets means that Germany does not have a functioning market for corporate control in the sense that market participants monitor management performance by reference to share prices.²⁸ Internal monitoring of management, performed by a combination of committed shareholders and labour representatives on the supervisory board, may constitute a functional equivalent of the market for corporate control.²⁹ However, the identity and interests of the monitors, coupled with the fact that

²⁷ Painter, R and Kirchner, C, "European Takeover Law - Towards a European Modified Business Judgment Rule for Takeover Law" (2000) 1 *European Business Organization Law Review* 353 at 391; this is because "Few bidders are willing to enter a market where the success or failure of tender offers is determined not by wealth maximizing shareholders, but by managers of other companies who are themselves hostile to hostile takeovers."

²⁸ Dore, R (2000) (*supra* note 7) at 174 suggests that "the equity market has hitherto served as a market only in income-yielding assets, not also as a market in corporate control"

²⁹ Monitoring internally may be more appropriate where there is a large degree of firm-specific investment, since only those on the inside of the corporation are able to assess its extent, which as we have seen, is impossible for the market.

the monitoring occurs by reference to criteria other than the publicly-quoted share price, means that, management are not monitored exclusively according to the criterion of shareholder value.

The absence of hostile takeovers does not mean that German corporations do not merge and consolidate. In fact mergers play an important role in fostering industrial efficiency (by creating synergies and economies of scale), but this is functionally separated from the internal task of disciplining management. Takeovers normally take the form of a privately-agreed sale,³⁰ with "managers getting the agreement, in face-to-face contact, of representatives of large blocks of holdings"³¹ for the acquisition of a controlling stake, rather than a market-based tender offer leading to a contest for control. Since the blockholder is likely to have long-term strategic interests in common with the corporation whose shares are being sought, they are likely to scrutinise the offeror's business plan carefully. Consent is only likely to be forthcoming if the bidder sets forth a stable business policy.³² It has been suggested that the transfer of block shareholdings "may serve as a substitute for the Anglo-American type of market for corporate control" as the incoming shareholders begin to monitor management.³³ However, a more common view is that the mergers which are witnessed in Germany "are based less on financial or governance logic than they are on industrial logic: horizontal and vertical mergers between firms in the same industry aim at rationalization and economies of scale, while horizontal mergers diversify into new but related product areas."³⁴

If a change in control occurs by reason of a transfer of a controlling shareholding, the party gaining control is required to make a mandatory tender offer to the other

³⁰ Of course, the sale may well be opposed by management: Franks and Mayer, (1998) (*supra* note 23) at 643

³¹ Dore, R (2000) (*supra* note 7) at 174

³² See further Lutter and Lammers, "Hostile Takeovers: Possibilities and Limitations According to German Law" in Maeijer, JMM and Geens, K (eds), *Defensive Measures Against Hostile Takeovers in the Common Market* (1990), 113at 135: "A raider has the best opportunities of rapidly acquiring extensive influence in a company if he is able to convince the representatives of the banks of his further intentions."

³³ Prigge, (1998) (*supra* note 17) at 993. Purchasers normally pay a premium to the selling blockholder, but this tends to be lower than the premia paid in hostile takeovers in Anglo-American jurisdictions. Another important difference is that minority shareholders normally do not receive a share of the premium. See Franks, JR and Mayer, C (2001) (*supra* note 1) at 3.

shareholders, a requirement which is clearly aimed at protecting minority shareholders.³⁵ Alternatively, the acquiring company may make a voluntary public tender offer for the remainder of the shares.³⁶ As a major business transaction, either of these methods is likely to require the approval of the supervisory board of the offeror company, or the shareholders if there is none.³⁷

The absence of a market for corporate control has important consequences for the way in which corporations are governed. It means that "firms retain the option of pursuing strategies other than maximizing the return on equity...firms can absorb higher labor costs, thus avoiding layoffs more easily during cyclical downturns and thereby protecting employee morale and firm-specific human capital."³⁸ Höpner and Jackson argue that this 'insider' system may lead to a different equilibrium than that reached under the Anglo-American system in which "markets for corporate control make the 'equilibrium' of lower market capitalization and lower distribution of value-added for shareholders more difficult to sustain."³⁹

Signs of Change in German Corporate Governance

There are signs that the above picture of long-term stability and commitment on the part of shareholders may be beginning to change.

First there have been several important legal changes. Capital Gains Tax was abolished on the sale of cross-holdings from the commencement of the 2002 tax year. This is likely

³⁴ Höpner, M and Jackson, G (2001) (*supra* note 18) at 15

³⁵ This provision applies in various situations where control changes, see Beinert, D (2000) (*supra* note 11) at 66 for further details: "mandatory tender offers are not used to acquire control. Rather, they are a legal consequence of corporate measures taken by a shareholder already holding a controlling interest."

³⁶ This is a very unusual route, and is not usually for the purpose of gaining control: Per Beinert, D (2000) (*supra* note 11) at 67, "during the period from 1995 to mid-1999, there were only 105 cases. In most of these cases, the goal of the offer was not to acquire control."

³⁷ Beinert, D (2000) (*supra* note 11) at 66: however if no internal authorisation has been obtained, the transaction will normally be binding unless the other party knows that the transaction is ultra vires. This rule does appear to offer some protection to the shareholders of the offeror company against empire-building on the part of the board of the offeror company.

³⁸ Höpner, M and Jackson, G (2001) (*supra* note 18) at 12

³⁹ *ibid* at 48

to facilitate the sale of shareholdings which have been held for long periods of time.⁴⁰ Further, there has been incremental financial market deregulation, including the creation of a Federal Supervisory Office for Securities Trading, the relaxation of rules on investment companies, and permission for companies to engage in share buy-backs and the issue of stock options to management. These measures have gone some way towards creating a capital market framework which supports the pursuit of shareholder value.⁴¹ The growing number US (and to a lesser extent, UK) pension funds and other institutional investors, who bring their corporate governance standards with them, will seek to use these reforms to push for greater focus on shareholder value.⁴²

Second, the growth of international competition may have increased the vulnerability of German publicly owned corporations to hostile takeover, as evidenced by Vodafone's successful hostile takeover of Mannesmann. German banks are under competitive pressure from European and global rivals, and their need to produce increased returns is generally considered to have reduced the scope for patient investment strategies of the kind which have been historically dominant in Germany.⁴³ In addition, financial deregulation has put German banks under pressure to raise their share price in order to fight off the threat of hostile takeover by overseas competitors.⁴⁴ Accordingly, German banks focus increasingly on lucrative investment banking at the expense of relational banking. Greater attention to the bottom line is likely to increase the availability of large blocks of shares in those publicly-traded corporations which are underperforming (in terms of creating shareholder value). The danger that blockholders might exit is likely to turn the attention of management of those corporations towards enhancing shareholder

⁴⁰ As Hopt, KJ, "Takeovers, Secrecy, and Conflicts of Interest: Problems for Boards and Banks" (2002) *ECGI Working Paper 03/2002* points out at 4, some of the holdings date back as far as the mid-19th Century.

⁴¹ See in particular, the 1998 law (Control and Transparency Act – KonTraG).

⁴² Lannoo, K, "A European Perspective on Corporate Governance" (1999) 37 *Journal of Common Market Studies* 269 at 288

⁴³ Dore, R (2000) (*supra* note 7), Ch 8

⁴⁴ Dore (*ibid* at 177) notes that in this climate, banks have become "more cautious/calculative about landing themselves with the risk of having to perform the traditional role of a major bank shareholder - namely to bail out, or in extreme cases get involved the management of, failing firms." Jürgens, U and Rupp, J (2001) (*supra* note 8) at 24 note the "major shift from 'patient capital' to shareholder value orientation in the German banking sector" means that shares are now viewed as investments and expected to produce a return.

value with the aim of maintaining a stable shareholder base. Further stimulus is given to the whole process by the above changes in capital gains tax rules which have spurred on the banks to sell off some of their shareholdings and to use the resulting liquidity to seek higher returns from the market.⁴⁵ These changes mean that banks are no longer as reliable a defence to hostile takeover as they were, although the erosion of these longstanding networks of relationships will clearly be a slow process.

The Legal Position before the Enactment of the New Takeover Act

Social norms, the ownership structure described above, and post-bid restrictions on taking control, rather than German company law, led to the virtual absence of hostile bids in Germany. From a legal perspective, those rare companies with dispersed shareholders appeared particularly vulnerable because German company law before the new Takeover Act only permitted the board to take limited defensive measures in the face of an unwelcome bid.

The position before the enactment of the new Takeover Act remains important because, as we shall see below, the new German takeover law permits the shareholders in general meeting or the supervisory board to authorise the management board to take defensive measures against the bid; presumably the range of defensive measures which may be authorised in this way is determined by general company law.

i) Availability of Defensive Measures to the Board

As a preliminary matter it should be noted that the board owe duties to act in the best interests of the company and in the face of a bid are obliged to provide the shareholders with their opinion of the bid so that the shareholders may make an informed decision.⁴⁶

⁴⁵ However, *The Economist, A Survey of Germany*, 7th December 2002 at 10 reported that "the sell-off has been slower than expected" because markets started to "plummet" around the time of the legal changes.

⁴⁶ Lutter and Lammers, (1990) (*supra* note 32) at 118

a) Voting rights limitations

Generally the rule of one share, one vote holds, although listed preference shares without voting rights are fairly common.⁴⁷ Multiple voting shares have been prohibited in principle since 1937.⁴⁸ Perhaps the most common defensive measure was, until recently, the limitation of voting rights to a specified percentage, which tended to be between 5% and 15% of the votes.⁴⁹ These limits applied to all blockholders, including banks, but not to the banks in their capacity as proxies for depositors. This rule further strengthened the bank's governance position. The introduction of new limitations on voting rights has been prohibited for listed companies since the law was changed in 1998, and those limitations which did exist lost their effectiveness on 1st June 2000.⁵⁰ This is a particularly significant change because, among the 20 or so AGs which had maximum voting rights provisions in force, many have widely dispersed shareholders.⁵¹ These corporations are presumably now considerably more vulnerable to hostile takeover.

b) Registered shares

A company may still change its articles to require that the shares of the company be registered, effectively requiring the company's approval for registration. This would give the management board broad discretion over whether to register the new owner. As a defensive measure, this course of action is of limited use if the provision is not already included in the articles, because every shareholder must consent to the change. They are unlikely to do so because of its effect on the marketability of their shares. Furthermore, any potential bidder who has already gained a "toe-hold" in the company will clearly not consent. Finally, this does not appear a viable option for listed companies in the light of the requirement of Article 46 of Directive 2001/34/EC that publicly listed shares be freely transferrable.

⁴⁷ Prigge, (1998) (*supra* note 19) at 979

⁴⁸ Lutter and Lammers, (1990) (*supra* note 32) at 132

⁴⁹ Franks and Mayer, (1998) (*supra* note 13) at 644 note that "In a list of 19 companies which had voting right restrictions in 1988, we found that 17 had no single shareholder owning more than 25% of the shares.

⁵⁰ Pursuant to the provisions of KontraG, see Beinert, D (2000) (*supra* note 11) at 72

⁵¹ See Prigge, (1998) (*supra* note 19) at 979 for more details

c) Poison pills and other increases in share capital

An increase in share capital to respond to the bid also faces fairly intractable difficulties. First, the notice period required to call a meeting to increase share capital is unviable once a bid becomes live.⁵² Second, under §202-6 of AktG, the board may be authorised for up to five years to increase the share capital of the company provided the consent of the supervisory board is obtained. For this to be effective against a raider, however, requires the removal of his statutory pre-emption rights under §186 AktG. While the virtual absence of hostile takeovers to date makes this a rather theoretical issue, it appears unlikely that the requirements for the withdrawal of pre-emption rights will be satisfied where the aim is to avert a hostile takeover.⁵³

d) Reduction of share capital or "greenmail"

The company may attempt to reduce its share capital by buying back shares on the market in order to head off the takeover threat. Up to 10% of the share capital may be repurchased for transfer to the employees and this may form a partial defence.⁵⁴ Since the KontraG law of 1998, the rules on share buy-backs have been greatly relaxed,⁵⁵ which may mean it becomes a more important defensive strategy.

e) Other strategies

Asset sales and seeking a white knight appear to be viable options under German company law.

ii) Post-bid Obstacles to Gaining Control: Co-determination

Even where a bidder succeeds in gaining a majority of the shares, there are further obstacles to the exercise of control, in the form of "...regular company law [which]...

⁵² Four weeks notice must be given and a range of formalities observed per § 184 AktG: Lutter and Lammers, (1990) (*supra* note 32) at 119

⁵³ Lutter and Lammers, (1990) (*supra* note 32) at 120-122; withdrawal of pre-emption rights must be in the interests of the company, must be necessary and suited to the aim pursued, and compatible with the requirement of reasonableness. These requirements are unlikely to be met where the board does not have full information about the bidder's intentions.

⁵⁴ §71(1) No.2 AktG

⁵⁵ See Jürgens, U and Rupp, J (2001) (*supra* note 8) at 15-16

slows down the rapid influence of a majority shareholder on the fortunes of "his" company."⁵⁶ In combination with the structural factors discussed above, this appears to have been an important factor in discouraging hostile bids.

The co-determined two-tier board,⁵⁷ with its employee representatives, which governs decision-making in large German corporations appears to have been instituted for political reasons.⁵⁸ However, its impact on the German system of corporate governance is fundamental in both political and economic terms. Co-determination fits with Germany's broad political requirement that corporations act in the public interest, and has created institutional complementarities between governance structure and the source of competitive advantage of German corporations.⁵⁹ These issues are dealt with further below.

In contrast to American constituency statutes and s309 of the Companies Act 1985, which apparently permit the board to take stakeholder interests into account, the German system of co-determination is based on the twin mechanisms of employee representation on the supervisory boards of large corporations (*Aufsichtsrat*) and representation through

⁵⁶ Lutter and Lammers, (1990) (*supra* note 32) at 140

⁵⁷ For an account of the historical evolution of co-determination see Hopt, (1998) (*supra* note 9) and Robilotti, MG, "Codetermination, Stakeholder Rights, and Hostile Takeovers: A Reevaluation of the Evidence from Abroad" (1997) 38 *Harvard International Law Journal* 536 and the sources cited therein. In particular, it is notable that the "mandatory supervisory board of 1870 and mandatory disclosure were the prices set by lawmakers for permanently giving up their charter requirement and former state control. Therefore, the German supervisory board is historically the incarnation of the idea of a strictly separate outside board to control the management board for the sake of the shareholders, but also to protect the public interest. Public interest was considered both before and after 1870 to *extend beyond the mere shareholders*." (Hopt, (1998) (*supra* note 9) at 230)

⁵⁸ Dore, R (2000) (*supra* note 7) notes at 182 that "This system has its roots in 1890s laws of catholic corporatist inspiration designed to promote works councils, thereby mitigating class conflict by institutionalizing the positive-sum elements of the capitalist employment relation." Hopt, 1998 (*supra* note 9) at 236-7: "Formal boardroom co-determination beyond mere works council representation was introduced first in 1920 and again in 1952, i.e., both times after the wars when solidarity was badly needed. A further factor may have been the massive loss of private savings by superinflation and two currency reforms. This not only hindered the development of broad capital markets, but it equalized German society more than in other Western countries. Cooperation and consensus were the forces needed to deal with *collective crises*." In addition, many writers note the role of the allies post WWII in encouraging co-determination, see for example, Dore, R (2000) (*supra*) at 183. On the history of co-determination, see also Thelen, K, *Union of Parts* (1991).

⁵⁹ Roe, MJ (2003) (*supra* note 3) also points to an institutional complementarity between the persistence of blockholders and co-determination. Blockholders have the advantage over dispersed shareholders that they can bypass the co-determined supervisory board and monitor management directly.

works councils at plant level. This means that there are often multiple works councils within a single corporation or group.⁶⁰ A more detailed analysis of German co-determination would also take into account the German system of collective bargaining which is concentrated at sectoral level. However, it is on board level representation that this analysis will focus, because it is there that employees potentially have the opportunity to exercise voice and/or influence the outcome of takeover bids.

The division of power within the two-tier board is strict.⁶¹ The "incompatibility"⁶² rule states that the management board (*Vorstand*) runs the firm in the interests of the entire organisation,⁶³ while the *Aufsichtsrat's* duties include the selection and appointment of the management board, its supervision (at least four supervisory board meetings per year are mandated⁶⁴) and, if necessary, its dismissal.⁶⁵ The shareholders are not allowed to give instructions to the *Aufsichtsrat* and if they exercise undue influence over the management board, they may be liable for damages.⁶⁶

The supervisory board is described as a "relationship board" which is only the legal representation of the "network" which historically supported German industrial development, with the clear implication that even if it did not exist formally it would still find expression through voluntary advisory mechanisms.⁶⁷ This network of co-operation, which we encountered above in the form of long-term shareholdings by banks and other corporations, forms a marked historical, cultural and economic difference from Anglo-American industrial organisation, which was more market-led.

⁶⁰ Works Councils co-determine matters relating to pay, hours, leave etc, and are consulted or informed on other matters.

⁶¹ Aoki, M, *The Cooperative Game Theory of the Firm* (1984) at 157 that "German law establishes two levels of control in the corporation. Its aim is to separate the responsibility of monitoring management from the actual managing of the corporation."

⁶² Hopt, (1998) (*supra* note 9) at 229

⁶³ §76 of the German Stock Corporation Act, *Aktiengesetz* (AktG)

⁶⁴ §110 AktG; introduced by the 1998 German board reform law. Sadowski, D, Junkes, J, and Lindenthal, S, "The German Model of Corporate and Labor Governance" (2000) 22 *Comp. Labor Law & Policy Journal* 33 at 36 note that this number is rarely exceeded.

⁶⁵ Although "the appointment and dismissal of members of the management board is in general prepared by the chairman of the supervisory board." (Hopt, (1998) (*supra* note 9) at 245)

⁶⁶ Beinert, D (2000) (*supra* note 11) at 69 for more details of these mechanisms.

The extent of the employee presence on the supervisory board depends on the size of the company. Where there are more than 500 employees (whatever the legal status of the company), one third of the supervisory board will be employee representatives and the board will make decisions by simple majority.⁶⁸ In companies with more than 2000 employees, on the other hand, "quasi-parity" representation applies, meaning that there are equal numbers of employee and shareholder representatives on the board, subject to a proviso that the chairman (a representative of the shareholders) has a casting vote in the event of a tie.⁶⁹ A resolution to appoint or remove representatives to the management board requires a two-thirds majority in the first ballot, and if this is not achieved, a conciliation committee (consisting of two shareholder and two employee representatives) must be convened before the chairman can exercise his casting vote.⁷⁰ In any event, the casting vote is rarely exercised and "it is common for shareholder and labor representatives to vote with one voice."⁷¹ This is above all a corporate governance mechanism: the "employee representatives should not be regarded as a homogeneous group. The instructive contributions by internal employee representatives...are said to be focused on the company, whereas [external members provided by unions] are thought to have a broader, at least sectoral, perspective and to pursue union interests."⁷²

⁶⁷ Known as *Beirat*: see further on this, Hopt, (1998) (*supra* note 9) at 234-5, who doubts whether the labour representatives on the supervisory board may yet be considered part of this network, despite occasional coalitions with the banking constituency.

⁶⁸ Under §76(1) of the Works Constitution Act 1952 (*Betriebsverfassungsgesetz*). This applies to some 40,000 corporations: see the figures cited in Sadowski, D, Junkes, J, and Lindenthal, S (2000) (*supra* note 64) at 39

⁶⁹ Under the Codetermination Law 1976 (*Mitbestimmungsgesetz*). This applies to some 728 corporations. 41 companies in the coal and steel industries have been subject to absolute parity since the Co-Determination Act of the Coal and Steel Industry of 1951 (*Montan-Mitbestimmungsgesetz*).

⁷⁰ Per Aoki, M (1984) (*supra* note 61) at 158: "Since the shareholder representatives may find it imprudent to force a candidate into office by means of this cumbersome procedure, the procedure in effect is likely to result in a veto power of employee representatives."

⁷¹ Sadowski, D, Junkes, J, and Lindenthal, S (2000) (*supra* note 64) at 38; they explain that in the "exceptional" cases where such consensus has not been possible, the voice of the employees has had a strongly persuasive effect and the proposal in question has been modified. For example, the shareholders' preferred candidate for the post of CEO in BMW declined to take up the post in the face of opposition from employee representatives. In addition, the employee constituency played an important role in modifying the proposed takeover of Thyssen by Krupp. Also Prigge, (1998) (*supra* note 19) at 1010.

⁷² Prigge, (1998) (*supra* note 19) at 1010. Note the recent controversy at Lufthansa about the role of union representatives on the supervisory board, *supra* note 5.

There is some evidence that information flow from the management board to the supervisory board is restricted because of the employee presence.⁷³ Shareholder representatives may hold informal separate meetings to avoid disclosing information to the employee representatives.⁷⁴ Further, separate meetings of the employee and shareholder sides of the board before the main meeting, which tends to be mainly concerned with issues of interest to the labour side,⁷⁵ are increasingly common. Committees are also prevalent.⁷⁶ However, given the flow of information to dominant shareholders through their other links with corporations, and the flow to employees through their involvement in works councils, the supervisory board should have access in practice to plenty of information about the activities of the management board. This information dissemination is backed up by statutory rights to call for information.⁷⁷ The chairman is the best-informed and decisive member, while his deputy, a representative of the employees, "seems to play no accentuated role."⁷⁸ Other commentators note that much depends on the relationship between the chairman and his deputy. However, the little evidence available suggests that "supervisory board co-determination weakens intensity of supervisory board control."⁷⁹ While not generally cast in terms of a principal-agent problem in German corporate governance scholarship, and depending on the role played by the dominant blockholder, management may enjoy a considerable degree of latitude in decision-making.

⁷³ See for example, Roe, MJ (2003) (*supra* note 3), chapter 8.

⁷⁴ Becht, M, Bolton, P, and Rowell, A, "Corporate Governance and Control" (*ECGI Finance Paper No2, October 2002* at 53

⁷⁵ Hopt, (1998) (*supra* note 9) at 247

⁷⁶ Theisen, "Empirical Evidence and Economic Comments on Board Structure in Germany" in Hopt, Kanda et al (1998) (*supra* note 9) 259 at 261-2. These two mechanisms are explained as "the historical and proven way to deal with the temporal and organizational restrictions the plenary sessions of the supervisory board have to cope with."

⁷⁷ In addition to regular reports from management (§90 Abs. 1 Nr 1-3 AktG), any member of the supervisory board is entitled to request a special report on any of the firm's activities (§90 Abs. 3 AktG)

⁷⁸ Prigge, (1998) (*supra* note 19) at 963. Also Hopt, (1998) (*supra* note 9) at 244-5: "It is common knowledge that the information flow both from the management board to the supervisory board and within the supervisory board from its chairman to the normal members is deficient. It is particularly striking that in many corporations the auditor's report is not handed out to the supervisory board members ahead of the session, a practice which purportedly is to prevent the details of the report leaking out via the labor side."

⁷⁹ At least in terms of pursuing shareholder value: see Prigge, (1998) (*supra* note 19) at 1010; Roe, MJ (2003) (*supra* note 3).

German co-determination law has come under pressure recently from European Community rules on freedom of establishment. German law imposes co-determination on all companies which have their "real seat" (or "siège réel") in Germany, applying a factual test to determine where a company has its central administration. This is in contrast to Member States, such as the UK, which apply the more liberal incorporation rule, allowing corporations incorporated anywhere to carry on business there without intervening in their governance structures. In its recent *Centros*,⁸⁰ *Überseering*⁸¹ and *Inspire Art*⁸² judgments, where EC nationals challenged a refusal by one Member State to recognise a company incorporated in another Member State, the ECJ held that Member States should not apply the real seat rule in such a way as to amount to an outright denial of the freedom of establishment.⁸³ In each case, the action taken had been disproportionate to its aims. In *Centros*, registration of a foreign company was denied, while in *Überseering*, legal capacity was denied to the company in question. In *Inspire Art*, a branch of a company incorporated in another Member State had to be described as a "formally foreign company" and comply with Dutch rules imposing minimum capital requirements. The ECJ did accept that Member States are permitted to take action in pursuit of "imperative requirements in the general interest", including the protection of employees, provided they fulfil the criteria for rules restricting fundamental freedoms.⁸⁴ However, on the facts of each case, these requirements were not satisfied.

While the precise scope of the "imperative requirements" exception remains in some doubt, it seems very likely that German co-determination would be found to be a

⁸⁰ *Centros Ltd v Erhvervs- og Selskabsstyrelsen* [1999] ECR I-1459

⁸¹ *Überseering BV v Nordic Construction Company Baumanagement GmbH* [2002] ECR I-9919

⁸² *Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd* (Case C-167/01), judgment delivered by ECJ 30th September 2003

⁸³ The application of this doctrine does, strictly speaking, contradict the logic of a single market, wherein "companies should be able to move freely across borders with a single incorporation." (Lannoo, K (1999) (*supra* note 42) at 280)

⁸⁴ *Centros*, Para 34, requiring the action also to be non-discriminatory, suitable and proportionate in accordance with *Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano* [1995] ECR I-4165, paragraph 37. In *Überseering*, the Court stated at 92 that "It is not inconceivable that overriding requirements relating to the general interest, such as the protection of the interests of creditors, minority shareholders, employees and even the taxation authorities, may, in certain circumstances and subject to certain conditions, justify restrictions on freedom of establishment." Following the decision in *Inspire Art*, arguments based on the protection of creditors now appear unlikely to succeed because of the possibility of

permissible restriction on freedom of establishment. It could be argued that mandatory rules are the only way to establish a governance structure which supports and sustains investment by employees in firm-specific human capital. The absence of Community legislation in the field of co-determination, despite a legislative power in Article 137(3) of the EC Treaty, would support the argument that the Member States retain some discretion in this area.⁸⁵ The Second Winter Report⁸⁶ offers a slightly different interpretation of the potential effect of these decisions on co-determination. It suggests that any restrictions on the freedom should be proportionate and based on an appropriate connecting factor. They envisage that imposition of local law would be hard to justify where fewer than 50% of employees are employed in the "host" state. This might eventually undermine co-determination of German corporations if the stage is ever reached where the majority of their employees are employed outside Germany. The Report suggests that liquidation and reincorporation should be a last resort following failure to agree on an appropriate system of representation.

Ex Post Impact of Co-determination on Takeovers

In the normal situation where the merger in question is consensual, co-determination is unlikely to present great obstacles. Hostile bids may be more problematic. While the bid itself falls outside the scope of co-determination, the successful bidder must gain approval of the supervisory board for their nominees to the management board. A simple majority in general meeting is not necessarily sufficient to do this. While the management board is appointed by the supervisory board, its members normally serve five year terms and cannot be removed except for cause. Further, "staggered appointments are customary".⁸⁷ Where the articles grant individual shareholders a right to designate a member of the supervisory board, only they may remove their representative. Subject to

self-help and the role of the fourth and eleventh company law directives in setting out a system of protection for creditors: see paragraphs 135 *et seq* of the judgment.

⁸⁵ The contrast with protection of creditors is clear: the provision of information to employees under Community law is not sufficient to enable them to use self-help because of the contracting difficulties they face. The role of mandatory co-determination in sustaining firm-specific investments is discussed in detail below.

⁸⁶ See "Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe", Brussels, 4th November 2002 at 102-106

these restrictions, the bidder may remove the supervisory board shareholder representatives with a resolution backed by three-quarters of the votes cast. Then the supervisory board may appoint the management board by simple majority. Finally, where quasi-parity co-determination applies, the employee representatives (who cannot be removed by shareholders) will be able to delay these changes at least until a second resolution can be proposed. The ability and right of employee representatives to make their voice heard may be important in the case of a takeover: as the price for their approval of the subsequent merger, they may make demands as to the future conduct of the business.

"Takeovers fall outside the realm of co-determination and upset the existing set of implicit contracts between stakeholders."⁸⁸ This potentially adverse effect on their interests means that "Employee representatives are likely to support defensive actions taken by management in the event of takeover battles. Co-determination can be particularly decisive if the shareholder side of the Supervisory Board is divided among competing factions."⁸⁹ German corporation law has accordingly been described as "The biggest poison pill of all",⁹⁰ preventing a bidder from realising all the gains available from replacing management with nominees who will breach implicit contracts and concentrate on shareholder value.

Co-determination and Theories of the Company

The wider conception of the company in German law has given rise to familiar critiques. For example, in a variety of the "classic argument", Hopt insists that "Legally, widening the scope of responsibility of the board beyond shareholders not only exacerbates the

⁸⁷ Beinert, D (2000) (*supra* note 11) at 68

⁸⁸ Höpner, M and Jackson, G (2001) (*supra* note 18) at 48

⁸⁹ Höpner, M and Jackson, G (2001) (*supra* note 18) at 18-19

⁹⁰ Maier-Reimer, "Protection Against Hostile Takeovers in Germany: Banks and Limitations on Voting Rights" in Hopt, K and Wymeersch E ed, *European Takeovers: Law and Practice* (1992), 242 at 242. Jürgens, U and Rupp, J (2001) (*supra* note 8) at 33 note that management, who tend to praise co-determination, might have "*ulterior motives* for praising a system which serves as a protection for incumbent management against hostile takeovers".

agency problem for the latter, but it adds the agency problem for labor and gives an excuse for respecting neither of these responsibilities."⁹¹

The legal imposition of co-determination has been criticised by economists who take a contractual approach to corporate governance. Jensen and Meckling argue that if it were *pareto* efficient, it would have been adopted by firms voluntarily rather than being imposed upon them by legislation.⁹² This of course is a difficult claim to refute given that there is no counterfactual data on the voluntary adoption of codetermination arrangements in Germany. To compare Anglo-Saxon data risks not comparing like with like since the underlying organisations are different. However, in opposing this claim, Sadowski *et al* argue that firms considering voluntarily introducing codetermination face a prisoner's dilemma. Co-determination could be justified on the basis of a productive coalition model of corporate governance, but such a strategy faces the risk of adverse selection, namely the "danger that codetermination rights would attract precisely the less productive employees"⁹³ because it is harder to dismiss employees under co-determination. These authors to argue that, assuming co-determination is desirable from an efficiency standpoint, only imposing co-determination by law can get around this problem since no firm will be the first to act.

Roe has also considered whether German co-determination may be reconciled with a contractual, and, more specifically, a productive coalition, approach to the corporation. He suggests that "[c]odetermination might be seen as part of German employees' investment in human capital and deferred wages in the firm. Having invested in the firm, the employees get governance rights."⁹⁴ However, he concludes, this argument suffers from two main weaknesses. First, the explanation fails the transaction cost test of company law because the "co-determination contract...[is not] hard to write, thus raising the question of why legal mandates are necessary for codetermination...when the

⁹¹ Hopt, (1998) (*supra* note 9) at 237

⁹² Jensen, M and Meckling WH, "Rights and Production Functions: An Application to Labor-Managed Firms and Codetermination" (1979) 52 *Journal of Business*

⁹³ Sadowski, D, Junkes, J, and Lindenthal, S (2000) (*supra* note 64) at 45

⁹⁴ Roe, MJ, "German "Populism" and the Large Public Corporation" (1994) 14 *International Review of Law and Economics* 187-202 at 201

corporate form could be adapted...without mandating codetermination."⁹⁵ Instead, given an insistence on co-determination by the legislator, there will tend to be a "contractarian reaction...as parties try to remold the framework - to re-contract - to the most efficient forms."⁹⁶ Secondly, the institution of co-determination tends to have political rather than economic aims. These "rules tend to be put into place during or after periods of social unrest, suggesting that rational private contract-making was subsidiary to stabilizing the political system."⁹⁷

In response to his first point, and retaining a contractualist perspective, one might argue that the codetermination contract is just as difficult to write as the shareholders' contract. Indeed, if one accepts that the employees are also residual claimants by virtue of their firm-specific investment, their needs for governance protection are not qualitatively different from those of the shareholders. The point is that drafting a governance structure to protect the investments of either of these groups gives rise to costs, not that it is analytically difficult. Since these costs would be incurred every time a corporate contract is concluded, the adoption of a standard form contract may enable a reduction in transaction costs across the economy as a whole. The provision of these standard form contracts will save costs where they are likely to be used more often than they are rejected.

Further, where the law provides a standard form governance structure, this gives rise to the distinct advantage that the courts in that jurisdiction may then develop a set of rules to determine rights and responsibilities of the actors involved as and when problems arise.⁹⁸ The introduction of a range of individually-tailored governance structures for either shareholders or employees would be likely to give rise to great legal uncertainty, and,

⁹⁵ *ibid*

⁹⁶ *ibid*

⁹⁷ *ibid*; see further note 58 above.

⁹⁸ Easterbrook, F and Fischel, D, *The Economic Structure of Company Law* (1991) at 35 suggest that "court systems have a comparative advantage [over the drafters of contracts] in supplying answers to questions that do not occur in time to be resolved *ex ante*. Common law systems need not answer questions unless they occur. This is an economizing device." Note also the arguments about network externalities made by Klausner, M, "Corporations, Corporate Law and Networks of Contracts" (1995) 81 *Virginia Law Review* 757, discussed in chapter 1.

through repeated and extensive litigation, considerable transaction costs. The only reason to force employees to fall back on self-drafted protection would be on the basis that more firms would bargain around the standard form contract than would accept it, leading to higher costs. The answer to this question depends on both the amount of firm-specific investment in the economy as a whole and the amount which is desired. Varieties of capitalism analysis suggests that firm-specific investment cannot be looked at in isolation from the institutional background, including co-determination.

One might go further and seek to justify mandatory co-determination on the basis that if it were not mandatory, this would tend to undermine the productive coalition. Imposition by law is a mechanism to steer market actors towards consensual, trust-based relations by facilitating the making of credible commitments. The imposition of mandatory co-determination significantly conditions the evolution of a political economy by ruling out certain courses of action. Of course, if one takes the view that economic efficiency can only be achieved by maximising the return to shareholders then co-determination must reduce economic efficiency since it introduces greater agency costs and reduces the likelihood of shareholder value being pursued. However, advocates of the view that contractual remoulding of the mandated governance structure should be permitted must rebut the assertion firm-specific investments by employees contribute to the productive efficiency of enterprises and the economy.

The answer to Roe's second point requires a move outside the contractualist perspective. For the contractualist, the corporation is a matter of purely private ordering established to govern the central incomplete contract, so external, public interference is illegitimate and inefficient. Similarly, the use by one corporate constituency of its political power to persuade the government to use its law-making power to grant it rights in corporate governance, which they could not achieve through bargaining, is illegitimate. However, within the German political economy, the corporation is not conceived of as a matter of

purely private ordering, and, being considered to have elements of a public social organisation, is a legitimate target of political interference.⁹⁹

Looking at co-determination in exclusively political terms, Streeck considers it as a measure attaching to the "status" of industrial citizenship, and, as a non-contractual measure, is not open to being bought or sold because "industrial citizenship constitutes part of the public machinery for the social regulation of labour markets and employment, as an institution of public rather than private governance. Created to balance the fundamental asymmetry of power involved in relations of employment, it would cease to be what it is if it were open to renegotiation in the shadow of this asymmetry."¹⁰⁰

In any event, the fact that a rule might have been introduced for politically-imperative reasons does not necessarily mean that it cannot contribute to economic efficiency. Mandatory co-determination may also be considered from the evolutionary perspective of path dependency, treating it as one of the decisions which was made in the past and which has sent the German political economy down the route which it has taken. The corporate governance system as created by law has interacted with relational investors and a historically strong apprenticeship system for training employees to produce an equilibrium. While the German system has certainly been constrained in the choices available to it by the existence of the codetermination laws, comparative political economists argue that these "beneficial constraints" support "flexible and high-skill

⁹⁹ Streeck, W, "The Transformation of Corporate Organization in Europe: An Overview" (2001) *MPIfG Working Paper 01/8, December 2001* notes that in continental systems generally, corporations are treated "as "constitutional associations" whose internal structures of decision-making are a matter of public concern... As a consequence, governments assume a right to intervene in the internal structures and governance arrangements of corporations, in order to institutionalize the public obligations of firms within their internal bargaining or decision-making arrangements." Similarly, Hutton, W, *The World We're In* (2002) at 67 says that "Property is not a right or a simple network of private contracts; rather it is a concession made by the society of which it is part that has to be continually earned and deserved." Also Teubner, G, "Enterprise Corporatism: New Industrial Policy and the "Essence" of the Legal Person" (1988) 36 *American Journal of Comparative Law* 130 at 131: "internal pluralism is legitimate only insofar as it is oriented towards the corporate actor's goals, which in turn must be legitimized by the firm's function and performance in society."

¹⁰⁰ Streeck, W, "Industrial Citizenship under Regime Competition: the Case of the European Works Councils" (1997) 4 *Journal of European Public Policy* 643 at 644

internal labour markets",¹⁰¹ leading to the development of comparative advantage based on diversified quality production¹⁰² with incremental innovation in manufactured goods.

In any event, it appears beyond dispute that the rationale for co-determination rules was political rather than economic. There is no evidence that historically co-determination was introduced specifically in order to facilitate investment by employees in firm-specific capital.¹⁰³ However, in combination with other environmental factors (such as the institutional structure of the broader political economy¹⁰⁴ and social norms of corporate behaviour which differ from maximising shareholder value), the "German system [of co-determination] also reduces the risk that employees' human capital will be expropriated by the company by increasing the information flow to workers through their representatives on the supervisory board."¹⁰⁵ This is one of the modern arguments in favour of maintaining co-determination. As Sadowski et al point out, "The German co-determination regulations do not differentiate according to this criterion (one difficult to operationalize), but require all companies to bear the costs involved in co-determination."¹⁰⁶ Differentiation on the basis of firm-specific investment would be practically impossible since one would have to measure not only the extent to which employees have made investments, but also estimate the extent to which they would do so, and to which this would benefit the firm in question, if rules were put in place. Different industries, and even different firms within the same industry would have different needs depending on their strategy for competitiveness. Perhaps the most one can say is that in economies where firm-specific investment is important (or desired as a

¹⁰¹ Höpner, M and Jackson, G (2001) (*supra* note 18) at 12

¹⁰² Streeck, "Productive Constraints: on the Institutional Conditions of Diversified Quality Production" in Streeck, W (ed), *Social Institutions and Economic Performance* (1992),

¹⁰³ As Streeck, W (2001) (*supra* note 99) explains, the Kommission Mitbestimmung 1998 "did not undertake to establish a direct causal connection between co-determination and the prosperity of the German economy. It pointed out, however, that strong rights of workforces to information, consultation and co-decision making had obviously not interfered with international competitiveness. It also suggested that co-determination might have contributed to the evolution of a specific mode of production in Germany that emphasizes the cultivation of human resources and of dedicated, long-term employed workforces."

¹⁰⁴ See Hall, PA and Soskice, D, *Introduction to Varieties of Capitalism* (2001), Casper, "The Legal Framework for Corporate Governance: The Influence of Contract Law on Company Strategies in Germany and the United States" in Hall, PA and Soskice, D (eds), *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (2001), 387

¹⁰⁵ Robiloti, MG (1997) (*supra* note 57) at 552

¹⁰⁶ Sadowski, D, Junkes, J, and Lindenthal, S (2000) (*supra* note 64) at 43

source of competitive advantage), the co-determination rule can help to get around the prisoner's dilemma of the first mover, to reduce the transaction costs of negotiating and establishing the system, and to provide a free flow of information which will facilitate the making of credible commitments.

These institutional measures push firms towards a strategy of firm- or industry-specific skills:

"Put in a nutshell, co-determination, and in particular, parity co-determination, has contributed to making labor as a factor of production less variable and more fixed than it traditionally was in capitalist enterprises...For many practical purposes labor in co-determined enterprises is almost as difficult and costly to dispose of as fixed capital. In this sense the status of capital and labor as factors of production has been made more similar by co-determination, and this may be exactly what 'parity' in economic terms is all about."¹⁰⁷

Legal Position after 2nd January 2002

i) Voluntary Self-Regulation: The Takeover Code

Before the enactment of the new takeover law, the rare takeovers which occurred were regulated voluntarily. The voluntary self-regulatory takeover code (*Übernahmekodex*) was introduced in October 1995, and amended in 1998. It regulated the contents of an offer and the duties of the bidder and the target. It permitted partial bids, but required a mandatory bid within 18 months of the acquisition of 50% of voting rights. The ultimate decision on the outcome of the bid was a matter for shareholders, who were given 28 days to decide. This was reinforced by a requirement that "the target company must refrain from any measures that may impede the takeover offer"¹⁰⁸ unless permission was

¹⁰⁷ Streeck, "Co-determination: After Four Decades" in Streeck, W (ed), *Social Institutions and Economic Performance* (1992), at 159

¹⁰⁸ Baumann, "Takeovers in Germany and EU Regulation: Experience and Practice" in Hopt, Kanda et al (1998) (supra note 9) 659 at 662

given by means of a "shareholders' meeting decision."¹⁰⁹ Otherwise, the role of management was limited to advising the shareholders on the merits of the bid.

The only sanction available to the takeover commission (*Übernahmekommission*) was to publicise breach. Many commentators found the impact of the code "disappointing".¹¹⁰ Widely accepted by listed companies in 1997,¹¹¹ the code was strengthened in 1998 when recognition became a precondition for listing on DAX and MDAX, withdrawal leading to exclusion.¹¹² Like the City Code, this code had the aim of securing "the reputation of Germany as a centre of finance, and to set up a reliable framework for takeover offers so that investors from in- and outside Germany would know how public offers are to be conducted."¹¹³

ii) The New German Takeover Law

The new law may be considered as a reaction to the failure of the second draft Takeover Directive in 2001, or as a reaction to the hostile takeover of Mannesmann by Vodafone. In either case, it can be seen as a clear statement of Germany's current political position that hostile takeovers need to be regulated. While the Mannesmann takeover may have been exceptional in the sense that the company was particularly vulnerable, the draft of the directive which was rejected, as we shall see in the next chapter, was largely based on the UK's City Code and was aimed at the introduction of a market for corporate control. While in the UK, this gave rise to rather narrow concerns about whether the proposed directive would allow the continuation of the self-regulatory system, more far-reaching concerns about its effects on the structure and operation of the productive economy were raised in Germany.

¹⁰⁹ *ibid*

¹¹⁰ Prigge, (1998) (*supra* note 19) at 993

¹¹¹ Baumann, (1998) (*supra* note 108) at 662. He also points out the practice of banks requiring their clients to observe the code when they provide takeover finance.

¹¹² As it did for Metallgesellschaft: see Prigge, (1998) (*supra* note 19) at 994; despite this, Höpner, M and Jackson, G (2001) (*supra* note 18) at 22 describe compliance with the Code as "very weak"

¹¹³ Baumann, (1998) (*supra* note 108) at 660

The draft Purchase of Shares and Takeover Law (*Wertpapiererwerbs- und Übernahmegesetz* or WpÜG) was first presented on 29th June 2000.¹¹⁴ This interrupted the second revision of the voluntary code which had begun in 2000.¹¹⁵ The Act was finally passed on 15th November, 2001, and came into force on 1st January, 2002. Article 3 of the Act contains 5 general principles, including that the "management board and supervisory board of the target company must act in the target company's interests."

The version which was finally enacted, and was not published by the German government until after the fate of the takeover directive was known, grants the management board of the target considerable discretion when faced with a bid, provided they can gain the approval of the supervisory board. This is in stark contrast to earlier versions, which had at first outlawed all defensive measures in line with the proposed second draft takeover directive.¹¹⁶ Following reservations from politicians, trade associations and trade unions, this position was then softened to allow an exception for defensive measures authorised in advance by the shareholders (by a 75% majority of votes cast) which would last up to 18 months (effectively requiring annual approval).¹¹⁷

The Act which eventually entered into force allows the managing board even more scope. They may also take frustrating measures which "a prudent and conscientious manager of a company that is not subject to a takeover bid would have taken",¹¹⁸ they may seek a white knight, and they may take measures which have been approved by the supervisory board.¹¹⁹ As in earlier drafts, measures authorised by the shareholders up to 18 months in

¹¹⁴ Payne, "Introduction" in Payne, J (ed), *Takeovers in English and German Law* (2002), 1 at 1. She points out that this was "partly in response" to the success of the Vodafone bid, which had made it clear that "the existing non-binding Takeover Code, which operated by way of voluntary self-regulation, had not created an appropriate legal framework within which takeovers could take place in Germany and should be replaced."

¹¹⁵ The voluntary code has now lapsed: see Krause, N, "Germany: The New German Takeover Law" (2002) 23 *Company Lawyer* 319 at 319

¹¹⁶ With the exceptions of seeking a "white knight" and actions taken in the ordinary course of business for the benefit of the company: see Mennicke, P, "The Draft German Takeover Act" (2001) 22 *Company Lawyer* 34 at 38

¹¹⁷ Mueller, "A New Takeover Regime for Germany: German Act on Acquisitions and Takeovers" in Payne, J (ed), *Takeovers in English and German Law* (2002), 173 at 173-4

¹¹⁸ Including in the company's interest under Article 76 of the AktG.

¹¹⁹ Section 33(1); the approval of the shareholders is only required if the defensive measure falls within the scope of authority of the shareholders' meeting. As stated above, the supervisory board may presumably authorise only those defensive measures which are permissible under German company law, discussed above. Krause, N (2002) (*supra* note 115) at 323 suggests, for example, that the board could seek to defend

advance are also permitted, but must be specified in detail and approved by at least a 75% majority¹²⁰ and then specifically authorised by the supervisory board.

It is notable that there are no limitations on the power of the supervisory board or Delaware-style provisions for review of the proportionality of any defensive measures taken by the board, or of any decision to break up the company in order to keep it out of the bidder's hands. Gordon argues that boards are likely to take the kind of irreversible value-destroying defensive measures which were superseded in the US by the poison pill, such as "crown jewels" sales to friendly buyers and tin parachutes for employees.¹²¹ Unlike the redeemable poison pill, these tactics are irreversible. These critics argue that the position of shareholders is further weakened by the limited cultural and managerial norms of shareholder value in Germany, as well as the dilution of their influence by the stakeholder concerns of the supervisory board.

Theories of the Company and the New German Law

From an agency perspective, the German law, like the regulation put in place by many US states, must be seen as a political choice measure. The provisions allowing defensive measures are likely to allow the board to entrench themselves where they get approval from one shareholder representative along with the representatives of the employees.¹²² The introduction of a market for corporate control, already complicated by the structural factors described above, has become more difficult because the management and

itself by placing newly authorised capital with shareholders who will not sell to the bidder, subject to the difficulty of finding a suitable shareholder.

¹²⁰ Advance shareholder authorizations under section 33(2) of the takeover law are considered unlikely because "before having had the opportunity of seeing the actual offer, the shareholders cannot really evaluate whether it is worthwhile or not...Indeed, such a shareholder resolution could signal that the enterprise considers itself a candidate for takeover, which may have unwelcome consequences at the stock market."¹²⁰ (Hopt, KJ (2002) (*supra* note 12) at 22)

¹²¹ Gordon, JN, "An American Perspective on the New German Anti-takeover Law" (2003) *European Corporate Governance Institute Working Paper No.02/2002*

¹²² Painter, R and Kirchner, C, "Takeover Defenses under Delaware Law, the Proposed Thirteenth EU Directive and the New German Takeover Law: Comparison and Recommendations for Reform" (2002) 50 *American Journal of Comparative Law* 201 at 218. This is not unlikely while block shareholders concerned with more than shareholder value continue to play an important role in German corporate governance. For example, one of the shareholder representatives to the supervisory board could have been appointed by a bank which has very different priorities from the rest of the shareholders.

supervisory boards have been granted unreviewable discretion to prevent its operation. Despite changes in the law, the use of adaptive mechanisms to align shareholder and management interests is likely to "run afoul of strong cultural constraints on managerial compensation."¹²³ Hopt describes the measure as "worse than a pyrrhic victory"¹²⁴ and echoes Roe's political explanation of US takeover regulation: "Hostile takeovers are still highly unpopular with many in Germany, particularly with trade unions and labor but also among large parts of German industry and the German press. As everywhere, politicians who live but for reelection reckon with such fears. Therefore, the German takeover act was prepared with great care."¹²⁵ Höpner and Jackson argue that "it is not surprising the takeover of Mannesmann has raised demands for a more target-friendly law that would protect domestic firms."¹²⁶ It is notable that the unions supported the proposal that the supervisory board be allowed to determine the defensive measures permitted to management, while industry associations also wanted broader powers for management.¹²⁷

Besides the "classic argument" about managerial unaccountability, it is also argued that the German law is likely to hinder the cross-border mergers which are essential for enterprises to "rapidly grow large enough to take advantage of the huge potential scale economies of EU-wide commerce."¹²⁸ The risk of "home country bias" and "economic nationalism" by the acquiror is best dealt with by rules which ensure "the mutual vulnerability to takeover bids by both firms in question."¹²⁹ This requires the establishment of a market for corporate control, which will ensure that the threat of

¹²³ Gordon, JN (2003) (*supra* note 121) at 8. However, that social norm may be at a "tipping point", supported by legal changes allowing companies to buy back their shares: see Eisenberg, MA, "Corporate Law and Social Norms" (1999) 99 *Columbia Law Journal* 1253 at 1263-4.

¹²⁴ Hopt, KJ (2002) (*supra* note 12) at 4

¹²⁵ Hopt, KJ (2002) (*supra* note 12) at 4; elsewhere, Hopt refers to "post-bid defensive measures of the board...perhaps with permission of the supervisory board; a popular demand in business circles." (Hopt, "The Duties of the Directors of the Target Company in Hostile Takeovers - German and European Perspectives" in Ferrarini, G, Hopt, KJ, and Wymeersch, E (eds), *Capital Markets in the Age of the Euro: Cross-Border Transactions, Listed Companies and Regulation* (2002), 391 at 407)

¹²⁶ Höpner, M and Jackson, G (2001) (*supra* note 18) at 36

¹²⁷ *ibid* at 44 fn 23

¹²⁸ Gordon, JN, "An American Perspective on the New German Anti-Takeover Law" (2002) *Columbia Law School Center for Law and Economic Studies Working Paper No 209* (available at http://ssrn.com/abstract_id=336420 at 4; this does appear to ignore the existing German mechanisms of industrial consolidation which occur by the transfer of a controlling block, discussed above.

hostile takeover hangs over all firms. Rather than seeing the German measure as simple protectionism, Gordon suggests that the new German rules may simply be "a bargaining chip in a kind of trade negotiation, a raising of barriers designed to precipitate a crisis and force a new round of negotiations that would lower trade barriers - here, takeover protections - across the board."¹³⁰ Alternatively, it might be suggested that the new German law is a response to developments in EU takeover regulation, and in particular, constitutes a clarification of the permissible scope of defensive measures in German law.

If one moves beyond the agency model to take a political stakeholder or productive coalition perspective, a different explanation begins to emerge. Looking at co-determination rules as a political measure of industrial citizenship, as Streeck suggests, means that an outright prohibition on defensive measures would result in a disenfranchisement of the supervisory board in the takeover context. If co-determination rules at board level are indeed supposed to "interfere with the rights of owners in the firm"¹³¹, then there is no apparent political reason why these joint rights of supervision over management should be abrogated just because a takeover bid is made. Indeed the opposite is true: if the employees' representatives rights did cease, then this would undermine the value of the co-determination rights from the beginning, as any conflict at the level of the supervisory board could be met by threats of hostile takeover. We saw in the previous chapter that the establishment of a market for corporate control re-orientated US and UK corporate governance around shareholder value. Liberalisation of takeover rules would also contradict the model of the firm which underlies the structure of German company law, namely that it should be run in the public interest rather than in the private interest of the shareholders.

¹²⁹ Ibid at 4

¹³⁰ Gordon, JN, "An International Relations Perspective on the Convergence of Corporate Governance: German Shareholder Capitalism and the European Union, 1990-2000" (2003) *European Corporate Governance Institute (ECGI), Law Working Paper No. 06/2003, 7 February 2003 available at SSRN <http://papers.ssrn.com/abstract=374620>* at 6. This certainly appears to be reflected in the Germany's opposition to the new draft takeover directive, based on the fact that it prohibits German defensive measures at board level, while tolerating French and Swedish defensive measures in the form of multiple voting rights. See further, Financial Times, 3rd February, 2003 at 10.

¹³¹ Streeck, W, "Industrial Citizenship under Regime Competition: the Case of the European Works Councils" (1997) 4 *Journal of European Public Policy* 643 at 644

The new German rules may also be justified from a productive coalition perspective. They simply reflect the investor coalition represented on the supervisory board. If the system of co-determination is considered as one of the interdependent institutions of the German political economy which operate to encourage the making of investments in firm-specific skills by employees, then the new German rules simply further that conception of the institution's role. The supervisory board will not oppose takeovers which respect the networks of implicit contracts which constitute the corporation. The rights granted to the supervisory board are potentially very important in this respect as they should encourage bidders to take these considerations into account in framing their bid. By contrast, the introduction of a requirement of board neutrality would conflict with the overall co-operative schema of German corporate decision-making, by reserving for one constituency the exclusive right to make a decision on a key corporate transition which might adversely affect other constituencies.

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Chapter Six: Takeover Regulation in the European Union

Introduction

This chapter traces the evolution of the proposed European takeover directive, and analyses it from the perspective of the theories developed in the first part. The various drafts of the Takeover Directive, which were seen during its long gestation period, were largely based on an agency model of the corporation. However, the compromise text which was recently adopted gives Member States more latitude to allow companies to take defensive measures. The chapter also considers the extent to which, as advocates of an agency model takeover directive argued, labour law measures requiring information and consultation of the workforce offer sufficient protection for the interests of employees during a takeover. It is concluded that the Commission's insistence on a system of takeover regulation based on agency model assumptions was a key factor in preventing the adoption of the directive for so long. It is also suggested that the compromise which was reached is more appropriate if one takes a "varieties of capitalism" perspective on the diverse systems of corporate governance within the European Union.

The Changing Rationale for European Company Law

The rationale for European Company Law measures has evolved considerably over time. During the 1960s, the goal appeared to be full harmonisation of "all provisions concerning structure and organs of companies"¹ on the basis that the different rules in force in the Member States distorted the free movement of capital and the exercise of the right of establishment,² and so were an obstacle to the single market. The proposals have

¹ Wouters, J, "European Company Law: *Quo Vadis?*" (2000) 37 *Common Market Law Review* 257-307 at 268, citing the Berkhouwer report of 1966 (document 10/1964-1965); see also Ebke, WF, "Company Law and the European Union: Centralized versus Decentralized Lawmaking" (1997) 31 *International Lawyer* 961 at 973-4

² Wouters, *ibid*, considers this the most appropriate among early justifications for Community action in the field of company law.

also been justified on the basis that harmonisation would prevent a Delaware-style 'race to the bottom'³ and would guarantee legal certainty.

During the mid- to late-1970s the Commission's harmonisation proposals began to reflect widespread demands for industrial democracy.⁴ The Commission's Green Paper of 1975⁵ clearly reflects this new policy orientation, and a "political stakeholder" content may be seen in many proposals of this era, in particular the Fifth Company Law Directive in 1972,⁶ and the Vredeling Directive in 1980.⁷ If enacted as initially drafted, the Fifth Directive would have radically altered corporate structures across the EC. The proposal required all public companies to have a two-tier board, with employee representation on the supervisory board. As we saw in the previous chapter, these rules would have further hindered the market for corporate control by limiting the extent to which a successful bidder is able to take control over the company's governance mechanisms.

The failure of both of these important proposals⁸ gave impetus to a gradual shift in Commission policy away from full harmonisation. It became clear that the Member States could not agree on company law proposals dealing with employee participation or on full harmonisation of company law because no agreement could be reached as to the correct scope of company law. Member States whose company law focused solely on the central agency relationship would not accept the inclusion of employees within its scope,

³ Wouters, J (2000) (*supra* note 1) notes at 269 that harmonisation under Article 54(3)(g) was included in the treaty as a "quid pro quo for the liberal grant of a right of establishment to companies...[so that] the Netherlands, which was famous at the time for the flexibility of its company law, should not become a European 'Delaware.'" However, it is not clear that a Delaware-effect was ever likely: regulatory competition among systems of company law does not (yet) exist in the EC because the Member States apply different tests to determine whether or not a company is established in a particular member state. See the discussion on challenges to German co-determination in Chapter 5.

⁴ Streeck, W, "Industrial Citizenship under Regime Competition: the Case of the European Works Councils" (1997) 4 *Journal of European Public Policy* 643 at 646 notes that the "leading objective was harmonization of industrial citizenship arrangements by means of statutory intervention superseding or homogenizing national systems and proceeding primarily in the realm of company law."

⁵ Commission Green Paper, "Employee Participation and Company Structure in the European Community", Bull Supp 8/75.

⁶ COM (1972) 887 final, OJ C 131, 13.12.1972. See also Bull Supp 10/72.

⁷ "Proposal for a Council Directive on Procedures for Informing and Consulting the Employees of Undertakings with Complex Structures, in Particular Transnational Undertakings", OJ C 297, 15.11.80; see also *European Industrial Relations Review* No 82 (November 1980) at 22

⁸ No vote was ever taken on the Vredeling Directive, and the Fifth Directive was recently definitively withdrawn: see COM (2001) 763 final at 23

while those which included employees (to whatever extent) in corporate decision-making could not accept harmonisation on an agency model.

The Commission's response to this impasse in the company law programme⁹ was to begin framing employee participation proposals as labour law directives containing "menus of alternative solutions for actors to choose from."¹⁰ While the Member States were far from unanimous about the need for harmonisation of labour law protections,¹¹ the move to labour law did at least have the advantage of unblocking the company law programme. The Commission's new approach to company law from the 1980s onwards can best be characterised as a "pragmatic" one, with "hardly any trace of an over-arching vision in the harmonization process."¹² A good example of this new approach is the amended proposal for a Fifth Directive which retreated from harmonising employee involvement at board level in favour of allowing Member States a series of options of purportedly equivalent effect.¹³

In terms of models of the company, Streeck refers to the "relegation" during this period of industrial citizenship measures from company law to labour law, and from regulatory intervention to "voluntarism, first of national governments, and later of multinational firms."¹⁴ The Commission is now encouraging national corporations to take voluntary measures of corporate social responsibility.¹⁵ This reflects the changing centre of gravity

⁹ Streeck and Vitols, "Europe: Between Mandatory Consultation and Voluntary Information" in Rogers and Streeck (eds), *Works Councils: Consultation, Representation, and Co-Operation in Industrial Relations* (1995), at 249-50

¹⁰ Streeck, W (1997) (*supra* note 4) at 646

¹¹ For more details, see, for example, Barnard, "EC "Social" Policy" in Craig, P and De Burca, G (eds), *The Evolution of EU Law* (1999), 479 or Simitis and Lyon-Caen, "Community Labour Law: A Critical Introduction to its History" in Davies, P, Lyon-Caen, G, Sciarra, S, and Simitis, S (eds), *European Community Labour Law: Principles and Perspectives: Liber Amicorum Lord Wedderburn* (1996),

¹² Wouters, J (2000) (*supra* note 1) at 271-2

¹³ Following the European Parliament's opinion of 1982 (OJ C 149 (1982), p.17), a revised proposal was put forward in 1983 (COM (1983) 185 final, OJ C 240, 9.9.1983, Bull Supp 6/83) which allowed Member States to offer companies a choice between the one- and two-tier board. It also made the employee board participation measures optional where a majority of employees were opposed and provided four distinct participation models. Two were based on the German and Dutch methods of participation, the third allowed employee representation in a separate body (presaging the Works Council Directive), and the fourth allowed for participation to be provided for by collective agreement where this provided equivalent rights.

¹⁴ Streeck, W (1997) (*supra* note 4) at 647

¹⁵ The Commission's CSR initiative is discussed below.

of the political stakeholding debate, from industrial democracy during the 1970s to voluntary measures of CSR in the 1990s. By contrast, the agency model has been "promoted", no longer relying on adaptive contractual measures, to form the basis of legislative harmonisation proposals, in the form of capital market measures, and in particular, the takeover directive.

The Evolution of the European Takeover Directive

While the first draft appeared as long ago as November 1973, the Thirteenth Company Law Directive still has not been enacted. Professor Robert Pennington of Birmingham University produced a draft directive at the request of the Commission which was discussed for a couple of years before being rejected as premature.¹⁶ Broad differences in their corporate governance systems not only meant that hostile takeovers were more or less unknown in some Member States (and therefore that "take-over practice had not settled down to a pattern"¹⁷), but also, and perhaps more fundamentally, that there was no agreement on the question of the desirability of encouraging takeovers or otherwise. In this climate, the idea of a European takeover directive went into abeyance for a while. The continued absence of hostile takeovers from the continental corporate governance scene is widely attributed to concentrated share ownership.¹⁸

¹⁶ The Pennington proposal reference is "internal working paper, doc XI/56/74", cited in Clausen, NJ and Sorensen, KE, *Takeover Bids* (1998) at 13; see also Hopt, "European Takeover Regulation: Barriers to and Problems of Harmonizing Takeover Law in the European Community" in Hopt, K and Wymeersch E (eds), *European Takeovers: Law and Practice* (1992), 165 at 166. The Commission did issue a Recommendation to the Member States that they should introduce rules governing mandatory bids: see Commission Recommendation 77/534 OJ L 212, 37 *et seq*

¹⁷ Johnston, A, *The City Take-Over Code* (1980) at 183: even in the unlikely event of agreement, the version adopted may have been obsolescent.

¹⁸ With the striking exception of the UK, most Member States of the EU have concentrated share ownership. The German position was discussed in the last chapter. For further details of the concentration of continental shareholding structures see Becht, M and Rowell, A, "Blockholdings in Europe: An International Comparison" (1999) 43 *European Economic Review* 1049 at 1051: "In several countries, the median largest voting stake in listed companies is over 50%, suggesting that voting control by a large blockholder is the rule rather than the exception". The highly dispersed UK is the real outlier of the group. See also Becht, M, Bolton, P, and Rowell, A, "Corporate Governance and Control" (*ECGI Finance Paper No2, October 2002*). These structural conditions make hostile bids impossible, since the controlling shareholder by definition sides with incumbent management; any takeover takes the form of a negotiated acquisition.

The influence of the Pennington proposal may still be felt: all subsequent proposals have, to a greater or lesser extent, drawn their inspiration from the UK City Code. However, this thesis suggests that basing a pan-European legislative proposal on a purely agency approach to the company undermined its chances of adoption.

The First Commission Proposal

The first official reference by the Commission to the takeover directive is found in the White Paper programme for completing the internal market¹⁹ and the first proposal was published by the Commission on 19th January 1989.²⁰

i) Restriction of Defensive Measures

Article 8 of the draft prohibits the board, once the bid has been made public, from issuing "securities carrying voting rights or which may be converted into such securities" without the authorisation of the general meeting.²¹ This provision rules out the board issuing shares to a friendly party or creating a poison pill, actions often aimed at entrenchment, unless authorised by the general meeting.²² Article 8 further prohibits the board from engaging in other "transactions which do not have the character of current operations concluded under normal conditions", unless either authorised by the general meeting, or "the competent supervisory authority has authorized them, giving its reasons for such authorization."²³ Two interpretations of this clause are possible. The first is that the board retains full rights of management in the face of the bid. The role of the supervisory authority is simply to protect the shareholders by reviewing any action taken by

¹⁹ According to Bull Supp 3/89 at 1. The White Paper is COM (85)310, June 1985 at 34

²⁰ O.J. 14.3.1989, C64/8. An explanatory memorandum was published as Bull Supp 3/89

²¹ It appears from the amended first directive that, as originally drafted, this provision would have allowed the shareholders to provide consent in advance of the bid.

²² Note the Commission's statement that "company law in several Member States also allows companies to adopt a range of defensive measures to ensure that control of the company remains in the hands of friendly shareholders. These defensive measures are very widely used in some Member States. As a consequence, the conditions in which a takeover bid is carried out vary considerably between Member States." (Bull. Supp 3/89 para 13). This point was, somewhat bizarrely, raised in the context of whether a reciprocity clause should be imposed on bidders from third countries.

²³ The supervisory authority is dealt with in Article 6. The Member States are obliged to designate the body which will exercise supervisory functions within their jurisdiction.

management which does not fall into the category of "current operations"²⁴ to ensure that these actions are not taken for defensive or entrenchment purposes. The second interpretation is that this was an exception from the rule requiring general meeting authorisation of all defensive measures. The supervisory authority in each Member State would be given discretion to authorise specific defensive measures not involving the issue of securities, such as "greenmail" or a sale of key assets. The requirement of reasons presumably means that authorisation would have to be given on case-by-case basis. Whatever the correct interpretation, had this provision become law, its lack of specificity means that divergences in the approach of different national supervisory authorities could have been expected. This would have undermined the Commission's aim of equivalent protection across the EEC (discussed below). Unfortunately, no explanation for this clause is included in the draft or the explanatory memorandum, although the Commission does state that the board "must at all times act in the interests of the company."²⁵

These interpretations indicate a slight movement away from the agency model and absolute shareholder choice, towards allowing the board to take into account the interests of other stakeholders, perhaps with a view to calming the controversy over defensive measures. An outright prohibition would have had a strong effect on the systems of company law of those Member States, such as Germany, which adopt a more institutional view of the company with a pluralistic board mediating among the competing claims of the various constituencies.²⁶ Making space for the national authority to review measures taken by the board would allow a distinction to be made between action taken by the board to entrench themselves at the expense of the shareholders, and action taken with the aim of protecting the longer-term interests of "the company" (such as taking into account the interests of employees). However, this distinction between defensive measures involving the issue of shares and those involving other actions was not maintained in the second and third draft directives.

²⁴ In the Explanatory Memorandum at 9, the Commission explains that this refers to "operations of an exceptional nature which might cause a substantial loss of the company's assets." This would include sales of key assets or assumption of large amounts of debt.

²⁵ Bull Supp 3/89 at 9

²⁶ The effect of the City Code on the UK's managerialist system of company law was discussed in Chapter 4.

In the absence of shareholder or supervisory authority permission to take defensive measures, the board could only make their opposition to the bid known through their obligatory report under Art 14(1), hoping that the shareholders would accept their plan for the company.

ii) Protection of Employee Interests

More direct reference to the protection of employee interests is found in Articles 10(1)(I) and 19. Article 10(1)(I) requires the offeror to include in his offer document a statement of his

"intentions..., explicitly expressed, regarding the continuation of the business of the offeree company, including the use of its assets, the composition of its board and its employees."

The inclusion of this requirement was explained by the Commission on the basis that:

"In the interests of all parties to the bid and taking into account the social policy of the Commission, it seems indispensable to make clear in the offer document the intentions of the offeror concerning the future of the offeree company, especially as regards its activities, including the use of its assets but also as regards its management and staff."²⁷

Article 19 states that:

"The board of the offeree company shall communicate to its worker's representatives, as designated by national legislation or customary practice in Member States, the offer document and [other reports relating to the bidder's financial position]...as well as its own reports as referred to in Article 14 [stating whether the board is in agreement with

²⁷ Bull Supp 3/89 page 10

the offeror on the bid] and, if appropriate, the expert's report as referred to in Article 14(2)."

The combined effect of these provisions is to inform the employees about the offeror's intentions, at least in so far as they are disclosed by the offeror. It is notable that there is no provision for consultation of the employee representatives. While information may be considered a weak form of participation within a political stakeholder model, it must be timely in order to be treated in this way. Given that a hostile offer will normally have been published by the time the employees hear about it, these provisions should be considered as labour law measures aimed at giving advance warning to the employees of the likely approach of new management. Any protection of their interests will be achieved through adversarial labour law measures rather than more unitary company law mechanisms. The Commission's explanation of Article 19 makes it clear that these provisions aim to mitigate the social consequences of the takeover by facilitating a collective adversarial reaction rather than by allowing employees to become involved in the corporate decision-making process:

"One of the fundamental objectives of this Directive is to inform those chiefly concerned by *the operation of its consequences*. Among the persons mainly concerned are the employees of the target company, for whom the operation may have serious repercussions."²⁸

iii) Rationale for the First Draft Directive

The Explanatory Memorandum stated that the aim of introducing this coordination measure was "to afford shareholders and other interested parties equivalent standards of protection before the law in all Member States."²⁹ The Commission argued that the

²⁸ Bull Supp 3/89 at 13, emphasis added

²⁹ Bull. Supp 3/89 para 2; the identity of the "other interested parties" is not clear: the Commission's explanatory memorandum pays a great deal of attention to the position of shareholders, and does not, for example, consider the position of creditors or employees, the two most likely "other parties". While on its face, Art 44 (ex-54) of the EC Treaty allows measures aimed at protecting employees (referring to "the protection of the interests of members and others") as well as shareholders, measures aimed at protecting

growing use of the takeover mechanism for corporate reconstructions in Europe, and the highly uneven development of takeover regulation across the various Member States, made regulation of takeovers (or "share mergers" as the Commission described them) imperative, particularly in view of the progress of legislation in other merger-related fields.

The directives' main goals were to ensure shareholder equality,³⁰ and to put the shareholders in a position to make an informed decision on the outcome of any bid. These goals were to be achieved through the provision of "full and substantiated information"³¹ including a detailed, reasoned opinion from the board; the imposition of mandatory bid rules to protect minority shareholders by allowing them to exit on the same terms as those shareholders who tendered or sold on the market;³² and, most importantly for our purposes, the imposition of severe restrictions on the use of defensive measures by the board.³³

The equal treatment of shareholders may be understood as being aimed at ensuring the free movement of capital in an undistorted market. Equal treatment may be considered in a broad sense to require that shareholders of all public corporations in all Member States should be "afford[ed] equivalent standards of protection before the law in all Member States."³⁴ This would solve the problem of information costs discouraging investors from investing in other Member States, but requires fairly detailed harmonisation of national takeover rules. Rules relating to provision of information and mandatory bids can clearly be seen in terms of providing equivalent protection for shareholders and preventing

employees have in fact not been made under the company law provisions of Art 44, but rather under the labour law provisions of Art 137 (ex-118).

³⁰ Art 3 provides that "shareholders who are in the same position shall be treated equally".

³¹ Para 12 of the Explanatory Memorandum. It was anticipated that these provisions would particularly benefit small shareholders, who have access to very little information about the company, in other Member States given that the "company making the bid is usually better informed about the situation of the target company and the value of its shares than the company's shareholders, because it has taken the initiative."

³² Article 4 obliged a bidder "aiming to acquire a number or percentage of securities which, added to any existing holdings, gives him a percentage of the voting rights in a company which may not be fixed at more than 33 1/3% shall be obliged to make a bid to acquire all the securities of that company." It is notable that there is no equivalent "squeeze-out" right.

³³ The Commission drew specific attention to the wide divergence among Member States in the extent to which they permit defensive measures as one of the causes of the unequal treatment of shareholders.

discrimination among them. The prohibition on defensive measures is more problematic. It appears to have a substantive aim, which goes beyond making protection equivalent for all shareholders, namely to ensure that shareholders rather than any other constituency decide on the outcome of the bid. Granting shareholders an absolute right to decide does not necessarily arise from the aim of equality: the directive could achieve its aim of equivalent protection by the uniform imposition across the EC of, for example, a Delaware-style review rule, or some other rule which allows other corporate constituencies to be taken into account.³⁵ Accordingly, a single market explanation for the introduction of a strong prohibition on defensive measures is insufficient; rather, it depends on the additional rationale of the establishment of a pan-European market for corporate control, with its alleged effects of beneficial industrial consolidation³⁶ and better monitoring of management, and leading eventually to the prioritisation of shareholder value as the goal of the corporation. However, these aims remained tacit: the restructuring rationale was not discussed officially until the revised second draft, and the market for corporate control more generally was not discussed until the Third draft directive was published in 2002.

Remaining within a neoclassical perspective, and relying on its central Efficient Markets Hypothesis, one might go further and argue that harmonisation of defensive measures is not required for the protection of shareholders. According to that hypothesis, regardless of whether they have informed themselves of the legal regime in place, potential investors are automatically protected as the efficient operation of markets (driven by the actions of informed investors) factors into the share price the extent to which the board

³⁴ Bull Supp 3/89, para 2

³⁵ In any event, it is not clear that an absolute prohibition is necessarily in the best interests of the target company's shareholders: see, for example, Carney, WJ, "Controlling Management Opportunism in the Market for Corporate Control: An Agency Cost Model" (1988) *Wisconsin Law Review* 385, who argues at 392 that "there are widely varying outcomes for target shareholders for every [defensive] tactic. This means that any rule, whether of contract or law, that effectively prohibits any of these tactics is likely to be costly for some shareholders." He argues that many defensive measures are likely to increase shareholder wealth when used in the right circumstances, even greenmail, the most "vilified" defensive mechanism, may increase shareholder wealth because it "may be an effective means used by good managers to communicate private information as to how much the true value of a firm exceeds its market value, in the face of a bid which target managers believe undervalues the firm...." Alternatively, he suggests, greenmail may be paid by inferior managers who value the rents they are currently extracting from shareholders.

are permitted to maximise the utility of constituencies other than the shareholders, for example, by taking defensive measures. On this view, the efficient operation and interpenetration of capital markets could simply be backed up by detailed disclosure requirements about the defensive measures which are in place.³⁷

iv) The Revised First Proposal

When the first draft "met with more criticism than approval" in the UK,³⁸ Germany and the Netherlands,³⁹ the Commission produced a revised proposal on 14th September 1990.⁴⁰ In the revised draft, the limitations on defensive measures in the original proposal were expanded and fleshed out. Article 8(1) was amended to require shareholder authorisation to be given "within the period for acceptance". This was explained on the basis that it would "enable the holders of securities of the offeree company to take a decision in full knowledge of the conditions of the bid."⁴¹ Article 8(1)(c) added a prohibition against the corporation acquiring its own shares during a bid in the absence of general meeting approval. The Commission pointed out that this was an express derogation from the Second Company Law Directive.⁴²

³⁶ Although note in this context the role played by the market for corporate control in the conglomeration and deconglomeration processes in the UK and US, discussed in chapter four.

³⁷ In its Recommendation of 25th July 1977, the Commission explains at para 2 that "the lack of full information on the securities themselves and ignorance or misunderstanding of the rules governing the various markets have certainly helped to confine the investments of the great majority of savers to the markets of the countries in which they live or to a few well-known major international securities." It should be noted that the Winter Report concluded at 22 that the position had not changed greatly and that "efficient markets do not exist across Europe. The securities markets in Member States differ widely in levels of development."

³⁸ In the UK, fears were raised for the future of the UK self-regulatory system both in a DTI consultative document and in a report of the Company Law Committee of the Law Society for England and Wales in 1989: see Dine, J and Hughes, P, *EC Company Law* (1991) at 11-2 – 11-3; Consultative Document paras 18 and 20; *Memorandum on the Thirteenth Directive on Company Law* (the Law Society Nov 1990, No 244). Specifically, it was argued that the principle that the courts would not intervene during the course of the bid itself was under threat, and so the speed and flexibility of the UK system, which are widely perceived as two of its great strengths, were threatened. The Commission sought to allay these concerns by pointing out that the question of how "this regulatory system is organized is left to the Member States, provided the authorities have the power to effectively police the takeover rules" (Bull. Supp 3/89 para 11).

³⁹ Hopt, (1992) (*supra* note 16) at 167. The revised draft allowed certain exemptions from the mandatory bid requirement.

⁴⁰ O.J., 26.9.90 C240/7, COM(90) 416 final. This was as amended unanimously by the Council under Art 149

⁴¹ COM (90) 416 final at 7

⁴² *ibid*; Art 19(1)(a) of Directive 77/91/EEC provided that the general meeting could authorise the board to repurchase shares for a period of up to 18 months. The effect of the revised first draft would have been to

The preamble and Article 6a set out "principles" to guide the supervisory authority in the exercise of their powers. The requirement of equal treatment of shareholders in the same position was promoted to the status of general principle. The supervisory authority's task was to "seek to ensure" that "the board of an offeree company acts in the interests of all the shareholders, and cannot frustrate the bid."⁴³ The Directive explicitly stated that this principle would apply to the authority's power to grant exemptions under Article 8(1)(b)⁴⁴ with the aim of ensuring both flexibility and legal certainty. These amendments curtail any discretion conferred on the supervisory authority by the first draft to authorise defensive measures. The revised directive's clearly stated aim of preventing frustration would only allow the supervisory authority to authorise abnormal transactions⁴⁵ where this did not prejudice the bid's prospects. It appears that the only discretion given to Member States in this regard would be a choice between a rule of managerial passivity in the face of bids and a rule of management auctioning the company.

As for the rights of employees, Article 10(1)(l) was amended to require the offeror to include in the offer document certain information, including its plans for the continuation in office of the current board of the offeree company and the projected future employment policy of the offeree company. In addition, the offeror was obliged to disclose any intended "restructuring of the offeree company and of companies controlled by it". Presumably any disclosure of future redundancies in the offer document could trigger the provisions of the Collective Redundancies Directive.⁴⁶ This amended Article required the bidder to state his "objectives" and "intentions", but the reference to "explicitly expressed" was dropped. The bidder is also obliged to set out "any special

change this to mean that, once a bid became public, specific permission would have to be sought from the general meeting.

⁴³ C240/8 and 17; the inclusion of these principles was requested by the Parliament in its opinion: see COM(90) 416 final at 6

⁴⁴ Which, as reformulated in the revised proposal, prohibited the board without authorisation from the general meeting from engaging "in transactions which would have the effect of altering significantly the assets or liabilities of the company or resulting in the company entering into commitments without consideration, unless the supervisory authority authorizes such transactions, giving reasons."

⁴⁵ Art 8(1)(b) refers to "transactions which would have the effect of altering significantly the assets or liabilities of the company or resulting in the company entering into commitments without consideration"

⁴⁶ Directive 75/129/EEC (see text accompanying notes 168-171 below).

arrangements concerning employees' rights of participation which the offeror intends to maintain or to introduce." A bidder could always argue that the tender offer stage is too early to reach definitive conclusions on the details of restructuring, and one wonders whether in fact this requirement would have been easily satisfied, as is frequently the case under the City Code, by the inclusion of a "boiler-plate" formula in the offer document to the effect that the bidder intends to respect the employees' rights.⁴⁷

Finally Article 19(2) provided for disclosure of the offer document to the employees, which was to occur "immediately after they are made public in accordance with Article 11(1)". The first draft did not specify the timing of disclosure of the offer document and could arguably have allowed the board to disclose the report to the employees before publication (if they themselves had it, which is unlikely in the case of a hostile offer).

The Commission explains the failure of this "ambitious" amended proposal on the grounds of "strong opposition from certain Member States [as the economic situation changed]."⁴⁸ This thesis suggests that the tighter restrictions on defensive measures by the board, reinforced by the notion that the board should act in the interests of "all the shareholders" rather than "the company as whole", meant that the amended directive was more clearly based on an agency model of the firm.

The Second Commission Proposal

The proposal was entirely recast in 1996,⁴⁹ taking the form of a *framework* directive "consisting of certain common principles and a limited number of general requirements which Member States will be required to implement through more detailed rules

⁴⁷ See further, Chapter 4, note 168.

⁴⁸ See the Commission's Explanatory Memorandum dated 2nd October 2002, OJ C 45E/1. Defriez, A, "The Future of the Takeover Panel: Statutory or Non-Statutory?" (*LSE Financial Markets Group ESRC Special Paper Series No 113 May 1999* notes at 12 that "we [the UK] objected to the legislative approach and for most other countries our concepts of shareholder protection did not meet with their then perceived requirements. The Germans, for instance, were adamantly opposed to any mandatory bid obligation and the Dutch objected to restrictions on frustrating action."

⁴⁹ O.J. C162/5, 6.6.1996, COM(95) 655 final.

according to their national systems and their cultural contexts."⁵⁰ The preamble to the directive offers a justification in terms of subsidiarity, claiming that "only action at Community level can ensure an adequate level of protection for shareholders throughout the Union and provide for minimum guidelines for the conduct of takeover bids..."⁵¹

i) Prohibition of Defensive Measures

While the second draft allows the Member States more freedom in terms of implementation, its prohibition on defensive measures by the board is stricter. Article 5 sets out general principles, which the Member States are obliged to respect.⁵² Implementing legislation should respect equality of shareholders in the same position, require the board to act "in the best interests of the company as a whole", and ensure that shareholders have sufficient time and information to reach an informed decision on the bid. These general principles are then followed by more detailed minimum requirements to be met by rules put in place by each Member State.

Article 8 (a), which imposes a broad prohibition on defensive measures by the board is a considerable simplification when compared with its predecessor. It states that:

"after receiving the information concerning the bid and until the result of the bid is made public, the board of the offeree company should abstain from any action which may

⁵⁰ Preamble to the Directive; a "framework" directive does not appear to differ greatly from a directive as defined in Art 249 (ex 189) of the EC Treaty: "A directive shall be binding, as to the result to be achieved...but shall leave to the national authorities the choice of form and methods." It seems that in a framework directive issues of implementation are more broadly construed, and some areas, such as Article 9, require regulation of issues without in any way specifying their content beyond that they should conform with broad principles. The difference in emphasis may have been designed to allay the fears of the British, expressly allowing more discretion as to the means of implementation to the Member States, and permitting self-regulation. This appears to be confirmed by a statement in the preamble that "it is desirable to encourage the voluntary control exercised by self-regulatory bodies in order to avoid recourse to administrative or judicial action."

⁵¹ This hints at an underlying fear that regime competition does not necessarily lead to agency model efficient rules, as many commentators in the US since Cary, W, "Federalism and Corporate Law: Reflections upon Delaware" (1974) 83 *Yale LJ* 663 have suggested. Individual Member States might prefer to compete to attract incorporations on the basis of protecting management and employees, leading to a "race to the bottom" in shareholder value terms. In addition, Member States acting individually are not able to impose rules protecting shareholders where there is a cross-border takeover.

result in the frustration of the offer, and notably from the issuing of shares which may result in a lasting impediment to the offerer to obtain control over the offeree company, unless it has the prior authorization of the general meeting of the shareholders given for this purpose."

This simpler formulation does not give the Member States any room for manoeuvre as regards managerial action during the bid. In particular, the supervisory authority is not allowed to authorise extraordinary measures not involving the issue of shares; in the new formulation, the issue of shares in the face of a bid is simply a "notable" defensive measure, but is not otherwise distinctive. This strict rule of managerial passivity reflects Article 7 of the City Code, on which it is clearly modelled.⁵³ This gives an agency interpretation to the general principle that the board should act in the best interests of the company *as a whole*, which has no equivalent in the City Code.⁵⁴ Read in light of the absolute rule of managerial passivity, this principle equates the company with the best interests of the *current* shareholders, rather than an ongoing productive coalition or entity. Where the board considers that an offer is inadequate, for example because they think their plans for the corporation will produce more value, or that there is a temporary disjunction between the share price and the corporation's true value, their only option is to inform the shareholders via their opinion published in accordance with Article 8(b), and hope that the shareholders take a longer term view. They have no stronger means of protecting either the shareholders against an inadequate bid, or other corporate constituencies against a bid which threatens their implicit contracts. It is then up to the

⁵² This differs from the amended first draft, where the general principles were a matter specifically for the supervisory authority.

⁵³ For criticism of this rule, see Painter, R and Kirchner, C, "Takeover Defenses under Delaware Law, the Proposed Thirteenth EU Directive and the New German Takeover Law: Comparison and Recommendations for Reform" (2002) 50 *American Journal of Comparative Law* 201 at 209 and Painter, R and Kirchner, C, "European Takeover Law - Towards a European Modified Business Judgment Rule for Takeover Law" (2000) 1 *European Business Organization Law Review* 353 at 382-394. One point which only indirectly concerns employees, but which featured strongly in debates about the second draft directive was that the passivity rule threatened to give US corporations an unfair advantage as regards hostile takeovers because differences in the extent to which defensive measures are permitted would make takeovers by US corporations easier and cheaper. The authors also feared that the strictness of the rule might "encourage managers and other stakeholders to make a political case to regulators rather than an economic case to directors."

shareholders to decide between the incumbent board's plans and the bidder's offer. While this type of rule may be uncontroversial within an agency perspective on the firm, this legal vulnerability to "bust-up" takeovers would tend to undermine management's ability to make credible commitments to employees.

ii) Protection of Employee Interests

Article 6(3) maintains the requirement of a statement in the offer document concerning "the offerer's intentions with regard to the future business and undertakings of the offeree company, its employees and its management." Compared to its predecessor, this requires less "explicit expression", and so could more easily be met by a standard clause to the effect that contractual obligations will be honoured. In addition, there is no provision for informing the employees of the terms of the offer document, although given that the previous directive only informed the employees when the document was made public, this does not appear to make the employees' position any worse as their representatives may pick up the details on publication.

iii) The Revised Second Proposal

The Second Proposal was presented in revised form on 11th November 1997,⁵⁵ taking into account some of the amendments proposed by the Economic and Social Committee⁵⁶ and the European Parliament.⁵⁷ Certain changes were made as regards the position of employees. Of the general principles, Art 5(1)(c) was amended to include "employment" among "the interests of the company as a whole."⁵⁸ While this would not have made a great difference to the practical effect of the directive, given the absolute prohibition on

⁵⁴ Although General Principle 9 states that "It is the shareholders' interests taken as a whole, together with those of employees and creditors, which should be considered when the directors are giving advice to shareholders."

⁵⁵ O.J., 13.12.97, C378/10, COM(97) 565 final.

⁵⁶ OJ C 295/1, 7.10.96

⁵⁷ OJ C 222/20, 21.7.97.

⁵⁸ This followed a proposed amendment by the Parliament to include "safeguarding jobs" among the interests: see C222/22

defensive measures,⁵⁹ it at least paid lip-service to the idea that the company encompasses more interests than simply those of the shareholders. The preamble added that "appropriate information should also be given to the representatives of the company's employees or, failing that, to the employees directly." To this end, Article 6(1), which in the previous draft dealt with the publication of information concerning the bid, was amended to include a provision that

"As soon as the bid has been made public, the board of the offeree company shall inform the representatives of its employees, or, where there are no such representatives, the employees themselves."

While based on a proposal from the Parliament,⁶⁰ this amendment simply reintroduces the provisions about employee information from the first draft directive. Given that the Member States already had an obligation under Article 6 to ensure general publicity for the bid, this does not appear greatly to affect the position of the employees. On the suggestion of Parliament, Article 7(2) was also amended to include the employees among the beneficiaries of rules requiring disclosure of all information and documents.⁶¹ While these changes undoubtedly brought the interests of the employees to the forefront, they do not have any real impact on their ability to affect the outcome of the bid.

In contrast to these rather cosmetic amendments, the Parliament had also proposed an amendment to Article 8(b) requiring the board to consult the employees before finalising their opinion to the shareholders. This proposal was unfortunately rejected. It would have introduced a meaningful political stakeholder measure which ensured that the employees "had their say" about the takeover.

⁵⁹ As regards defensive measures, Article 8(a) was amended to require the consent of the general meeting to be given "during the period of acceptance of the bid." This amendment, which was proposed by the Parliament (see OJ C 222/24, 21.7.97), clarified that there was no possibility of authorisation of defensive measures before the bid.

⁶⁰ See OJ C 222/23, 21.7.97

⁶¹ Parliament amendment at OJ C 222/24

iv) Rationale for the Revised Second Proposal

In the Commission's communication to the Parliament of its position regarding the revised second draft directive,⁶² it emphasises the two main aims of the proposal: the protection of minority shareholders through a mandatory bid rule, and the "harmonis[ation of] national rules on takeover bids, particularly regarding the transparency of the procedure, in order to facilitate restructuring throughout Europe."⁶³

The prohibition on defensive measures is not necessary to protect minority shareholders, who will be adequately protected by the mandatory bid rule, and by rules requiring that they be offered a fair price, however this is calculated. Since an absolute prohibition on defensive measures is not necessary to ensure "equivalent safeguards" for shareholders, it can only be understood in terms of encouraging the necessary process of corporate restructuring. While the Commission first admitted its instrumental use of the takeover directive in this context, it had long been clear to commentators that the directive was aimed at enabling corporations to adapt to and fully exploit the single market.⁶⁴

The second draft's much-vaunted respect for national contexts did not extend as far as tolerating defensive measures or the grant of significant procedural rights to employees, and therefore models of the company other than the agency model. This was the reason for Germany's continued opposition to the directive.⁶⁵ Since it would have given the shareholders sole competence to decide on the fate of a takeover bid, the directive would have marginalised the role of the employee representatives on the supervisory board. The

⁶² SEC(2000) 1300 final, 26.07.2000

⁶³ *ibid* at 2

⁶⁴ Note in this regard Gilson's comment in Roe, "Takeover Politics" in Blair, MM (ed), *The Deal Decade* (1993), 321 at 379-80 fn 136 that "corporate acquisitions are an equilibrating mechanism that becomes important only following a change in technology, and hostile takeovers become important only when some managers resist the change. Consistent with this analysis, the current effort on the part of the European Community to reduce the barriers to takeovers is openly instrumental. Takeovers are to be encouraged because in the view of the Community, a technological change has increased the efficient scale of enterprise."

⁶⁵ Berglof, E and Burkart, M, "'Breakthrough' in European Takeover Regulation?" (*Site Staff Papers 02/03, Stockholm School of Economics and CEPR* note at 10 fn 4 that "German opposition was intense throughout this process, and ultimately Germany no longer backed the common position in the Council, but was voted down 14 to 1 three times within the Council." Painter, R and Kirchner, C (2002) (*supra* note 53) describe German opposition to the requirement of shareholder approval, which within the permissible timescales is practically impossible, as the "linchpin" of the German position.

strict neutrality rule risked undermining the consensual system of corporate governance. Whether one considers it a matter of economics or politics, Germany's opposition response to such a threat to its system of corporate governance was not surprising.

v) The Fate of the Revised Second Proposal

In any event, the directive failed. After the Council rejected a number of the amendments proposed in the Parliament's opinion,⁶⁶ it adopted a common position on the directive on 19th June 2000.⁶⁷ In the common position, Article 6(3)(h) required the offer document to contain a statement of "the offeror's intentions with regard to the future business of the offeree company, its employees and its management, including any material change in the conditions of Employment." Two changes were made to the position concerning defensive measures. First the board would be permitted to seek alternative bids.⁶⁸ Second, an amendment was introduced which allowed Member States to permit the board of the offeree company to increase the share capital of the company during the period for acceptance of the bid, provided that this had been authorised by the general meeting not more than 18 months previously, and that the company honoured the pre-emption rights⁶⁹ of all shareholders.⁷⁰

The Parliament rejected the common position and proposed further amendments giving the employees a role in deciding on the outcome of the bid.⁷¹ Many of the amendments are clearly aimed at the German co-determination situation.⁷² The proposed amendments

⁶⁶ OJ C 222, 21.7.1997, p.20

⁶⁷ OJ C 23, 24.1.2001, p. 1. See also the Commission's communication to the Parliament of its position: SEC(2000) 1300 final, 26.07.2000. That communication repeated the Commission's view that the twin aims of the proposal were protection of minority shareholders and transparency for the purposes of restructuring.

⁶⁸ Art 9(1)(a) as amended, although this was arguably already possible.

⁶⁹ Contained in Article 29(1) of the Second Company Law Directive, 77/91/EEC of 13 December 1976.

⁷⁰ Art 9(2) of the Common Position. The Commission in its Communication to the Parliament (SEC(2000) 1300 final, 26.07.2000) noted that they had "accepted this limited derogation from the principle of neutrality of the board of the offeree company in order to arrive at a consensus on the basic principle without, however, compromising it."

⁷¹ OJ C 232, 17.8.2001, p. 168.

⁷² For example the amendment to Article 9(1)(a) requiring the supervisory board's consent to any defensive measures.

extended the general principles to include the interests of the employees as well as the shareholders. Art 3(1)(c) was extended to state that:

"the board of an offeree company is to act in the interests of the company as a whole, *in particular in the interests of corporate policy and in continuation, shareholders and staff, and with a view to safeguarding jobs*, and must not deny the holders of securities the opportunity to decide on the merits of the bid."⁷³

Further Art 3(1)(b) provided that:

"holders of securities of an offeree company *and its employees or their representatives* are to have sufficient time and information to enable them to reach a properly informed decision on the bid."⁷⁴

The disclosure requirements of Art 6(3)(h) were also elaborated, adding a requirement that the offer statement set out the:

"offeror's strategic planning for the offeree company, the effect of such plans on job and location, their impact on labour law standards, social standards and collective undertakings and the consequences for bodies representing the interests of the workers."

The Parliament also proposed an amendment to Article 6(4), which gave the supervisory authority power to request information, extending it to allow the employees' representatives to request information at any time during the bid. They also proposed that if an opinion was available from the employees' representatives, it should be published.⁷⁵

⁷³ OJ C 232, 17.8.2001, p. 169, emphasis showing change. They also proposed changes which would have allowed the supervisory authority of a Member State to lay down guidelines setting out the permissibility of defensive measures not caught in para 9(1)(a)

⁷⁴ OJ C 232, 17.8.2001, p. 169. This amendment only makes sense where the employees have some kind of decision-making power in the first place.

⁷⁵ Art 9(1)(b); this replaced an earlier proposed amendment, which went even further, in which the Parliament proposed that before drawing up their opinion on the offer document, management should consult with the employee representatives or the employees themselves: see Recommendation for Second Reading (A5-0368/2000 FINAL) at 16

Finally, and most controversially, the Parliament attempted to revive and extend the provision from the first draft directive, allowing the national supervisory authority to "adopt guidelines as to the permissibility of any other defensive measures."⁷⁶ They also set out a number of optional models as regards the authorisation of defensive measures.

The Commission's response to attempts by the Parliament to change the theoretical basis of the directive was not surprising. The Commission perfunctorily rejected all these proposed amendments in its Opinion on the grounds that "they have no place in these provisions."⁷⁷ The requirement that the employees should have sufficient information to make an informed decision was dismissed by the Commission on the grounds that "only the holders of securities can decide whether or not to sell them and they are therefore the only parties concerned by [the bid]."⁷⁸ The Commission considered the provision to employees of the same information as the supervisory authority inappropriate because "the system was established to provide information to the supervisory authorities, and they are therefore the only parties concerned by it."⁷⁹ The amendment to Art 3(1)(c) was rejected on the basis that "an excessively detailed list has no place in a framework directive, and there is invariably the added risk that it may not be exhaustive."⁸⁰

The amendments to Art 6(3)(h), which required more detailed information to be set out in the offer document, were rejected on the basis that "the purpose of the Directive is to harmonise company law, Amendment 13 tends to focus on labour law, which is already governed by other directives...." The proposal to publish the employees' opinion was rejected on the same basis. Protection of employees is to take place as a remedial matter after the takeover has been completed. Finally, the proposal allowing the supervisory authority to authorise a broader range of defensive measures was rejected because:

⁷⁶ Art 9(2a)(a)

⁷⁷ COM (2001) 77 final at 5

⁷⁸ *ibid* at 5

⁷⁹ *ibid*

⁸⁰ This objection appears to be close to disingenuous: the list has no place in the directive because the board has no power to take into account these wider interests because its powers of management have been truncated. Similarly, fears that the list would not be exhaustive would be better served by an attempt at completing the list, for example, by adding customers, suppliers and the community.

"1) it is incompatible with the spirit of the rule whereby only the holders of securities can determine a company's future; 2) the supervisory authority must act as an arbiter, and it is not its role to take sides between two companies; 3) involvement of the courts may result in delays which are unacceptable to all parties to the bid, and should be avoided."

vi) The 'Conciliated' Version of the Second Proposal

The Council also rejected the Parliament's amendments and so the matter went to the conciliation committee in accordance with Article 251(3) of the EC Treaty. At that hearing, the German Government's proposal to grant the board wide discretion to take defensive measures was rejected.⁸¹ A compromise was agreed in the conciliation committee on 6th June 2001.⁸² The general principles were in line with those originally proposed by the Commission. Employees were to be informed on publication of the bid, and have information about the bid disclosed to them at the same time as the shareholders. Article 6(3)(h) was considerably narrower than the Parliament's proposed disclosure, merely requiring a statement of:

"the offeror's intentions with regard to the continuation of the business of the offeree company and, so far as affected by the bid, of the offeror company, and with regard to the continued employment of their employees and their management, including any material change in the conditions of employment. This relates in particular to the offeror's strategic planning for those companies and the likely impact on jobs and locations."

Article 9(1)(d) required the board to make public its opinion on the bid and the offeror's statement of intentions, and "at the same time communicate this opinion to the representatives of its employees or, where there are no such representatives, to the employees themselves. Where a separate opinion of the employees' representatives on the effects of implementation on employment is made available to the board of the offeree company in sufficient time, it shall be enclosed." If the employees desired to make public

⁸¹ Mueller, "A New Takeover Regime for Germany: German Act on Acquisitions and Takeovers" in Payne, J (ed), *Takeovers in English and German Law* (2002), 173 at 174

such an opinion, they would, like the board, be operating on a very strict timescale, given that they would only have been made aware of the takeover bid when it was made public (under Art 6(2)). Given that Art 7(1) requires an acceptance period of not less than two weeks or more than ten weeks from publication, and that they are only notified at the beginning of that period, the employees would usually find this rather difficult.

Article 9(1)(a) prohibited the board from taking frustrating measures, with the exception of "seeking alternative bids" and action specifically approved by the shareholders. The requirement of shareholder consent was extended to decisions taken before the bid but not implemented, where the decision in question is outside the ordinary course of business. Given the requirement of at least two weeks' notice of any general meeting called for this purpose (Art 9(1)(c)), consent would be procedurally difficult to obtain, even where the shareholders are willing.

However, the "conciliated" text was rejected by the Parliament on 4th July 2001 by a tied vote of 273 votes to 273.⁸³ The narrowness of the margin was perhaps the most surprising thing about the Parliament's rejection of the text, given the extent to which their proposed amendments were not reflected in the conciliated text. In a subsequent Communication, the Commission reported that the Parliament had rejected the draft directive on "political grounds". The prohibition on defensive measures without shareholder approval was rejected both because it created an uneven playing field with US competitors, making it easier and cheaper for them to take over European companies, and because the directive as a whole did not create a level playing field for companies in Europe facing takeovers. In addition, the Parliament did not feel that employee interests were not adequately protected.⁸⁴

⁸² The text of the "conciliated" directive is available as Annex 6 to the Winter Report on Issues Related to Takeover Bids.

⁸³ OJ C 65E/112, 14.3.2002.

⁸⁴ See Commission Communication of 2nd October 2002 which accompanied the first publication of the third draft directive, now published at OJ C 45E/1, 25.2.2003.

The Third Commission Proposal

The dramatic late failure of the Second Draft Directive led the Commission in September 2001 to instruct a "High Level Group" of experts, led by Jaap Winter, to report and provide independent advice on the issue of takeovers, and to assist with the preparation of a new draft.⁸⁵ The Commission's mandate sought advice on three distinct issues: how to "ensure the existence of a level playing field in the EU concerning the equal treatment of shareholders across Member States"; the definition of an "equitable price" to be paid to minority shareholders; and, for the first time in the Directive's history, rules concerning a "squeeze out" procedure, which would give a majority shareholder a right to buy out minority shareholders. The inclusion of a squeeze out right reveals clearly for the first time the Commission's aim of establishing a market for corporate control; this protection for bidders is the counterpart of the mandatory bid rule. While the Commission claims that its mandate reflected the positions of the Council and the Parliament during negotiations on the previous draft, the absence of any reference to employees is striking, given the number of amendments concerning employee rights proposed by the Parliament, and the Commission's explanation of the Parliament's rejection of the second draft directive.

i) The Winter Report

A capital market logic permeates the Winter Report which was produced in accordance with this mandate. The Winter Report is particularly salient for this thesis because it makes plain the assumptions which underlie the current draft directive with regard to the position of employees and the way in which their protection is envisaged. While the Report did not deal explicitly with the productive coalition argument that employees

⁸⁵ The mandate may be found as Annex 1 to the group's report, the "Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids" of 10th January 2002 (referred to in this chapter as "the Winter Report"). The High Level Group were also asked to produce a broader report considering other issues of EU company law. The "Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe" (referred to in this thesis as "the Winter Report on Company Law Reform in Europe") was published on 4th November 2002.

should often be considered residual claimants,⁸⁶ it is implicitly rejected in their assumption that

"proportionality between ultimate economic risk and control means that share capital which has an unlimited right to participate in the profits of the company or in the residue on liquidation, and *only* such share capital, should normally carry control rights, in proportion to the risk carried."⁸⁷

This assumption leads to the Winter Report's conclusion that the establishment of a "level playing field"⁸⁸ for shareholders should be guided by two principles: "shareholder decision-making" and "proportionality between risk-bearing and control".⁸⁹ The implementation of these principles should "enable liquid and coherent markets in capital and corporate control to operate throughout the Union."⁹⁰ As in earlier drafts, the agency model rather than the need for a "level playing field" underpins the prohibition of defensive measures. A level playing field simply requires uniform rules across the EU, which could, for example, allow management to take defensive measures where they are able to satisfy a Delaware-style intermediate standard of judicial review, or grant rights of consultation or even co-decision to employees before the bid is completed.⁹¹

The Winter Report rules out the EMH argument that shareholders are protected by the price they pay for their shares. While it accepts that "in a fully integrated and well developed securities market, whether or not companies should adhere to the proportionality principle should be left to the market itself", it concludes that "such

⁸⁶ The High Level Group's mandate did not require it to deal specifically with the issue of protection of employee rights: see the Winter Report at 16.

⁸⁷ Winter Report at 3, terming this constituency "risk-bearing capital"; this principle also requires the rejection of corporate structures which "grant disproportionate control rights to some shareholder(s)" because they may "operate to frustrate an otherwise successful bid for the risk bearing capital of the company." (at 21)

⁸⁸ According to the Winter Report at 18, a "level playing field" does not exist where "takeover bids cannot be undertaken with the same expectation of success in the different Member States and shareholders in Member States do not have equivalent opportunities to tender their shares."

⁸⁹ *ibid* at 20

⁹⁰ *ibid* at 26

⁹¹ While the Delaware-style rule would appear to be acceptable to most Member States except the UK, it would be impossible to reach agreement on employee co-decision.

efficient markets do not [currently] exist across Europe."⁹² The Report also argues, somewhat laconically, that shareholder decision-making could also be left to the market, but that "the conflict of interest of the board may well lead to market failure in this context."⁹³

Since the Winter Committee's assumptions directly contradict the productive coalition model set out in Chapter Three, and heavily influence the Report's recommendations, the justifications offered for them by the Winter Committee will be considered here in some detail.

In considering the preliminary public policy issue of whether takeovers should be encouraged at all, the Winter Report, in line with its assumptions, concludes that takeover bids are "basically beneficial" because their effects in creating synergies, disciplining management and allocating resources where shareholders are dispersed are "in the long term... in the best interests of all stakeholders, and society at large."⁹⁴ However, this is tempered by a recognition that takeover bids are not "always beneficial for the companies concerned, the target and the bidder, and their respective shareholders."⁹⁵ Offeror shareholders, for example, may suffer a detriment where management in an inefficient market indulge in "empire building".⁹⁶

The Report also recognises that "the interests of other stakeholders and in particular employees may be at stake in the context of a takeover bid". However, the Committee "believes that this in itself does not justify defensive measures by the board which deny shareholders the opportunity to successfully tender their shares to a bidder who is willing to buy their shares."⁹⁷ Use of defensive measures by the board to take into account the

⁹² Winter Report at 3 and 22

⁹³ *ibid*

⁹⁴ *ibid* at 2

⁹⁵ *ibid* at 19

⁹⁶ The Report notes that "Whether or not it [the board] should confer with its shareholders before executing the bid, is a matter of general corporate governance principles as applying to the bidder. It is outside the scope of the Directive."

⁹⁷ Winter Report at 16

employees' interests is rejected on the grounds that they are "often costly"⁹⁸ in the sense that "any regime which confers discretion on a board to impede or facilitate a bid inevitably involves unacceptable cost and risk."⁹⁹ These costs are agency costs to shareholders. The risk is that the board's decisions will be tainted by conflict of interest. The Report is unequivocal that this risk is high: the board's "claims to represent the interests of shareholders or other stakeholders are *likely* to be tainted by self-interest."¹⁰⁰ Accordingly, "Shareholders should be able to decide for themselves and stakeholders should be protected by specific rules (e.g. on labour law or environmental law)."¹⁰¹

These three arguments will be addressed in turn. First, the argument about the board's conflict of interest when faced with a takeover has been discussed at length in previous chapters. However, we have seen that in Delaware, the courts inquire into the board's motivations, invalidating only action aimed at entrenchment. Similarly, the English courts appeared willing to do so before the introduction of the City Code. Thus a total prohibition on defensive measures is not the only way of getting around the board's conflict of interest. The courts are able to distinguish between illegitimate self-serving behaviour on the part of the board, and genuine "mediating behaviour" which is to be encouraged where quasi-rent generating implicit contracts are at stake. An outright prohibition on defensive measures is a mechanism to constrain management to pursue shareholder value; it is not an essential element of creating a "level playing field".

The Winter Report acknowledges the Parliament's concerns about the lack of a level playing field with the US as regards defensive measures,¹⁰² but argues that, although

⁹⁸ *ibid* at 2

⁹⁹ at 21

¹⁰⁰ *ibid*, emphasis added.

¹⁰¹ *ibid*

¹⁰² See the Parliament's "Recommendation for Second Reading" dated 29th November 2000 (A5-0368/2000 Final) at 21-2. The Report recognises that its proposals differ from "controversial" US rules permitting defensive measures, and suggests that any remaining "political concerns" might be met by restricting the effect of these two guiding principles to "European listed companies making general takeover bids for other European listed companies, to the extent this would not violate international agreements and could practically be enforced." (Winter Report at 42). However, Painter, R and Kirchner, C (2002) (*supra* note 53) at 221 comment that "such an approach would go to the opposite extreme from that feared by opponents of the Thirteenth Directive and create a market for corporate control within Europe that would be impregnable from outside."

there is no US federal regulation of defensive measures, management of US public corporations operate in a very different context from their EU counterparts: social, cultural and market norms put pressure on boards to enhance shareholder value, and they are "judged by their performance on the capital markets."¹⁰³ In addition, the needs of the European Union are altogether different from those of the US, given its stated aim of developing an integrated capital market by 2005, something the US has had for a considerable time.¹⁰⁴

The second argument, that the shareholders alone should decide on the bid, rests on an agency analysis of the corporation, and in particular on the Committee's assumption that shareholders are the only residual claimants. The Committee concludes, correctly on the basis of its assumptions, that "holders of these rights to the residual profits and assets of the company are best equipped to decide on the affairs of the company as the ultimate effects of their decisions will be borne by them."¹⁰⁵ If the Committee had instead assumed that other corporate constituencies might also be residual claimants, they would presumably have recognised that allowing them some input would add legitimacy to the takeover process and at the same time enhance efficiency. It is crucial to note that it is the agency theoretical assumption that only shareholders bear risk, rather than the creation of a "level playing field", which is the basis for the outright prohibition on defensive measures.

Finally, the Report argues that employees are better protected through labour law, rather than company law, measures,¹⁰⁶ and suggests that the second draft of the directive in any event "provided for extensive information requirements towards the employees."¹⁰⁷ To describe the provision of information to employees at the same time as it is made public as "extensive" is overstatement. Details of the offer will be widely circulated in any

¹⁰³ Winter Report at 40. These "post-hostile takeover" adaptive mechanisms were discussed at length in Chapter 4.

¹⁰⁴ *ibid.*

¹⁰⁵ *ibid.* at 3

¹⁰⁶ This echoes the point made by Paul Davies, discussed in Chapter two, that regulation of the employment relationship should not depend on the legal vehicle adopted by the employer: see Davies, P, *Introduction to Company Law* (2002) at 272.

¹⁰⁷ Winter Report at 16

event, and UK experience with a similar provision suggests that disclosure of the offeror's intentions as regards future employment is likely to be superficial. The report also claims that employees already receive adequate labour law protection in the form of "specific legislation providing for information and consultation of employees and for their protection in the event of a bid leading to restructuring."¹⁰⁸ The EWC, CRD and the general information and consultation directives will be binding on the bidder after the acquisition, meaning that the "decision to sell by target company shareholders does not affect the legal protections afforded to employees and other stakeholders."¹⁰⁹ This reliance on ex post measures rejects (or at least does not consider) the argument that some employees rely on implicit contracts.

In Annex 3, the Group reports that it received suggestions that there should be a "re-examination of the social issues and recognition of the right for the employees to be consulted, and not only informed about the conditions of the bid" and that "the Board should consult the employees before preparing its report on the bid, in order to have a joint evaluation of the bid and possible defensive measures."¹¹⁰ The Report is not explicit as to the reasons for the rejection of these suggestions. Certainly they would have exceeded their mandate had they addressed them. In addition, the Group's assumption that labour law mechanisms, reinforced by rights to information and consultation, provide employees with adequate protection means additional measures ex ante the takeover would serve no useful purpose. The impact of takeovers on implicit contracts does not appear to have been raised.

ii) The Committee's Recommendations

The Committee distinguishes pre- and post-bid structures. Pre-bid structures "have the effect of concentrating control rights in the hands of the board and/or minority shareholders."¹¹¹ Annex four lists the numerous structural deviations from the two

¹⁰⁸ *ibid*

¹⁰⁹ *ibid* at 16-17. Of course, the Directive supplementing the European Company Statute Regulation will only apply where the company in question decides to adopt that form.

¹¹⁰ *ibid* at 73; the European Parliament proposed similar amendments to the second draft directive.

¹¹¹ *ibid* at 7 and 23

guiding principles which exist across the EC, forming pre-bid barriers to takeovers by preventing the bidder taking control. These measures include voting caps, registration restrictions, multiple voting rights and even co-determination, although this is not normally a company-specific "deviation", but rather a requirement of law. The Committee recognises that many of these deviations frequently have a justification which transcends simply preventing takeover bids, such as responding to country-specific governance problems arising from the separation of ownership and control.¹¹² For example, they suggest that "depository receipt structures have arguably been developed to protect a company with dispersed ownership against a small minority dominating the general meeting."¹¹³ Accordingly, they accept that it is not possible to deal comprehensively with all these barriers.¹¹⁴ While the Committee was not convinced that the operation of the market would eradicate the mechanisms which were the most harmful to shareholders - because "efficient markets do not exist across Europe"¹¹⁵ - it did propose a general, permanent rule that listed companies "be required to fully disclose their capital and control structures" both for the benefit of investors "in order to enable them to assess the value of and risks related to their investment" and so that "markets [can] properly judge the efficiency of companies with different capital and control structures."¹¹⁶

The Group also recommended the introduction of a rule which would allow a successful bidder¹¹⁷ to immediately "break-through" pre-bid measures¹¹⁸ contained "in the articles of association and related constitutional documents of the company which deviate from the principles of shareholder decision-making and proportionality", and to exercise

¹¹² There is no indication that the Committee considered any measures in terms of dealing with governance problems beyond the agency model.

¹¹³ Winter Report at 24

¹¹⁴ Which would have involved looking at each measure in context and checking whether it could still be justified. The Committee was in any event unsure whether general agreement could be reached "on which structures could remain as acceptable deviations" and in any event this would involve addressing the underlying governance problems that the structures were put in place to deal with. (ibid at 24)

¹¹⁵ ibid at 22

¹¹⁶ ibid at 25

¹¹⁷ Success being defined as crossing a threshold not exceeding 75%.

¹¹⁸ Or measures put in place post-bid: ibid at 34

proportionate control.¹¹⁹ Control is of course limited to the "core control rights that company law grants" and the "break-through" rule would exclude "nomination or appointment rights of third parties which are mandatory in the company law of the Member States", such as co-determination. The break-through rule would not apply to contractual barriers to bids, like golden parachutes and shareholder agreements or to pyramid holdings.¹²⁰

In terms of post-bid measures, the Winter Group recommended a prohibition of defensive measures after announcement of the bid in very similar terms to earlier draft directives. Management would be permitted to take measures where they were specifically authorised by the general meeting, provided that the authorisation also complied with the proportionality principle.¹²¹ The Committee rejected the idea that the board should be allowed to take defensive measures on the basis of a general advance authorisation because, before the bid, the shareholders would not be able to take into account all the relevant factors, because these are essentially unknowable *ex ante*. In fact, the "circumstances leading shareholders to authorise the board to frustrate a potential future bid may very well have changed fundamentally by the time a bid is actually made."¹²² The rejection of any defensive measures means that the role of the board would be limited to advising the shareholders on the merits of the bid, and, if appropriate, seeking alternative bids for consideration by the shareholders.¹²³

¹¹⁹ *ibid* at 29-31. The Group suggested this should apply to golden shares whether held by the state or a private party. In fact, as regards the state, the ECJ subsequently ruled in *Commission v. Belgium*, (Case C-503/99, 4 June 2002), that golden shares "may be relied on only if there is a genuine and sufficiently serious threat to a fundamental interest of society." This requirement was to be "interpreted strictly" and the power reserved for golden shares also must be proportionate to the objective pursued. While the Belgian shareholding was upheld on the basis of national interest in energy supply, state-held golden shares were ruled unlawful in *Commission v. Portugal*, Case C-367-98, and *Commission v. France*, Case C-483-99, (Elf-Aquitaine) decided on the same day.

¹²⁰ Although the Group suggested that it should be considered outside the context of the directive whether these measures should remain binding.

¹²¹ *ibid* at 28, i.e., "an authorisation by the general meeting of shareholders to take actions frustrating the bid would only be valid if made by a majority of votes exercised by the holders of the proportionate majority of the risk bearing capital of the company."

¹²² *ibid* at 28

¹²³ *ibid* at 20

Finally, as regards "squeeze out"¹²⁴ and "sell out"¹²⁵ rights following a takeover, the Group recommended harmonisation across the EU. Member States would broadly be free to fix the threshold between 90% and 95%, and the price paid in the takeover presumptively fair. Squeeze out rights are justified in terms of preventing minority shareholders abusing their position and imposing costs on bidder. The ability to consolidate control keeps takeovers attractive to bidders. It does not conflict with property rights because of the "general and public interest in having companies efficiently managed on the one hand, and securities markets sufficiently liquid on the other hand."¹²⁶ The sell out right is justified to prevent shareholders being pressured to tender, to protect minorities with small shareholdings from abuse, and "as a fair counterpart for the squeeze-out right conferred on the majority shareholders and a component in the proportionality of the squeeze-out solution."

iii) The Commission's Third Proposal

The third draft proposal takes "broad account"¹²⁷ of the Winter Committee's recommendations, and rests on its principles and assumptions. The draft, which was published by the Commission on 2nd October 2002,¹²⁸ follows the format of the second proposal, with general principles being supplemented by more specific rules. The legal basis is also the same.¹²⁹

iv) The Position of Employees under the Third Proposal

The offer document should be disclosed promptly to the shareholders and the employees (Art 8(2)). Article 9(5) provides that the employees should receive a copy of the board's

¹²⁴ This refers to the bidder's right to compulsorily acquire the remaining shares when he crosses a certain threshold.

¹²⁵ This refers to the right of remaining minority shareholders to require the bidder to purchase their shares.

¹²⁶ *Ibid* at 61

¹²⁷ OJ C 45/2, 25.2.2003

¹²⁸ See Commission Communication of 2nd October 2002, now published at OJ C 45/1, 25.2.2003

¹²⁹ The original directive was based on Art 54(3)(g); the second and third proposals on Article 44(2)(g); Hopt, (1992) (*supra* note 16) comments at 174 that "even without further workforce protection, the Directive is not really a company law measure since it clearly goes beyond company law and regulates a transaction which takes place not within the company, but in the capital market."

opinion of the bid at the same time as it is made public.¹³⁰ It also gives the employees the opportunity to append a separate opinion to the board's opinion, where the board receives this "in good time". Both board and employees will be working to a very strict timetable, and their opinions will only reach the shareholders rather late in the day, given the provision in Article 7 that the period for acceptance of the bid should be between 2 and 10 weeks. This provision of the third draft repeats almost verbatim Art 9(1)(d) of the text approved before the Conciliation Committee.¹³¹

In its explanatory notes accompanying the proposal, the Commission explains that the aim of these provisions is to ensure that the "offeree company's employees should be associated with the opinion and should be able, if they disagree, to communicate their own opinion at the same time. These opinions are addressed to the shareholders, who have the responsibility to decide on the bid."¹³² This raises an important issue. The employees are to be "associated" with the board's opinion, but must rely on the shareholders accepting that opinion. The reason for the inclusion of these provisions is obscure. If one assumes that employees are fully protected by their contracts, then these provisions are redundant from an employee protection perspective. Otherwise, as with the position under the City Code, being able to make representations to the shareholder decision-makers is unlikely to be sufficient given the premium on offer. Accordingly, the opinion of employees is likely to be of use to shareholders only where they are being offered shares rather than cash.

Beyond these provisions concerning publication of the offer document and the board's opinion, Article 13 adds that:

"Without prejudice to the provisions of this Directive, the provision of information to and consultation of representatives of the employees of the offeror and the offeree company

¹³⁰ Art 9(5) requires the board to produce "a document setting out its opinion on the bid, together with the reasons on which it is based, including its views on the effects on all the interests of the company, including employment, and on the offeror's strategic plans for the offeree company and their likely effects on employment and the locations of the company's places of business as set out in the offer document in accordance with Article 6(3)(h)."

¹³¹ PE-CONS 3629/1/01 REV 1 dated 19 June 2001, annexed to the Winter Report at Annex 6

shall be governed by the relevant national provisions, and in particular those adopted pursuant to Directives 94/45/EC, 98/59/EC and 2002/14/EC.”

The interaction between the proposed takeover directive and this trio of directives dealing with information and consultation is considered below. According to the Commission, Article 13 "confirms that the close and effective involvement of the companies' employees, via their representatives, is an important factor not only for the success of the operation but also for proper consideration of the different interests that may be affected by the takeover."¹³³

However, it should also be noted that employee information and consultation under this draft is narrower than under the City Code, which theoretically allows management to consult the employees before the bid is made public, subject to appropriate confidentiality safeguards.¹³⁴

v) The Position of Shareholders under the Third Proposal

The third draft goes considerably further than its predecessors in strengthening the position of shareholders both pre- and post-bid. Article 9 prohibits defensive measures unless specifically authorised by the general meeting, a meeting in which restrictions on voting become unenforceable, reinstating the proportionality principle. In accordance with the Winter report's recommendations, Article 10 makes detailed provision for disclosure of information in the company's annual report about capital structure, restrictions and intra-corporate contracts in order to allow the market to reflect these arrangements in the share price.¹³⁵

¹³² OJ C45/6, 25.2.2003

¹³³ OJ C45/7, 25.2.2003

¹³⁴ The draft directive's proposal only to inform employees after the event remained a clear point of contention in the public debate over the directive: See "New takeover directive needs further improvement, say experts", European Parliament News Report, 30th January 2003, available at: <http://www2.europarl.eu.int/omk/sipade2?PUBREF=-//EP//TEXT+PRESS+NR-20030130-+0+DOC+XML+V0//EN&LEVEL=2&NAV=S>

¹³⁵ Art 10(3) provides that these "structural aspects and defensive mechanisms" should be put to a vote in the general meeting at least every two years.

The break-through proposals were not adopted in full because they "met with opposition from virtually all Member States and interested parties" both because of legal problems like compensation and because they "would have had far-reaching implications for company law."¹³⁶ Instead, Article 11 renders transfer restrictions unenforceable during the bid; renders voting restrictions imposed by the articles or contract without effect during any vote on defensive measures; and renders voting restrictions concerning the right to appoint the board or amend the articles unenforceable at the first general meeting following closure of the bid. Consequently, this rule affects a narrower range of structural barriers to the exercise of control than the Winter Report's proposed break-through rule, in particular as regards multiple voting rights.¹³⁷ The break-through rule set out in the draft does not affect employee rights, such as co-determination, which are imposed by national law. It is explicitly limited to the control which the bidder can take "under the applicable national law", and so only allows break-through of restrictions on voting contained in the articles or in contractual arrangements. Articles 14 and 15 do adopt the Report's proposals as regards squeeze-out and sell-out rights.

vi) *The Rationale for the Third Proposal*

The aims of the proposal are confirmed in the explanatory notes which accompany the third draft directive.¹³⁸ Alongside the integration of European markets in accordance with the 1998 *Financial Services Action Plan*,¹³⁹ which aims to create an integrated capital

¹³⁶ OJ C 45E/2, 25.2.2003

¹³⁷ The notes to the directive state that "It can be argued that securities with multiple voting rights form part of a system for financing companies and that there is no proof that their existence renders takeover bids impossible. The same applies to securities with double voting rights, which may make for a stable shareholder base." This is a point of contention for Germany, which opposes the directive on the basis that this prevents a "level playing field". While German-style defensive measures are prohibited by the directive, the Commission is not seeking to prohibit multiple voting rights, which are a key defensive mechanism in France and Scandinavian countries (where "the majority of listed companies are based on a multiple voting structure"), "since it fears that such a ban might be interpreted as "expropriation" and "give rise to questions of a constitutional nature that could jeopardise or at least delay for a long time the adoption of the Directive." See also European News Report *supra* note 134.

¹³⁸ OJ C 45E/2, 25.2.2003

¹³⁹ See Commission Communication entitled *Financial Services: Building a Framework for Action*, COM (1998) 625, 18.10.98 ("Building a Framework"), which responded to a call from the Cardiff European Council to produce a "framework for action" (Pt. 17, Presidency Conclusions from Cardiff European Council (15/16 June 1998)), and its follow up, *Financial Services: Implementing the Framework for Financial Markets: Action Plan*, COM (1999) 232, 11.5.99 ("Implementing the Framework")

market by 2005, and the facilitation of corporate restructuring,¹⁴⁰ which are described as "general objectives", the directive is intended to strengthen legal certainty of cross-border takeover bids "in the interests of all concerned" and to ensure protection for minority shareholders.

Alongside the financing of consumer credit, the *Plan* focuses on the creation of "deep and liquid European capital markets which serve both issuers and investors better" and which "can serve as the motor for growth, job-creation and the competitiveness of the European economy." The aim is to reduce the cost of capital to companies by removing the existing barriers to cross-border activities, and "ensuring a level playing field for financial operators is one of the key elements of an integrated market for financial services."¹⁴¹ Certainly within an agency-based approach to corporate governance, the provision of efficient capital markets and the maintenance of investor confidence are key aspects of the system. One way of maintaining investor confidence is to introduce mechanisms which increase board accountability to shareholders, although as we saw in Chapter 1, it is unlikely that dispersed capital market investors will spend their own resources to do this. In *Building the Framework* the Commission comments that while "there is no single model of good corporate governance which could facilitate integration of wholesale markets",¹⁴² a capital market consensus is emerging around the equitable treatment of shareholders and the transparency and accountability of the corporate process. Accordingly, the directive implements an agency model of corporate governance, in which accountability of the board and the equitable treatment of shareholders are equated. A market for corporate control, which is a central mechanism for ensuring management accountability, is established by the Directive.

The second important aim of the takeover directive which emerges from the Commission's *Plan* is that it will assist in the task of creating corporations large enough to take advantage of the single market, by eliminating those "differences in styles and

¹⁴⁰ The Commission discusses the directive's role in contributing "to the development and reorganisation of European firms, a key condition for withstanding international competition."

¹⁴¹ *Building a Framework* at 3

¹⁴² *ibid* at 10

forms of governance [which] can limit cross-border investment and hinder the creation of supra-European corporations."¹⁴³ The European Company Statute (which after a long and tortuous process to rival that of that of the takeover directive, is now in place¹⁴⁴) and the Takeover Directive are of "fundamental importance"¹⁴⁵ to this process. The Directive aims to create "EU-wide clarity and transparency in respect of legal issues to be settled in event of take-over bid" and to prevent "patterns of EU corporate restructuring from being distorted by arbitrary differences in governance and management cultures."

This distinction between "arbitrary" and "non-arbitrary" differences appears to be a difficult one to draw. The Commission does not, however, term all differences in corporate governance systems "arbitrary", and therefore to be eliminated. It draws a distinction between, on the one hand, differences in "corporate governance arrangements [which] could give rise to legal or administrative barriers which might frustrate the development of an EU financial market (e.g. practical arrangements for the exercise of voting rights by shareholders in partner countries)", and on the other, "a wide series of issues whose ramifications for the single financial market are at present unclear."¹⁴⁶ Arrangements in this latter category, which "spring from long-standing legal and socio-economic traditions"¹⁴⁷ raise more difficult questions and "[a]t the present juncture, any EU involvement in this area should be confined to identifying any barriers to the development of the EU financial market resulting from corporate governance arrangements."¹⁴⁸

¹⁴³ *ibid* at 10

¹⁴⁴ Regulation 2157/2001 and the supplementary directive 2001/86/EC, which, per recital 19 of the Regulation is an "indissociable complement" and "must be applied concomitantly."

¹⁴⁵ Implementing the Framework at 4

¹⁴⁶ *ibid* at 15

¹⁴⁷ *ibid*

¹⁴⁸ *ibid.* The review of corporate governance arrangements, prepared at the Commission's request, recognises that differences in the degree of involvement of employees in corporate governance present a formidable obstacle to harmonisation. Although given a low degree of priority in the *Plan*, this review has now been published: *Comparative Study Of Corporate Governance Codes Relevant to the European Union And Its Member States*, January 2002 (STUDY CONTRACT ETD/2000/B5-3001/F/53). At 33-4 it discusses the role of employees: "The greatest difference among EU Member States relates to the role of employees in corporate governance, a difference that is usually embedded in law... legal systems in EU Member States make different choices about how best to ensure that the interests of certain resource providers are protected. They express different conclusions on issues such as... Whether labour concerns and protection of creditors can be sufficiently protected by contract and other specific laws tailored to address such concerns, or whether such concerns are better addressed through board structures and other

The history of the EEC company law programme demonstrates that wholesale harmonisation of corporate governance is impossible because of the Member States' differences in approach. Yet the Commission has insisted on presenting the third draft of the takeover directive as a technocratic measure, based on an "emerging consensus" which would benefit capital markets and shareholders by creating a "level playing field", while not adversely affecting other corporate constituencies. These assertions rested firmly on an agency conception of the company, and the vain hope that the directive would not "spill over" into broader issues of corporate governance and the organisation of the productive economy.¹⁴⁹

If the third draft takeover directive had been adopted as originally drafted, but no progress made on the broader harmonisation project, Member States would have retained responsibility for their own national corporate governance systems, with the exception of the law relating to takeovers which would have been largely determined at the supranational level. A clear, functional separation would have been unlikely because the various elements of corporate governance systems are interlocking and interdependent.¹⁵⁰ The most obvious spill-overs were already apparent at the time the directive was proposed. It would have had the effect of reorientating European corporate governance systems from managerialism towards shareholder value. For example, a prohibition on all defensive measures would have adversely affected the ability of the German supervisory board to act as a corporate constitutional representation of a coalition of specialised investors.¹⁵¹ By insisting that shareholders should be accorded an exclusive right to decide on the outcome of a bid, the directive sought to impose a norm of shareholder primacy, albeit in narrow circumstances, to replace the more cooperative, consensus

company law requirements... Although a significant degree of company law standardisation has been achieved throughout the European Union, some commentators suggest that the remaining legal differences are the ones most deeply grounded in national attitudes, and hence, the most difficult to change."

¹⁴⁹ The preamble to the third draft of the directive makes it clear that the Member States are firmly opposed to a takeover directive which has "far-reaching implications for company law."

¹⁵⁰ This is discussed below.

¹⁵¹ See further Sadowski, D, Junkes, J, and Lindenthal, S, "Labour Co-Determination and Corporate Governance in Germany: The Economic Impact of Marginal and Symbolic Rights" (*Quint-Essenzen Nr 65, August 2001, IAAEG*)

decision-making process which currently prevails on supervisory boards. This may have undermined allocative efficiency as shareholders "may favour takeovers that increase the value of their shares even if they involve greater losses for unprotected creditors or employees."¹⁵² A transfer of decision-making responsibilities from management to shareholders would have had an adverse effect on the ability of management across the economy as a whole to make credible commitments to employees. UK and US experience suggests that truncating managerialism and introducing a market for corporate control would have increased managerial focus on shareholder value far beyond the narrow confines of the hostile takeover. In this way, the directive would have had an indirect but substantial impact on Member States' systems of corporate governance going far beyond takeovers. To judge from the German response to the second draft directive (discussed in chapter five), it might be argued that the threat was anticipated.

From the perspective of bidders, many structural barriers to the assumption of control would have remained; the third draft of the directive would only have prevented the board from putting up barriers to a takeover once it had been announced. Apart from this restriction, and the third draft's prohibition on voting right and transferability restrictions, the question of whether the bidder can take control of the board and the company would have remained largely a question of domestic company law. National measures of company law would therefore have been likely to continue to distort the market for corporate control. This means that the Directive would not really have satisfied anyone.

vii) The Fate of the Third Proposal

In the light of the long history of deadlock, the third draft of the takeover directive always had rather uncertain prospects. Although it only required a qualified majority, the opposition of Germany seemed almost certain, particularly in light of the contents of the new German takeover law.¹⁵³ It also became apparent that Britain would support Germany's insistence that any prohibition on defensive measures should extend beyond

¹⁵² Becht, M, Bolton, P, and Rowell, A (2002) (*supra* note 18) at 20

¹⁵³ While the third draft sought to outlaw the archetypal German defensive measure, action by the board, it would have allowed the practice of attaching multiple voting rights to certain shares to continue.

the board to take in multiple voting rights and similar techniques in return for support in opposing the temporary workers directive.¹⁵⁴ The formation of this coalition led to growing French reservations about the prospective introduction of a prohibition on multiple voting rights. Accordingly, the Commission suggested that the prohibition should be "grandfathered", not coming into force until 2010, and should provide for compensation.¹⁵⁵

In addition, despite the rhetoric of the Commission and the Winter Committee, the draft did deal fully with the concerns of the Parliament as regards the protection of employees. This undermined its chances of obtaining a majority in the Parliament, given that the narrow failure of the previous draft was widely ascribed to the same defects. Parliament's concerns about an uneven playing field with the US also remained unresolved. Commentators began to argue that the directive's prospects had been "perhaps diminished by the sharp decline in stock market values, the related decline in cross-border merger activity throughout the world, and the loss in prestige of the shareholder capitalism model in light of the potential weaknesses revealed by the Enron and WorldCom financial frauds."¹⁵⁶ Finally, financial commentators suggested that Germany's economic difficulties and low growth were creating political pressure to protect German enterprises from takeover by foreign companies.¹⁵⁷

However, the issues raised by the draft directive went beyond simple political disagreement. The draft directive threatened to extend the City Code's agency model of takeover regulation across continental Europe. Despite the influence and perceived strengths of the UK method, there were, and remain, good reasons to be cautious about its generalisation across the EC. In particular, the UK system of takeover regulation is path dependent. The rapidly increasing dispersal of shareholdings after 1945 and the approach taken by the courts to takeover regulation led the City of London to take over the mantle

¹⁵⁴ See *The Economist*, 24th May 2003, pp 62-3 for a pessimistic assessment of the draft's prospects.

¹⁵⁵ See *The Financial Times*, 15th February 2003.

¹⁵⁶ Gordon, JN, "An International Relations Perspective on the Convergence of Corporate Governance: German Shareholder Capitalism and the European Union, 1990-2000" (2003) *European Corporate Governance Institute (ECGI), Law Working Paper No. 06/2003, 7 February 2003 available at SSRN <http://papers.ssrn.com/abstract=374620> at 57*

of de facto regulator from the courts, in order to pursue their sectional interests through more informal means. The UK government did not oppose this privatisation of regulation and UK industry has survived, (depending on one's point of view) because of or despite this. Agency theorists assume that even removing only some of the barriers to the market for corporate control will cause improvements in the quality of management and the allocation of resources, with no adverse consequences for other corporate constituencies. From this perspective, the takeover directive would simply hasten the process of corporate governance convergence, already underway as a result of globalisation, around the agency model norms and the ideology of shareholder value.¹⁵⁸ By contrast, European systems of corporate governance do not share any single theoretical orientation, and incorporate aspects of political stakeholding or productive coalition models to varying degrees. There are also huge variations in the concentration of shareholdings across the Member States, and as the Winter Report demonstrates, there are many other structural barriers to the assumption of corporate control by a takeover bidder, including codetermination. The introduction of norms drawn from any single model are likely to upset the equilibrium of these systems. Interdependency and co-evolution within corporate governance systems means that alterations to one aspect are likely to have consequences in others. Further, differences between corporate governance systems mean that the introduction of new 'extrinsic' norms are likely to produce differing results in different systems.

In this context, an assumption that harmonisation of capital market regulation along UK lines was desirable and would not have an impact on other corporate constituencies was questionable, and, it is submitted, led to the failure of the third draft of the directive as proposed following the Winter Report.

¹⁵⁷ See, for example, *The Financial Times*, 20th December 2001 and 27th February 2002

¹⁵⁸ Hansmann, H and Kraakman, R, ("The End of History for Corporate Law" (2000) *Discussion Paper No 280 Harvard Law School Centre for Law, Economics and Business (Olin Center)*) expect convergence on a shareholder value model without intervention as competitive pressures drive legislators to create an attractive environment for capital investors.

viii) *A Compromise is Reached*

When it became apparent that agreement would not be reached on the third draft of the directive,¹⁵⁹ a compromise text was presented by the Italian Presidency at the European Council of 26th and 27th November 2003.¹⁶⁰ The compromise text essentially makes the proposed prohibition on defensive measures and the proposed break-through rule optional. Article 11A(1) allows Member States to reserve the right not to apply Articles 9(2) and (3) and Article 11 to publicly-listed companies “having their registered office on their territory.”¹⁶¹ Article 11A(2) obliges Member States which exercise this option to give companies with their registered office in their territory the right to apply those articles. Further, Article 11A(3) states that Member States may exempt companies which apply these articles (presumably either as a matter of national law or as a matter of choice) from applying them “if they become subject to an offer launched by a company which does not apply the same Articles as they do”. This would presumably also apply where a bid is launched by a company incorporated outside the European Union, since by definition they would not apply articles from the Takeover Directive.¹⁶²

The Council voted unanimously to adopt the compromise, with the abstention of the Spanish delegation.¹⁶³ The Commission did not support the compromise text.¹⁶⁴ The compromise accepted by the Council should also be seen in the light of the many amendments proposed by the Parliament, including in particular an opt-out from Articles

¹⁵⁹ *The Financial Times* (19th May 2003) reported German opposition to Article 9, which prohibited defensive measures, and Nordic opposition to Article 11 which allowed for break-through against multiple voting rights.

¹⁶⁰ See Council of the European Union Interinstitutional File 2002/0240 (COD) (15476/03 DRS 106 CODEC 1702). At the time of writing the text of the compromise has not been officially published.

¹⁶¹ The adoption of the *lex loci incorporationis* in preference to the *siège réel* as the connecting factor is notable in light of the difficulties posed for national systems of company law by EC provisions on freedom of establishment, discussed in chapter five. There is no doubt that this injects a degree of certainty into the directive. It also raises many interesting questions as regards regulatory competition which lie beyond the scope of this thesis. For example, the US literature (see further chapter 4, footnote 213 and the sources cited there) suggests the competing hypotheses that Member States might compete to attract incorporations by allowing managers to entrench themselves and that the need to attract investors might prevail.

¹⁶² This provision seems to allay the oft-repeated fear of the Parliament concerning the lack of a level playing field with the US as regards takeover regulation. It should also be noted that Article 11(4a) provides that “equitable compensation must be provided for any loss incurred by the holders of... rights” which are affected by breakthrough.

¹⁶³ See Conclusion of 2547th Meeting of Competitiveness Council (15141/03) at 9-10

9 and 11, and its continuing insistence on a discrete right to information and consultation for employees in the takeover context.¹⁶⁵ On 16th December 2003, the Parliament voted to accept the compromise text.¹⁶⁶

Protection of Employee Interests Through Existing European Labour Law?

The second and third drafts of the takeover directive consistently ruled out defensive measures by the board as a means of protecting the interests of the employees, and both the Winter Report and the Third Draft Directive claim that sufficient protection for employees is already provided by various labour law directives. It is therefore appropriate to consider briefly the operation of the three directives, 94/45/EC, 98/59/EC and 2002/14/EC in the takeover context in terms of their effectiveness in protecting employee interests, both explicit and implicit.

i) The Works Council Directive¹⁶⁷

The EWC Directive, the successor to the failed Vredeling proposal, is a political stakeholding measure, which requires transnational employers to inform and consult their employees where they "are affected by their decisions".¹⁶⁸ It recognises that European integration is likely to result in the consolidation and transnationalisation of enterprises, and proposes that cross-border information and consultation procedures must be developed if "economic activities are to develop in a harmonious fashion".

¹⁶⁴ *ibid.* See also the comments made by Commissioner Bolkestein during the Parliamentary debate on 15th December 2003.

¹⁶⁵ The report produced for the Parliament by its rapporteur (A5-0469/2003 FINAL) included (in Amendment 23) a proposal for an article 11a in terms broadly similar to that included in the adopted compromise. See also PE 327.329/Amendments 415-431 of 9th October 2003 - of particular note are Amendments 422 and 423, which sought to delete Articles 9 and 11 on the grounds of subsidiarity; Amendment 427 which sought to supplement the reference to existing EC employee information and consultation measures in Article 13 with a provision permitting Member States to require companies to inform and consult employee in good time before any takeover; and Amendment 428 proposed that Article 13 should state that "The boards of the offeror and offeree company must inform and consult the representatives of their respective employees, or where there are no such representatives, their employees themselves in a detailed and comprehensive manner in sufficient time before and during all stages of the takeover."

¹⁶⁶ Parliament voted by 321 votes to 219 to adopt the compromise, with 9 absentions.

¹⁶⁷ 94/45/EC, OJ L 254/64, 30/09/1994

¹⁶⁸ Preamble

The Directive potentially has an effect before the takeover where the target is a community-scale undertaking. The right of employees to information and consultation before completion of the takeover will then depend on whether the target has a Works Council agreement (whether made pursuant to the directive, or pre-dating it and covered by Article 13). Where the absence of a negotiated agreement means that the default provisions contained in the Annex come into effect, the Works Council has a right to an annual meeting with central management, and to be informed and consulted, *inter alia*, on "substantial changes concerning organization, introduction of new working methods or production processes, transfers of production, mergers, cut-backs or closures of undertakings, establishments or important parts thereof, and collective redundancies."¹⁶⁹ Depending on the timing of the bid, this might encompass information and consultation relating to the takeover, although as noted above, it is unlikely that the bid will be sufficiently specific as regards its consequences.

In addition, management is required to inform the Works Council where "there are exceptional circumstances affecting the employees' interests to a considerable extent, particularly in the event of relocations, the closure of establishments or undertakings or collective redundancies".¹⁷⁰ The Council then has a right to demand a consultative meeting on the matter. Again, the value of this provision depends upon disclosure by the bidder of his post-takeover plans. Both sets of provisions are aimed at facilitating protection through collective bargaining, rather than allowing employees to influence the fate of the proposed action.

If the offeror already has a Works Council, the target company's employees presumably come within its scope after completion. It is unlikely to be tailored to the precise circumstances of the target's employees. If the offeror does not have a Works Council, its taking control of the target¹⁷¹ will trigger an obligation to establish one if the acquisition

¹⁶⁹ Para 2 of the Annex to the Directive.

¹⁷⁰ *ibid*, para 3.

¹⁷¹ Art 3(2) presumes that the "controlling undertaking" can exercise a "dominant influence" where it "(a) holds a majority of that undertaking's subscribed capital; or (b) controls a majority of the votes attached to

takes the combined enterprise over the threshold of 1000 employees in all Member States, including two establishments in different Member States, each employing at least 150 people.¹⁷² In this case, the employees of the target company will bargain alongside the offeror's employees. If the enterprise remains based solely in one Member State, Directive 2002/14/EC should be considered instead.

ii) The General Information and Consultation Directive¹⁷³

The "GIC" directive makes provision for information and consultation with the dual aims of making employees aware of the need for adaptability and employability,¹⁷⁴ and of "promot[ing] employee involvement in the operation and future of the undertaking and increas[ing] its competitiveness."¹⁷⁵ The second aim seems to reflect to some extent a productive coalition model of the firm. However, the main thrust appears not to be to encourage the development of firm-specific competencies, but rather consultation with a view to "offsetting the negative developments or their consequences [arising from change anticipated by the employer] and increasing the employability and adaptability of the employees likely to be affected."¹⁷⁶ In other words, the main goal of the directive is remedial in the sense of giving employees more notice of change, brought on by global competition, which will adversely affect their interests. The directive envisages that its assistance in anticipating change will be an improvement on the "a posteriori approach" adopted by the rules in place for employee information and consultation at Community and national level.¹⁷⁷

The employer is obliged to provide information to the employees' representatives on "the recent and probable development of the undertaking's or the establishment's activities and

that undertaking's issued share capital; or (c) can appoint more than half of the members of that undertaking's administrative, management or supervisory body."

¹⁷² Art 2(1)(a).

¹⁷³ Directive Establishing a General Framework for Informing and Consulting Employees in the European Community: 2002/14/EC, OJ L 80/29, 23.3.2002.

¹⁷⁴ As discussed in the Gyllenhammar Report (Interim Report of the High Level Expert Group on the Economic and Social Impact of Industrial Change)

¹⁷⁵ Preamble paragraph 7

¹⁷⁶ Preamble paragraph 8

¹⁷⁷ Preamble paragraph 13

economic situation"; to inform and consult them on "the situation, structure and probable development of employment within the undertaking or establishment and on any anticipatory measures envisaged, in particular where there is a threat to employment"; and to inform and consult "on decisions likely to lead to substantial changes in work organisation or in contractual relations, including those covered by the Community provisions referred to in Article 9(1) [including the Collective Redundancies Directive]."¹⁷⁸ The Directive requires that "the timing, method and content [of the consultation]...are appropriate". It should occur "in such a way as to enable employees' representatives to meet the employer and obtain a response, and the reasons for that response, to any opinion they might formulate" and "with a view to reaching agreement on decisions within the scope of the employer's powers".¹⁷⁹ Non-compliance with, or infringement of, these requirements will be met by appropriate sanctions put in place under the law of the Member State.¹⁸⁰

a) Application of the GIC Directive in the Takeover Context

The GIC directive clearly obliges incumbent management to inform and consult employees where the offer document indicates that the bidder intends to dismiss some employees. An obligation would also arise where, before the takeover is completed, management anticipates that some dismissals are likely, for example, where the financial arrangements underlying the bid suggest cost-cutting will be necessary. Arguably, the incumbent board should also consult where they consider that the bidder is unlikely to honour the employees' implicit contracts, if it is accepted that the reference in Article 4(2)(c) to "contractual relations" embodies explicit contracts while "work organisation" refers to implicit contracts. One might go even further and insist that once management becomes aware that the company may be a takeover target, for example where the share price drops below the net asset value of the corporation, they should consult with the employees as just discussed about the increased risk to their positions from predators.

¹⁷⁸ Art 4(2)(a), (b) and (c)

¹⁷⁹ Art 4(4)(a), (d) and (e)

¹⁸⁰ Art 8(1) and (2)

If this interpretation of the incidence of management's obligations to inform and consult is correct, then Article 6(1) of the draft takeover directive, which requires the board to notify the employees "as soon as the bid has been made public", effectively sets out the latest time at which the board may inform the employees. If the board are aware of the bid before it is made public, they may decide to inform the employees before publication of the bid. Of course, any employee representatives who are informed and consulted in this way will be bound by a national law obligation of confidentiality under Art 6(1) of the GIC Directive. However, since such a bid would not be hostile, it seems unlikely that management would choose to inform the employees. This illustrates the difficulty with the assertion in the current draft of the takeover directive that the GIC directive applies to takeovers. The GIC directive envisages an adversarial process, whereas in a hostile takeover situation, the procedure is likely to be more consensual, because of the well-documented identity of interest between management and employees. The directive does not appear to have been drafted for application in this rather exceptional situation, and many of its provisions do not make sense in this context. For example, Art 6(2) allows the Member States to provide that the employer is not obliged to "communicate information or undertake consultation where the nature of that information or consultation is such that, according to objective criteria, it would seriously harm the functioning of the undertaking or establishment or would be prejudicial to it." There is also the logical difficulty that, in the takeover context, there is little point in consulting the employees "with a view to reaching an agreement"¹⁸¹ on the use of managerial prerogative, when that prerogative will be truncated by the takeover directive's prohibition on defensive measures by the board. Similarly a strong obligation to inform does not have much effect where the "employer" does not have access to the relevant information. For these reasons, it would be more appropriate and convenient to spell out explicitly in the takeover directive the precise parameters of the employees' rights to information and consultation in the takeover situation.

¹⁸¹ Art 4(4)(e)

iii) *The Collective Redundancies Directive*¹⁸²

The CRD was designed to protect the rights of employees in the event of the rationalisation of the enterprise for which they work. Along with the Acquired Rights Directive, it forms part of the "industrial restructuring" legislation enacted by the EEC during the 1970s in response to the economic climate during that period.¹⁸³

The Directive is triggered by the dismissal of at least 10 employees, or, in larger establishments, at least 10% of the workforce. Where the employer is "contemplating collective redundancies he shall begin consultations with the workers' representatives in good time with a view to reaching an agreement."¹⁸⁴ The Directive establishes an important labour law dialogue between employer and employee in the situation where collective redundancies are contemplated. It might be considered a limited political stakeholder measure on the basis that, although employees are not given decision-making power, they are informed about the reasons for the decision and consulted about ways of mitigating its harmful effects. In productive coalition terms, Deakin and Armour argue that the CRD (and also the ARD) "give[s] employees important process rights on events which may have a significant impact on the value of their firm-specific human capital, or on their entitlements to share in quasi-rents."¹⁸⁵

However, the directive will not apply in the takeover situation until the bid is completed. First, the offeror does not become the "employer" until the bid is completed, and incumbent management is unlikely to have access to their plans. Second, if they follow UK practice, offerors will confine disclosures in the offer document to a statement that they intend to respect the employees' contracts, delaying application of the directive until after the bid in any event. Third, even if the offeror states that some redundancies may be necessary because of duplication of work in the enlarged organisation, it would be

¹⁸² The original directive was 75/129/EEC, OJ L 48 (1975), p.29. The directive was amended in 1992 and became 92/56/EC, OJ L 245 (1992), p.3. The consolidated version is 98/59/EC, OJ L 225 (1998), p.16.

¹⁸³ Lyon-Caen, "Subsidiarity" in Davies, P, Lyon-Caen, G, Sciarra, S, and Simitis, S (eds), *European Community Labour Law: Principles and Perspectives: Liber Amicorum Lord Wedderburn* (1996), 49 at 58

¹⁸⁴ Art 2(1); the workers' representatives are defined by the laws or practices of the Member State in question: Art 1(1)(b).

¹⁸⁵ Armour, J and Deakin, S, "Insolvency and Employment Protection: the Mixed Effects of the Acquired Rights Directive" (*ESRC Working Paper 2002*) at 12

difficult to argue that such redundancies are actually "contemplated", because until the offeror's management takes control of the target, it will not be possible to spell out in any detail the extent to which redundancies will be necessary. In short, any projected redundancies would arguably be too nebulous to be "contemplated".

Since it can only take effect after the bid, the directive is unlikely to protect the employees' implicit contracts. Where wide restructuring is contemplated, and implicit contracts are particularly threatened, incumbent management is also likely to be removed and replaced by new management who feel less obliged to honour the commitments of their predecessors. Thus while this directive may mitigate some of the effects of collective redundancies, it will not inspire confidence in employees that any reliance they place on implicit undertakings from management will be safeguarded in the event of a hostile takeover bid.

iv) Voluntary Protection of Employee Interests by Companies

In its Green Paper on Corporate Social Responsibility,¹⁸⁶ the Commission suggests that socially responsible adaptation to change should form part of the "internal" dimension of a company's corporate social responsibility. Acting responsibly in a reconstruction situation may assist the company with its "objectives of reducing costs, increasing productivity and improving quality and customer service". The reason that these goals are often not achieved is because restructuring operations "often cause the motivation, loyalty, creativity and productivity of the employees to suffer." According to the Commission, socially responsible restructuring:

"means to balance and take into consideration the interests and concerns of all those who are affected by the changes and decisions. In practice the process is often as important as the substance to the success of restructuring. In particular this involves seeking the

¹⁸⁶ COM (2001) 366 final, 18.7.2001 at 8-10

participation and involvement of those affected through open information and consultation."¹⁸⁷

This may be seen as an attempt by the Commission to persuade companies voluntarily to introduce political stakeholding measures in order to temper the consequences of its agency-orientated takeover directive. Alternatively, it may be seen as encouraging companies to publicise the implicit commitments that they make to their employees so that the reputation mechanism makes compliance more likely.

After the Green Paper consultation, the Commission published the results in a Communication.¹⁸⁸ It argues that CSR will assist the development of the knowledge-based economy,¹⁸⁹ although the exact way in which this will occur is not specified. However, it is then argued that voluntary initiatives are more appropriate because the aim of an enterprise is to make a profit for its owners and accordingly improve the welfare of society.¹⁹⁰ These two positions appear to be contradictory, since there is no recognition that in a knowledge-based economy, the employees' non-transferrable skills contribute to wealth-generation. The Commission refers to "market-oriented yet responsible behaviour",¹⁹¹ which seems to be referring to "prudential" CSR in the sense of a management tool to assist with the problems of bounded rationality. CSR becomes more important as "knowledge and innovation become increasingly important for competitiveness, [and] enterprises have a higher interest in retaining skilled and competent personnel."¹⁹² The Commission refers to the role of voluntary initiatives in creating "an atmosphere of trust within companies, which leads to a stronger commitment of employees and higher innovation performance."¹⁹³ CSR is given a very broad scope as far as employees are concerned: "CSR relates to quality employment, lifelong learning,

¹⁸⁷ *ibid* at 10

¹⁸⁸ COM (2002) 347 final, 2.7.2002

¹⁸⁹ *ibid* at 3

¹⁹⁰ This takes a narrow view of wealth creation; see Blair, MM, *Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century* (1995) at 203-4

¹⁹¹ COM (2002) 347 final at 5

¹⁹² *ibid* at 6

¹⁹³ *ibid* at 8

information, consultation and participation of workers."¹⁹⁴ The difficulty is that while voluntary measures may contribute to developing trust, the legal prohibition against management taking defensive measures in order to protect a productive coalition which was contained in the various drafts of the takeover directive would have made the vulnerability of non-binding arrangements very clear to all concerned. Presumably, the Commission will continue to push for voluntary CSR measures despite its defeat on defensive measures in the takeover directive.

¹⁹⁴ *ibid* at 19

Convergence is Not the Only Hypothesis: Varieties of Capitalism

"It is not possible to conclude on the basis of economic analysis alone that there is a unique set of optimal rules that are universally applicable to all corporations and economies, just as there is no single political constitution that is universally best for all nations."¹⁹⁵

The picture presented by the "varieties of capitalism"¹⁹⁶ approach to political economy, which is sympathetic to institutional variation, is more complex than that of the agency model. Drawing on the insights of systems theory, it counsels against wholesale importation of norms from one area of one political economy to a nominally equivalent area of another. This caution is based not only on the complementarities which exist between, for example, systems of corporate governance and underlying relations of industrial production, but also on the very different roles which are played by apparently similar mechanisms different political economies.¹⁹⁷ Differences in the organisation of political economy cannot simply be explained in historical and cultural terms.

This complements the discussion of the models of the company developed in part one: the differences between the UK and Germany in terms of takeover regulation (and corporate governance structures more generally) reflect different underlying models of the company and different productive strengths. This is not to say that the laws in question necessarily formed part of a conscious implementation of the models. Laws may be put in place for a number of reasons, whether in response to the changing needs of the productive economy or as public choice measures where the regulatory process is captured by a sectional interest group. Yet legislative choices made long ago condition the institutional structure, including the legal framework underpinning the system of

¹⁹⁵ Becht, M, Bolton, P, and Rowell, A (2002) (*supra* note 18) at 58

¹⁹⁶ See in particular the collection edited by Hall, PA and Soskice, D, *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (2001)

¹⁹⁷ Conversely, very different mechanisms may be functionally equivalent.

corporate governance, and make the configuration of each political economy unique.¹⁹⁸ This path-dependency¹⁹⁹ then limits the range of viable future changes because the institutions which constrain and offer incentives to actors increasingly operate in a mutually complementary manner as they move towards a stable productive equilibrium.

In order to generalise these patterns of institutional complementarity, the varieties of capitalism literature draws a broad (and admittedly, not uncontroversial) distinction between liberal market economies (LMEs), in which co-ordination and resource allocation are determined "primarily via hierarchies and competitive market arrangements",²⁰⁰ and co-ordinated market economies (CMEs), in which "firms depend more heavily on non-market relationships...to construct their core competencies... [which] generally entail more extensive relational or incomplete contracting...."²⁰¹ The difference between these two types is one of degree and emphasis. With the development of institutions (in response to the needs of firms or for other reasons), these tendencies tend to become self-reinforcing as firms "gravitate towards the mode of coordination for which there is institutional support."²⁰² Firms which do not take advantage of the available institutional structure will either never come into existence, or will fail, or will now relocate to a jurisdiction which offers a more institutionally-appropriate environment.

All parts of the system are interdependent because they have co-evolved and are in (fairly) stable interaction. In LMEs, an agency conception of corporate governance tends to have evolved alongside and pursuant to the demands of an arm's-length system of corporate finance, which is based on dispersed shareholders and market-led lending, backed up by important provisions of public information disclosure; this kind of financing system requires liquidity and so demands a productive system based on

¹⁹⁸ There may be some "loose convergence" in the sense that while "institutions are not exactly replicated across advanced economies, there exist functional equivalents." (Amable, B, "Institutional Complementarity and Diversity of Social Systems of Innovation and Production" (2000) 7 *Review of International Political Economy* 645 at 647)

¹⁹⁹ See Roe, MJ, "Chaos and Evolution in Law and Economics" (1996) 109 *Harvard Law Review* 641

²⁰⁰ Hall, PA and Soskice, D, *Introduction to Varieties of Capitalism* (2001) at 8

²⁰¹ *ibid*

²⁰² *ibid* at 9

employees having general, redeployable skills allocated through market contracting, allowing firms to construct and dismantle competencies quickly in line with market demand. Within this type of system, competitive advantage stems from "radical innovation" or lower labour costs. By contrast, the more relational approach to questions of corporate governance in the CME complements a system of financing which tends to be more long-term with less public disclosure; this more "patient" framework allows companies to rely on firm- or industry-specific skills, and leads to a system of industrial relations which relies heavily on dialogue and joint decision-making, and in which the market plays less of a role in resource allocation than governance structures such as internal job markets. This type of system is considered to generate "incremental innovation", and draws its competitive advantage from "diversified quality production" rather than wage costs.

In contrast to agency theorists' expectations of convergence,²⁰³ the Varieties of Capitalism approach expects diversity to persist because of the role it plays in sustaining the competitive advantage of different political economies.²⁰⁴ While regulatory competition may be expected to lead some companies to relocate away from CMEs in search of lower costs (a "Delaware effect"), many firms will not do so because "firms are not essentially similar across nations".²⁰⁵ A reduction in wage costs may not be sufficient to compensate for the loss of "competitive advantages [arising] from the institutions in their home country that support specific types of inter- and intra-firm relationships".²⁰⁶ Hall and Soskice argue that firms based in LMEs are more likely to relocate to lower-burden jurisdictions because they "already coordinate their endeavors using the market structures that less developed nations usually provide, while [CMEs] often pursue

²⁰³ Hansmann, H and Kraakman, R (2000)(*supra* note 158)

²⁰⁴ However, in a recent paper, Lane offers a more pessimistic view, noting a tendency towards convergence of corporate governance systems on the LME model, with negative consequences for labour. In particular, the changing demands of the financial system, supported by powerful actors within firms and the political system, has "fundamentally changed the logic which governs relations". Since "hybridisation" (a mixture of market and non-market co-ordination) is a temporary state, this movement will "spill-over" into other dependent parts of the system, restoring complementarity, but centred on the demands of the financial system. (Lane, C, "Changes in Corporate Governance of German Corporations: Convergence to the Anglo-American Model?" (2003) *ESRC Centre for Business Research, University of Cambridge Working Paper No 259*)

²⁰⁵ Hall, PA and Soskice, D (2001) (*supra* note 196) at 56

corporate strategies that rely on high skills and institutional infrastructure difficult to secure elsewhere."²⁰⁷

The normal criticism of this dichotomy is that while it adequately differentiates Germany and Japan from the US and the UK, it does not account so well for France and Italy, for example.²⁰⁸ Despite these criticisms of the descriptive merits of its dominant categorisation, the varieties of capitalism approach is an important counter-weight to agency theory in the context of an analysis of the takeover directive. As an approach grounded in systems theory, it recognises that the imposition of a one-size-fits-all takeover regulation on differentiated systems of industrial organisation will have important consequences for the stability of those systems.²⁰⁹ Accordingly, the introduction of takeover regulation must be expected to have implications for the broader system of corporate governance. To approach the issue on the basis that it only affects capital markets is too simplistic because "the introduction of more competition in the financial system threatens the stability of long term relationships."²¹⁰ The introduction of a takeover directive premised on agency model considerations would have undermined those corporations which rely on more relational systems of governance. Whether a less relational model will be more efficient depends on a whole host of interlocking factors, including, in particular as far as employees are concerned, the extent of firm-specific investments in human capital, and their importance to competitive advantage. With a recognition that every firm is relational to some extent,²¹¹ comes the conclusion that the efficiency of corporate governance arrangements cannot be measured *in abstracto*. The

²⁰⁶ *ibid*

²⁰⁷ *ibid* at 57; this of course is not to suggest that firms might not relocate certain divisions according to the logic of cost-cutting or acquiring specific skills only available elsewhere.

²⁰⁸ Amable, B (2000) (*supra* note 198) at 669.

²⁰⁹ Casper, "The Legal Framework for Corporate Governance: The Influence of Contract Law on Company Strategies in Germany and the United States" in Hall, PA and Soskice, D (eds), *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (2001), 387 at 414: "The legal system is not an autonomous institution. Rather the character of laws is strongly determined by the broader configuration of the political economy. An institutional complementarity exists between the legal system and the system of business coordination within the economy."

²¹⁰ Amable, B (2000) (*supra* note 198) at 658

²¹¹ Hall, PA and Soskice, D (2001) (*supra* note 196) conceive of the firm as a bundle of "core competencies" or "dynamic capabilities" which are kept in place through framework which may be more or less relational. The relational nature of the firm means that it suffers from co-ordination problems which should be met by the development of appropriate governance arrangements.

imposition of regulation aimed at reducing agency costs between management and shareholders will not necessarily increase efficiency where it does this either at the expense of massively increasing transaction costs by requiring contracts to be more fully presentiated, or at the expense of employees' willingness to make firm-specific investments in the first place.

The vulnerability of institutional complementarities, and the system as a whole, to non-evolutionary reforms has important economic policy implications. It should

"preclude any sort of 'institutional tinkering' that some politicians have in mind when they mention the absolute necessity of reforming a specific area of the economic system (for example, liberalizing the financial system, making the labour market more flexible). Changing one element of the system may have consequences well beyond the area concerned and threaten a certain pattern of complementarity."²¹²

The reason that the takeover directive faced such opposition and took so long to be adopted is that it ignored these complementarities. Its focus on providing rights to financial capital, and accompanying denial that this had broader implications, threatened to undermine productive coalition governance arrangements. Hall and Soskice suggest that the imposition of "high levels of regulatory homogeneity on the member-states would be to compromise the institutions and firm strategies on which national comparative advantages depend."²¹³ The Fifth Company Law Directive was not acceptable because it attempted to impose a German-style stakeholder-orientated board structure and a conception of the company going beyond the agency model on all Member States regardless of context.²¹⁴ In the same way, the takeover directive attempted to impose a capital market logic on all Member States regardless of the way in which their economies are organised. Despite the insistence of the drafters in each case,

²¹² Amable, B (2000) (*supra* note 198) at 658

²¹³ Hall, PA and Soskice, D (2001) (*supra* note 196) at 54

²¹⁴ Ebke, WF (1997) (*supra* note 1) at 975-7. These differences have characterised the company law harmonisation programme from the beginning as "each Member State felt the specificities of its own system were not properly appreciated by the Brussels lawmakers, and would unnecessarily disappear in the

complementarities in political economy mean that one issue, such as takeover or board structure cannot be looked at in isolation from all others. The dangers posed by the takeover directive to national systems of productive organisation were reflected in the high level of opposition to it. If the third draft had been introduced, it would have been likely to hinder those corporations across the EU which rely on firm-specific skills, in particular in the increasingly important service sectors of all the EU Member States. Furthermore, by undermining employees' willingness to make firm-specific investments, it would have contradicted the goal set by the Lisbon European Council for the European Union "to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion."²¹⁵

The compromise which has been adopted will no doubt be criticised by agency theorists for failing to introduce a market for corporate control and for allowing management to entrench themselves. However, it might be defended on the grounds that it is appropriate to provide Member States with a menu of options to choose from. Viewed in this way, the takeover directive is another measure of reflexive harmonisation, which is sensitive to the diversity of the Member States' systems of productive organisation. It is capable of encompassing systems of takeover regulation based purely on agency model considerations, as well as systems which seek to reflect productive coalition considerations.

Conclusion on the Takeover Directive

Leaving aside considerations of industrial consolidation, an agency perspective on corporate governance suggests that the takeover directive which was enacted will not achieve anything. A prohibition on defensive measures was needed in Europe because hostile takeovers have not yet sufficiently inculcated shareholder value in European management. Prohibiting defensive measures would have been the essential catalyst to

harmonization process." (Lannoo, K, "A European Perspective on Corporate Governance" (1999) 37 *Journal of Common Market Studies* 269 at 270)

²¹⁵ Lisbon European Council Conclusions, 23rd-24th March 2000, para 5

kick-start the pursuit of shareholder value in corporations across the whole EU. The failure of the directive to include such a provision means that the takeover directive will not drive European capital markets towards "maturity", i.e., dispersal of shareholders, diversification of investors and an increased use of lower transaction-cost adaptive mechanisms, like stock options, which further prioritise shareholder value on a system-wide basis.

If the Commission, with its insistence that the takeover directive was purely a capital market measure dealing with the accountability of management to the holders of share capital, had prevailed, the takeover directive would have exercised a strong gravitational pull upon the systems of corporate governance in all Member States. The British experience suggests that the introduction of a market for corporate control would have caused a shift away from managerialism towards an agency model, and focused management's attention squarely on creating shareholder value. However, a system of takeover regulation based on the agency model alone would have been highly controversial and caused systemic instability for those Member States' systems of corporate governance which include productive coalition or political stakeholding considerations. This is because, as we have seen in this chapter (and the two which preceded it), managerial decision-making in the takeover situation is not necessarily qualitatively different, and therefore cannot be separated, from broader issues of corporate governance. Thus, the introduction of takeover regulation based on an agency model of the firm would not have caused any further "irritation"²¹⁶ to a system of corporate governance which is broadly orientated around neoclassical conceptions of the firm, such as the British one. However, where institutions of corporate governance exist to produce and underpin an equilibrium around a productive coalition model, the introduction of norms drawn from an agency model would have caused serious systemic disturbances. The diversity of corporate governance systems across Europe means that the flexibility offered by the 'compromise' takeover directive should be interpreted in these terms and welcomed.

²¹⁶ Teubner, "Legal Irritants: How Unifying Law Ends up in New Divergences" in Hall, PA and Soskice, D (eds), *Varieties of Capitalism* (2001), 417

Conclusion

Until recently, corporate governance debate remained polarised between the agency model of the corporation, which insisted that companies had the narrow aim of enriching their shareholders, and the political stakeholder model, which insisted that they ought to take a wider range of interests into account. The choice was a straight dichotomy between efficiency and democratic considerations. An intensive conflict between the two models ensued, and the subsequent failure of the political will to make changes in support of industrial democracy led to the triumph of the agency model, and the relegation of political stakeholding to voluntarism.

Or so it seemed. Recent work on corporate governance has built on the insights of institutional economics and relational contracting to challenge many of the assumptions on which the normative arguments of the agency model rest. In particular, the assumption that employees are protected by fully “presentiated” contracts looks like an oversimplification at best, and increasingly anachronistic in modern productive conditions. Market-based contracting is less and less appropriate as a basis both for developing the competencies which firms need to compete, and for ensuring continuity of supply of increasingly specialised factors of production. Accordingly, the productive coalition model suggests, more sophisticated, consensual governance is not only appropriate, but essential in conditions of globalisation and increased competition.

The main difficulty created by the emergence of this new, more complex paradigm of the company is that, unlike its predecessors, it does not yield easy prescriptions. One-size-fits-all governance is not appropriate for the differentiated, modern, service-orientated corporation. It might be argued, as Margaret Blair does, that the law already provides a sufficiently flexible system, as company law offers a default governance structure as a public good. Looked at through the lens of company law alone, corporate governance is basically managerialism, that is, co-ordination and exercise of discretion by central management in response to the firm's environment, subject only to the minimal control of the general meeting. Managerialism is certainly one route by which a productive coalition

may be sustained, with management mediating between the demands of the various constituencies, although the "classic argument" about the dangers of managerial unaccountability has been well rehearsed.

The second, more conflictual, route would see all those with incomplete contracts represented at some level of the corporate hierarchy, whether management or supervisory board, or some new organ. The political difficulties of achieving such radical change have been highlighted by the recent definitive shelving of the EC's Fifth Company Law Directive. Movement in the direction of interest group representation is now limited. Employers are now subject to information and consultation obligations towards their employees, and these may turn out to be powerful procedural rights in the event of threats to firm-specific human capital. They may also formalise an opportunity for the articulation of employee interests in the decision-making process.

Finally, voluntaristic measures of Corporate Social Responsibility may offer a way for a company to "operationalise" its reputation. However, the lack of formal representation within the corporate decision-making structure suggests that conceiving of management as mediating hierarchs appears to be the simplest way in which the law might support the increased allocative efficiency promised by the productive coalition model. The well-documented systemic tendency towards managerial unaccountability may be countered by the grant of procedural rights to the various constituencies to articulate their interests in the rent-seeking process, and perhaps even to monitor management.

Most agency theorists do not address the theoretical claims of the productive coalition model, let alone address empirical matters. They simply assert that adequate protection is already available through existing mechanisms, such as reputation and collective organisation on the part of employees. They do not offer a qualitative reason why employees should have to rely on informal or self-constructed mechanisms for the protection of their interests while shareholders receive company law as a "public good". Their refusal to address systematically the claims of the productive coalition model is

unsatisfactory, particularly as agency model considerations justify the market for corporate control and its related "adaptive mechanisms".

While the letter of the law has remained managerialist, corporate governance outside law has gradually become "shareholder value", as the post-hostile takeover era witnesses the alignment of managerial incentives with the interests of shareholders and the development of other market pressures, which compel management to focus on the share price. From an agency perspective, these changes are heading in the right direction, albeit that recent corporate scandals have demonstrated that the short-term share price is not necessarily an optimal proxy for measuring the creation of shareholder value, and a more sophisticated system is needed to ensure that managerial remuneration actually reflects achievement. From a productive coalition perspective, however, these changes are a disaster. They undermine management's neutrality, and so reduce their ability to make credible commitments to employees about their future treatment. This in turn makes employees less willing to make the "sunk", co-specialised investments which are needed to generate quasi-rents and maximise the wealth of society. This decline in the level of trust, which means that contracts must become more explicit, raises transaction costs across the economy as a whole. The likely result is the "de-institutionalisation", or "marketisation", of the corporation, which becomes ephemeral and able to expand and contract at will, but at the price of a reduction in efficiency as corporate participants become less specialised to their functions. The corporation comes to resemble a spot market on which commodities are traded rather than a framework in which investors cooperate for mutual benefit. Certainly, in the short term, returns to shareholders are enhanced as the capital markets put pressure on management to allocate "spare" cash flow to investors. Yet there must be a danger that this process simply "hollows out" corporations, replacing networks of skilled individuals, who interact and develop with each other, with unskilled, commodity labour, undermining tomorrow's productive capacity to achieve today's desired distribution.

The agency model was pushed hard in the UK and the US in the 1980s, and takeover laws in those countries are testament to what occurred there. In the UK, the regulatory

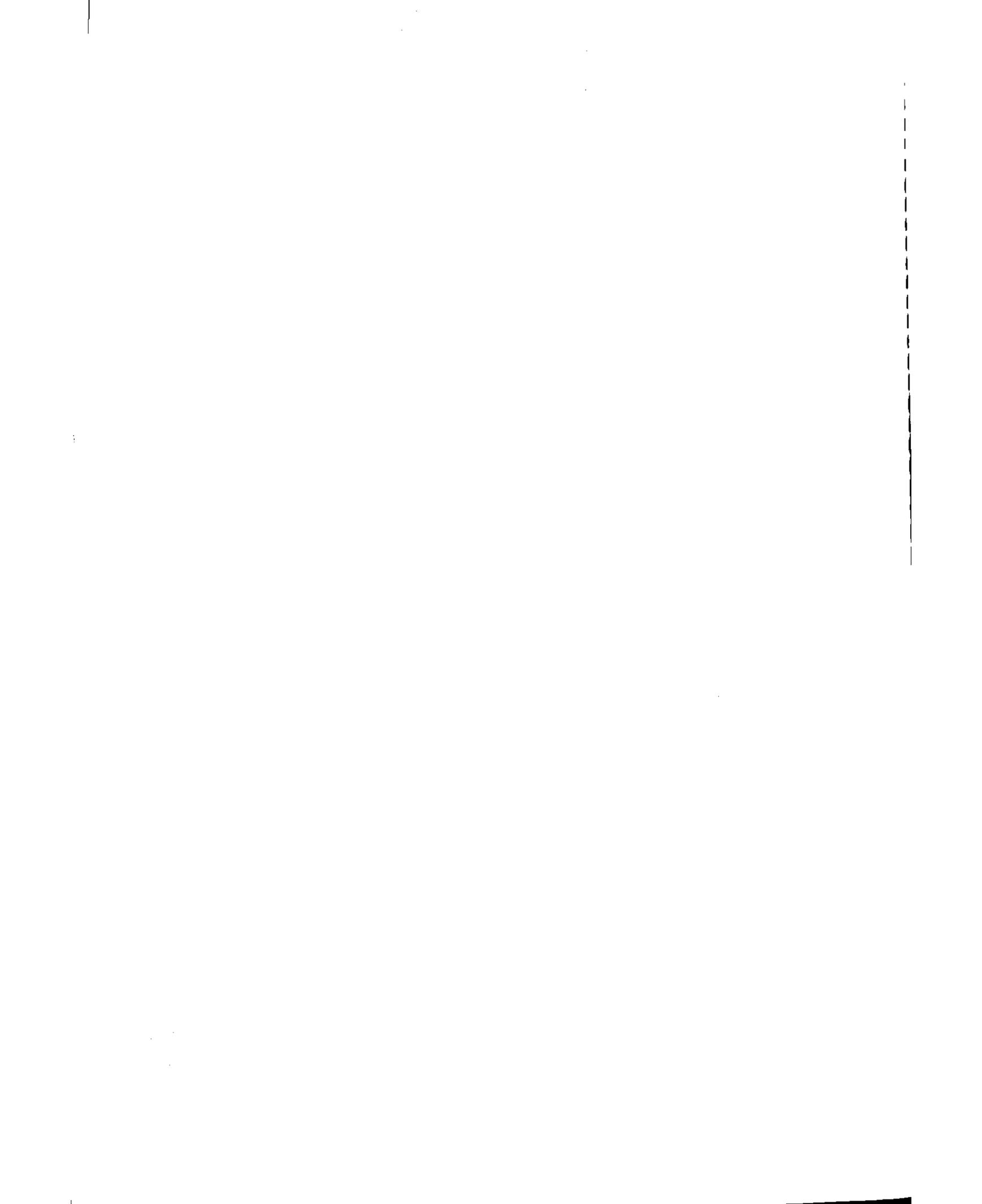
process was captured early from the courts and has remained in private hands ever since. The US witnessed a more dynamic regulatory process as the states responded to threats to employment within their jurisdiction with increasingly powerful antitakeover laws. This then generated a counter-reaction from the capital markets, in which managerial contracts were adapted to reflect the capital market's demands, linking the bulk of their remuneration to short-term movements in the share price. Compared with the hostile takeover, this was a relatively low-cost and unspectacular step, which has gradually spread to the UK too. Once the neutrality of managerialism had been undermined by the capital market's hostile takeover mechanism, adaptive mechanisms were a cheaper and more "friendly" way of carrying out restructuring and redistributing wealth from human capital investors to financial capital investors.

In many countries in Europe, a model more akin to a productive coalition has held sway, albeit to different degrees. The institutional configuration of each country's political economy reflects its history and politics, and ultimately contributes significantly to its competitive advantage. Capital markets have traditionally played a minor role in monitoring management, this role being played by various coalitions of insiders. Recently, however, pressure has been increasing for the introduction of agency model norms into this picture. The Commission's steadfast commitment to an agency-model Takeover Directive clearly illustrates the increasing normative influence of capital market considerations. Meanwhile, market actors are urged by the Commission to take into account the "social" aspects of their actions in codes of conduct and similar documents.

Arguments in favour of takeover regulation reform emphasise that, as a capital market measure, it may be compartmentalised, having no "spill over" effects on other corporate constituencies. These assertions rest on agency model assumptions of contractual completeness and a belief that the political stakeholder model may be confined to voluntarism without any adverse effect on efficiency. However, changing the role of management to make them more accountable to shareholders at the expense of employees and creditors is very risky where corporate governance has been based on a productive coalition model. The introduction of an "irritating" extraneous norm risks alienating the

latter constituencies, and the destruction of trust will make the long-term supply of human or loan capital far more expensive, or even impossible. Meanwhile, the US and UK experience suggests that the new favoured constituency will actually become the "least productive stakeholder" – a net withdrawer of equity capital – at least so far as established businesses are concerned.

This thesis has demonstrated that Anglo-American takeover regulation, adaptive mechanisms and the general system of corporate governance strongly support shareholder interests. In the UK and the US, a public policy choice has been made to allow shareholder interests to take priority over those of other constituencies. During the evolution of the takeover directive, it was proposed that that policy choice should be generalised across the EU. This thesis has demonstrated that the possible adverse consequences of doing so require that the arguments for and against be made with more clarity and in more depth, in particular taking into account the insights of the productive coalition model.



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