MARKET DYNAMICS IN CORPORATE GOVERNANCE:

LESSONS FROM RECENT DEVELOPMENTS IN ENGLISH LAW

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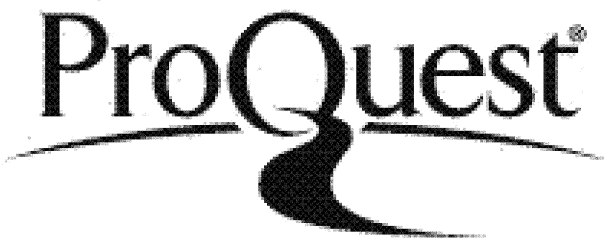
Submitted for Ph.D. in Law at the London School of Economics



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Abstract

It is one of the key insights of economics that markets always adjust. Any change in law will change the way the game is played; the market has no obligation to accomplish the aim of the law, it will attempt to maximize interests within the constraints of that law. This thesis will focus on three areas of corporate law: 1) minority rights, 2) secured credit and 3) insolvency.

Minority Rights. This chapter argues that a) there are valid reasons for concentrated ownership and b) a much better indication of the control afforded by corporate law is the control premium. Control confers a premium under any system; in a dispersed shareholding, it falls to the managers, in a concentrated shareholding, to the majority shareholders. The legal method for controlling majority shareholders is through derivative suits, or in the UK, unfair prejudice suits.

Secured Credit. The academic literature in the field has cast doubts on the efficacy and desirability of secured credit (particularly the seminal article by Bebchuk and Fried). This chapter argues that most arguments against secured credit are flawed, excepting perhaps the case for the priority of tort creditors.

Insolvency. This chapter analyses the changes to UK insolvency law ntroduced by the Enterprise Act 2002. This chapter argues that the changes do little to change the UK into a "rescue culture" although it can perhaps be argued that the changes do weaken the liquidation bias. It concludes that the current UK insolvency regime appears to shift the balance of power in the direction of unsecured creditors.

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Chapter 1
Introduction

To some, the corporation has emerged as the last super-villain. These days, it need not even machinate; its executions can be committed in plain sight. Possessing unnatural powers, potentially immortal, certainly immoral, the corporation is the bedrock of all that is wrong with Westernized civilization. Walk the shelves of any bookstore and, in the business section, slightly beyond the display shelf of inspirational biographies of retired CEOs, adjacent to the shelf containing parables of animal displaying sound business attitudes, you will find a selection of volumes (suspiciously written by what looks like only a handful of people) accusing corporations of taking over democracy, impoverishing the Third World, and infecting the general moral countenance of the world. The fundamental argument is the same: separate legal personality and limited liability have made for a system that produces creatures without moral restraints, driven only by greed. (As one early anti-corporatist put it: corporations have no soul.) Legal witchcraft has produced the closest thing we have to flesh-eating zombies (or, if you like, legal technology has produced the real killer tomatoes).

However, those books mentioned above share their space with Micklethwait and Wooldridge (2003: xv) who state in their history of the company, without much reservation, that "[t]he most important organization in the world is the company: the basis of the prosperity of the West and the best hope for the future in the rest of the world." There is no necessary conflict between these two viewpoints. The corporation has, from its very inception, been recognized as a necessary evil. The creation of a

"fictional", legal personality has always seemed a little, as it were, inhuman and the notion of limited liability has always seemed somewhat perfidious. The corporate form is tolerated primarily because it is so profitable. The corporate form appears more prone to attack now because recent scandals have illustrated how internal conflicts in the corporate form itself can impair its profitability.

A strand of academic thinking has attempted to describe the company as a "nexus of contracts", however, I would suggest that the company is best understood by examining precisely how it differs from a collection of individually negotiated contracts. A sales contract in a bazaar requires no "corporate governance" because it is conducted between two principals, and consummated instantaneously. Nearer to the company, we have closed-end investment funds, that state clearly the limitations on future funding, the return to each investor and the fund managers, as well as the scope of the investments. Even with the corporate form, there are venture-capital funded companies, which are tightly controlled by the venture-capitalists (VCs are the ultimate institutional investors), again with strict limitations on management activity and future funding. With the availability of so many alternative forms, we are left with the rather unsatisfying conclusion that there must be some kind of efficiency to the corporate form, despite its loose rules concerning management conduct, shareholder rights, and uneasy relationship with creditors.

The General Theme

Markets adapt. Markets compensate for whatever restrictions are put on them, continuing to maximize profit, if not necessarily welfare, to their participants. But it is

facile, perhaps even misleading, to speak of "markets". What we are really talking about is people. Given the right incentives, people can be very ingenious in solving problems. Economics is strongest when it is dealing with easy problems (e.g. open markets, sufficient parties, clear property rights, enforceable, simple contracts): it is weakest when it has to deal with innovation. (Ingenuity is hard to predict.) What the economic process at its most interesting comes down to, though, is ingenious people solving difficult problems.

This is how Friedman generalizes the Coase theorem: "If transaction costs are zero- if, in other words, any agreement that is in the mutual benefit on the parties concerned get made- then any initial definition of property rights leads to an efficient outcome".[1] A strong (perhaps too strong) corollary of this would be: the main impediment to the proper functioning of markets is unclear property rights and uncertain contract enforcement. However, one can point out that there is one standard solution to this problem: use strong rights to compensate for weak rights. We can cite two examples of this in action:

Example. Libertarian economists, such as David Friedman and Robert Ellickson have produced several books and articles arguing that it is possible to have an efficiently working society even without government. Friedman (1984, 1989) describes a system of private enforcement in Iceland in the Middle Ages, where order was imposed by the institution of bounty hunting. Ellickson (1991) describes rules generated in communities where learning the law is too costly, leading members to

invent their own informal norms, with their attendant punishments. In both cases, people can use their own limited enforcement abilities (hiring bounty hunters in Friedman's case, social ostracism in Ellickson's case) to emulate legal solutions.

Example. A more mundane example would be Islamic banking. Islamic financing is distinctive because it needs to overcome restrictions in the Koran, principally the prohibitions against riba (interest) and gharam (excessive risk). The prohibition against riba means that most conventional forms of debt-financing are not possible. Islamic financiers, however, have use three forms of financing to overcome these impediments. Islamic debt is structured in three ways: 1) murabaha, a type of hire-purchase agreement, where the financier buys the equipment, leases it to the borrower, and accepts payment, with a "profit" (characterized as a payment for risk), at the end of the specified period, 2) ijiara, or leasing and 3) istisna, a contract where the financier builds (or hires someone else to build), typically an infrastructure project, such as bridges and buildings, for the borrower, who then pays for it, with a markup. (Maurer 2005)

However, in most of these cases, there will be limits to how far the "strong" rights can be made to compensate for the "weak" rights. The interesting questions concerning these types of structures are: 1) What are the limits to the compensation? 2) What *can't* be done under these "alternate" structures that can be done under more

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[1] http://www.davidfriedman.com/Libertarian/The_Swedes.html

conventional rules? 3) How does the necessity of having to use these "innovative" schemes distort the incentives of market participants?

Or, to phrase the question another way, what are the deadweight costs of using such structures? The analogy is, of course, to monopolies. A simple understanding of monopoly is that any loss suffered by the consumer is offset by the gain to the monopolist. However, economic analysis would suggest there is a deadweight cost, as the monopolist has an incentive to produce lower amounts of the good than would be socially optimal. In the same manner, one can ask about economic systems that have some "weak" and some "strong" property and contract rights: what types of projects will not be funded, what projects would be inefficiently funded, and, in general, how would incentives be skewed under that system?

Example. Some recent work has argues that even though China has weak law enforcement and property rights, projects can still be funded because of the strength of the 'guanxi' (personal connection networks). (Wang 2001) However, as many studies on China report, such a system is not conducive to arms-length financing, which impedes the development of stock and bond markets. As McGregor (2005:125) puts it: "Guanxi, the oft-cited Chinese word for relationships or connections, is overrated, temporary, nontransferable, and resides in the hands of the individual that has it. Never, ever put your business in the position where you are dependant on one individual for access to government officials." This system also makes it difficult to develop an entrepreneurial culture, as

such a system requires the entrepreneur to have significant social and political capital before she can obtain financial capital.

Most studies of corporate governance follow a simple format: they will specify a set of criteria for "good" governance/corporate law, ranging anwhere from 5 measures (La Porta, Lopez de Silanes, Shleifer and Vishny 1998) to 86 measures (Cheung, Connelly, Limpaphayom and Zhou 2005), and then correlate this with measure for a "strong" equity or debt market, usually measured by ownership concentration, debt/equity ratios, stock market capitalization (as a percentage of GDP) or public (that is, bond) debt ratios. The problem is that it is not simple to specify what is a "good" law and it is equally difficult to describe a "strong" market. Take for example, strictness of corporate laws: it has been argued that in jurisdictions where minority shareholders are likely to be disadvantaged, corporate law should require that nearly all corporate decisions require supermajority (Black 2000), however, it has also been argued that a reason for the vibrancy of the corporate form in America is ability of companies to choose the elements of corporate governance they find most appropriate (Romano 1999). Is restrictive corporate law a "good" or a "bad" thing? It is clear that the appropriate choice of law would depend highly on the specific situation.

There are simply unavoidable internal conflicts within the corporate form, especially in public companies. These are worst in companies that exemplify "arm's length" investment: dispersed shareholders as well as dispersed bondholders. Corporate governance, at least "financial" corporate governance (as opposed to a "stakeholder" concept that may include employees, suppliers and customers, among

others) can be characterized in terms of three conflicts: 1) managers against shareholders, 2) majority shareholders against minority shareholders, and 3) creditors against shareholders (we can also include a fourth that usually occurs in bankruptcy: 4) unsecured creditors against secured creditors).

In this thesis, I will examine corporate and bankruptcy laws across a number of jurisdictions and attempt to answer two questions; 1) How should corporate and bankruptcy laws be characterized as "weak" or "strong"? and 2) Given that the market can adapt to relative weakness in certain rights, what effect does that arrangement have on financing in that jurisdiction? This thesis, then, extends the current literature in corporate governance by moving the question: "Does strong corporate law lead to strong financial markets?" to a detailed exploration of the question: "What, in fact, constitutes a strong law or a strong market?". This thesis is meant for policy makers, as it intends to complement the current literature with two additional concerns: while it is surely desirable to improve all types of laws and rights, given that resources are limited and existing structures can adapt and often are already adapted to overcome certain problems, what problems exactly does a country with a weak set of certain laws face? What laws should it concentrate on improving?

This thesis will examine these corporate governance issues in three substantive sections:

1) What does it mean to have "weak" corporate laws? Which corporate laws are important? How are they important? It is widely argued that standard methods of compensating for "weak" corporate laws are ownership

concentration and the use of debt. How does the widespread use of these two methods affect the financing pattern of that economy? Are there businesses that are inadequately funded?

2) What does it mean to have "strong" secured transactions laws? These is a current academic debate on the proper scope for secured transctions. It is clear, at least, that strong secured creditor rights do not necessarily benefit all parties. Who benefits from secured transaction rights? How does this affect financing in an economy?

3) What is "strong" insolvency law? There are scholars arguing strongly on both the side of Chapter 11 type insolvency law and "liquidation-prone" insolvency laws. Who benefits under each type of system? How does the market adapt to the insolvency regime? Specifically, how is capital use affected by the insolvency regime?

Methodology

Corporate law is often a delicate matter. Legal analysis requires making extremely minute distinctions between situations. As such, it is difficult to make meaningful empirical studies of corporate law, as the level of aggregate data necessary for scientific plausibility often requires these distinctions to be glossed over. Econometrics is frequently, and rather frustratingly, too clumsy a tool for the study of corporate law. This thesis is an attempt at clarity. It is an investigation into the nature

of how capital markets and capital users (i.e. companies) adapt to changes in corporate and insolvency laws. This thesis presents a middle way: while it recognizes that it is simplistic to categorize most corporate laws as either "good" or "bad" (corporate laws shift the deployment of capital is certain directions), it also takes the view that these laws may also distract capital from its most valuable use.

As Diamond (2005: 17) puts it, when "confronted with the problem of acquiring reliable knowledge without being able to resort to replicated controlled experiments", then: "A frequent solution is to apply what is termed the "comparative method" or the "natural experiment"- i.e. to compare natural situations differing with respect to the variable of interest." Because natural experiments are extremely rare and social experiments in general are too complex to be replicated in a laboratory setting, economic argumentation tends to be inductive. That is, we have little choice but to draw analogies between situations that we think we understand and attempt to apply the conclusions to novel situations. To maintain a level of rigor, these arguments should be empirically testable, however, to quote Sutton (2000: 92):

> the bulk of empirical work in economics is not concerned with theory-testing as such. Rather, such work is investigative in nature. The aim is to try fitting some model with a model with a view to uncovering the mechanisms that are driving outcomes in a particular data set. A to-and-fro process may develop between such investigations and the development of theoretical models.

This thesis is part of a "to-and-fro"-ing process. It takes the current available empirical research and searches for alternate explanations that may be more powerful than current hypotheses can provide. Most of the argumentation takes econometric corporate governance studies and asks if qualitative studies of the relevant laws may yield deeper or subtler insights into how these results were reached. Many parts of this

thesis are calls for further research and collections of additional data that may provide deeper insight into these questions. As such, some parts of this thesis may seem speculative. This viewpoint is expressed splendidly by Nozick (2001: 114):

> The fact that our theories reach farther than our data shows how far extended the reach of our theories is- a cause for celebration, not for lament. To be sure, the further we reach, the more our theories become susceptible to being wrong or being overthrown in new ways. (Recall, though, that the observational data presuppose the regularities and incorporate the theories that evolution has instilled.) However, the further we reach, the deeper our understanding goes. This deeper understanding also points toward new obtainable data that, when gathered, makes less shaky some previous moves beyond the then existing data.

Corporate Governance: an overview

Before we begin a discussion of the three main conflicts, it must be mentioned that all three conflicts can be mitigated by greater disclosure. Appropriate action can only be taken if the affected parties are informed. Disclosure, however, is not a panacea; adequate remedies must also be available.

1. Managers and Shareholders.

This is the standard Berle/Means (1933) problem: with dispersed shareownership, it is difficult to unite sufficient shareholders to constrain managers, whether through voting or lawsuits, effectively giving control of the company to the managers. In the US, this has been the dominant type of conflict in recent scandals. However, many of the reforms (including the Sarbanes-Oxley Act) may be focusing on the wrong aspects of corporate governance reform.

A. Board composition. Several studies have shown board composition to have minimal correlation with firm performance. (Romano 1999) In facts, most books on board design recognize that there is an necessary tension in board composition: the board must a) understand the business and b) maintain a cordial relationship with management. The main issues in board composition are then practical and personal, rather than legal and structural. (See, for example, Carter and Lorsch (2004), Garratt (2003), MacGregor (2000).)

B. CEO compensation. While excessive CEO compensation has received intense criticism, in most cases the level of CEO compensation does not affect the performance of the company. This is not to say that the issue should not be addressed. In their masterful discussion of the topic, Bebchuk and Fried (2004: 210-213) argue for reforms in corporate law and securities regulation that would allow shareholders more power in selecting and removing directors. (Note, however, Rajan and Wulf (2004) which finds that many managerial perks can genuinely be explained as improving managerial productivity.)

C. Director liability. The most obvious legal solution to any problem is to make those deemed responsible legally liable for any misconduct. However, in the case of director liability, this has proven ineffective. In a study of four common law countries

(Australia, Canada, Britain and the USA) and three civil law countries (France, Germany, and Japan), Black, Cheffins and Klausner (2005) found that, despite the varying standards of liability between these jurisdictions, directors rarely have to pay out-of-pocket. (In jurisdictions where liability is often found against the directors, i.e. the USA, they are protected by insurance.)

However, this does not mean that all corporate governance measures are irrelevant to firm performance. Bebchuk, Cohen and Ferrell (2004) have proposed an "entrenchment index" which they demonstrate have significant negative impact on firm valuation. The entrenchment index is composed of six provisions (staggered boards, limits to shareholder bylaw amendments, supermajority requirements for mergers, supermajority requirements for charter amendments, poison pills and golden parachutes). They find that the provisions contained in this index are the only provisions in the broader (24 provision) Institutional Investor Research Center (IRRC) index that economically and statistically significantly affect firm valuation and stock returns.

It could then be that instead on focusing on rigid rules on board composition or compensation, or legal actions against directors, corporate governance reform should focus on making boards more responsive to shareholders. A good starting point would be to weaken provisions that insulate boards from removal.

2. Majority and Minority Shareholders

Minority shareholders are unable to use the voting procedures of corporate law to protect their interests. As such, majority controlled companies are prone to majority shareholders extracting private benefits of control, that is, benefits that are not shared with the minority shareholders. This can be viewed as a trade-off. Majority shareholders have the power and incentives to closely monitor management so there is less risk of manager expropriation. (Holderness and Sheehan 2000: 165) This is again a necessary evil: managerial control can fall either with managers or the majority shareholder; the advantage of it falling with the majority shareholder is that the majority shareholder has stronger incentives to create value for the company.

Gilson and Gordon (2003) provide a useful taxonomy of private benefits of control. They separate the means of obtaining benefits into: a) benefits from operating the company, b) sale of control at a premium and c) freezing out of minority shareholders. Chapter 1 of this thesis will deal in depth with the issue of regulating private benefits of operating the company.

3. Shareholders and Creditors

Creditors can exercise control over a company in two principal ways: a) ex ante- by selectively lending only to companies that meet specific criteria and b) through the threat of bankruptcy. Bankruptcy law can distort investment incentives. For example, the American Chapter 11 system is said to favor debtors, which should raise the cost of debt capital. Any study of bankruptcy has to keep in mind, however,

that bankruptcy systems basically come in only three forms: a) auction, b) third party controlled administration and c) debtor controlled administration.

No system is demonstrably superior to the others. So far, there has not been any cross-jurisdictional studies detailed enough to compare these systems satisfactorily. A series of papers (Eckbo and Thorburn 2000, 2004, Thorburn 1999) has argued for the Swedish auction style system, but Bris, Welch and Zhu (2004) would seem to indicate that in the US, Chapter 11 (debtor-led administration) is more efficient than Chapter 7 (auction). Chapter 3 of this thesis provides an analysis of recent reforms in UK insolvency proceedings.

4. Unsecured Creditors and Secured Creditors

These two groups come into conflict primarily in bankruptcy. While there is a nearly universal trend to expand the scope of security, a substantial academic literature has developed questioning the desirability and efficiency of secured credit. Chapter 2 of this thesis argues that secured credit is, for the most part, efficient and argues further that attempts to weaken secured credit should be very selective.

This thesis is motivated by the combination of three strands of thought: 1) the structural causes of the Asian crisis, 2) the sequence of papers produced by La Porta, Lopez-de-Silanes, Shleifer and Vishny explaining the causes and consequences of financial structure around the world and 3) recent theoretical developments in corporate and insolvency law. Particularly, this thesis aims to apply insights from the theory of corporate and insolvency law to issues raised by the Asian financial crisis,

and in so doing, demonstrate that many econometric studies, such as those by LLSV, are misleadingly simplistic.

The Asian Crisis

The last decade has been a busy one for macroeconomists. First a succession crises in Latin America (the 'tequila' effect) then a contagious meltdown of the entire East Asian region (previously the darling of economists). The perplexing part of the Asian crisis is, however, the fact that it cannot be explained in terms of common macroeconomic variables. Notably, pre-crisis, all of the so-called Tiger economies had balanced budgets, a budget surplus, and decent to ample foreign reserves (Corsetti, Pessotti and Rubini 1999, henceforth referred to as CPR). The Asian crisis pointed to the fact, while not exactly novel to macroeconomists, at least one not previously studied in depth, that macroeconomic crises could have micro causes and that these causes are strongly related to a field often mentioned but rarely explicitly studied in economics: the infrastructure of an economy.

The superficial cause of the Asian crisis is clear: rapid exodus of capital from the region triggered by a devaluation of the exchange rate. In the early days following the crisis, two main explanations were put forth: the contagion theory, which held that investors, not fully rationally perhaps, were alarmed into reacting drastically, escalating the event into a crisis (e.g. Sachs and Radelet 1998) and the 'soft rot' theory, which pointed out that there were many fundamental problems with the region that were due to be addressed by an outflow of capital and the crisis was simply an unavoidable, albeit extreme, result of fundamental flaws in the East Asian economic system (most clearly expressed in CPR). More recently, both sides of the economic

debate have reached a kind of compromise, as Sachs summarizes: 'the crisis was built on national weaknesses that were greatly magnified by a flawed international financial system'. (Sachs and Woo 2000)

Even before the crisis, a small minority of economists were already warning that East Asian growth was bound to wane. Studies by Alwyn Young (Young 1992, 1995), popularised by Krugman in Foreign Affairs (Krugman 1994), argued that growth in Asia came largely from increased inputs, that is more mobilisation of natural resources, labour, and capital, and that actual productivity growth had actually been rather low, no higher than in developed countries (or in the case of Singapore, dramatically lower- 0.2%). As inputs cannot increase indefinitely, Young and Krugman warned, Asian growth will eventually have to slow. This becomes dramatically apparent upon examination of data from the crisis period. Hussain and Radelet report that export growth slowed significantly in 1996-1997 in all of Tiger economies (except the Philippines). (Hussain and Radelet 2000) One main reason for the export slowdown was an erosion in cost competitiveness caused at least in part by rising wages. As Hussain and Radelet put it: 'if productivity gains lag behind wage hikes, firms will begin to lose their competitive position, and neither export growth nor job growth can be sustained.' In general, though, the problem with Asian economies in the period directly preceding the crisis was, concisely: high growth, low productivity. According to Lewis: 'In much of the Asian manufacturing sector, profitability levels were below the real cost of capital, and some were in decline.' (Lewis 2000) Such growth is clearly unsustainable as new projects cannot pay for themselves but are instead funded by previous profits.

How did this situation develop ? Or to put it in economic parlance, how could the market allow such inefficiencies to happen ? If we address the question of misallocation of resources in detail, we have to note that the Asian situation prior to the crisis consisted of two related, but separate factors: a) excessive and imprudent lending by financial institutions and b) poor corporate governance.

Weaknesses of the financial system. The East Asian financial system was basically a relationship-based system (therefore undisciplined by the market) further driven by the perception of government support (moral hazard).

Financial systems can broadly be distinguished into two types: market-based (arms-length) or relationship-based. Market-based systems are characterised by significant portions of the financing in the economy coming from a vibrant capital market, e.g. the US and UK. Market-based systems work with investors acquiring information regarding the company from extensive mandated disclosures enforced (usually) by securities commissions. Relationship-based systems are characterised by a reliance on bank-financing, with limited recourse to capital markets, e.g. Germany and Japan. (There are, however, significant differences in German and Japanese financing structures. These will be explored later.) In relationship-based systems, banks act as information gatherers and therefore usually have nearly exclusive financing relationships with their clients.

East Asian economies are markedly relationship-based. Following the crisis, coming at a time of American economic triumphalism, this has come under increasing criticism. As the Economist mentions: 'One of the most striking features of the past

decade is that most of the arguments in favour of German or the Japanese models of corporate governance seem to have vanished.' However, there are sound reasons for a relationship-based system. Aoki argues that relationship systems are better at a) acquiring tacit information about a business and b) enforcing contracts extra-judicially. (Aoki 1998) Banks play a part in assessing tacit information not readily digestible by markets even in the US. In economies where disclosure is not reliable, however, and courts are not trusted to enforce contracts, relationship systems may be inevitable. Rajan and Zingales point out that major weakness of relationship systems is the absence of mark-to-market price signal information, which means capital may be allocated by banks in an inefficient manner because it does have the market to monitor its lending. (Rajan and Zingales 1999, henceforth referred to as RZ) The argument, therefore, is that pre-crisis, when capital was abundant and relatively cheap (due to fixed exchange rates), Asian banks, because unmonitored by the market, were led into lending where perhaps more prudence was called for.

This leads to the moral hazard argument (put forward strongly post-crisis by Krugman among others)- that banks lent easily because they perceived that governments would not let them fail. (Krugman 1998) East Asian governments certainly had a record of bailing out major banks in previous bank failures. Even in cases where banks had been allowed to fail, as in Thailand, rapid pre-crisis growth led the government to lend tacit support to borrowings from foreign currencies via the Bangkok International Bank Facility (BIBF) by promising full banking licenses to foreign banks based on the volume of BIBF lending. (Hanna 2000) According to this viewpoint, the perception of being 'too big to fail' coupled with poor prudential norms

throughout the region led banks to overextend themselves, in particular by risky investments in real estate. (Roy Ramos, 1999, Clarke 2000)

Another aspect of overextension arises from nearing bankruptcy or being undercapitalised. If agents (in this case banks) perceive that they have little to lose or their previous commitments are unsound and are likely to bankrupt them, they have an incentive to take high-risk projects, that is, projects that have a high, but unlikely, payoff, as they stand to gain if the project succeeds but do not have much more to lose if the project fails. (Goodhart, Hartmann, Llewellyn, Rojas-Suarez, and Weisbrod 1998: 48-50) Sachs neatly summarizes the situation in a discussion of Latin American banks:

> Under-capitalised banks have incentives to borrow abroad and invest domestically with reckless abandon. If the lending works out, the bankers make money. If the lending fails, the depositors and creditors stand to lose money, but the bank's owners bear little risk themselves because they have little capital ties up in the bank. Even the depositors and the foreign creditors may be secure from risk, if the government bails them out in the case of bank failure. (Financial Times, July 30, 1997)

RZ speculate that one of the causes of the Asian crisis was that investors accustomed to arms-length systems invested in relationship-based systems without full awareness of the differences between the system. As the discrepancies in disclosure and accountability became apparent, investors fled back into the safety of their arms-length systems. (RZ 2000)

Weaknesses in corporate governance. Rohwer wrote, pre-crisis 'The biggest flaw in the success stories of modern Asia- including Japan- has been their failure to develop the transparent and objective public institutions needed to run the more

sophisticated societies and economies that their fabulous economic growth is producing.' (Rohwer 1996: 18) Scott, in a study of corporate governance in East Asia, reached the conclusion that the major flaws were twofold: a) a weak or nonexistent notion of fiduciary duty and b) inadequate disclosure. (Scott 1998) There are two main types of corporate governance problems: i) managerial agency problems and ii) outright tunnelling.

Managerial agency is probably the fundamental problem arising from the separation of ownership and control, put simply, the interests and incentives of the people who run the corporation and the people who own the corporation are different. (Jensen and Meckling 1976) Fundamentally, the problem is that managers do not necessarily act in such a way as to maximize shareholder value, instead using company resources for their own purposes, such as managerial perks (e.g. the proverbial corporate jet) or empire building (increasing the size of the company or department with no regard for profitability). The problem is exacerbated when shareholders are dispersed and uncoordinated, therefore leaving control of the corporation firmly in the hands of managers. (Berle and Means 1933)

In East Asia, ownership of corporations is concentrated. Studies have shown that, perhaps because concentrated ownership (where the majority owner is also the manager of the corporation) limits the managerial agency problem, concentrated companies tend to be valued higher than dispersed companies in East Asia. (Claessens, Djankov and Lang 2000) However, this only holds in the first decades of the company; as the company matures, concentrated ownership tends to hurt share value (this could be due to limits to growth or the problem of succession).

Concentration does not mean that the company is without managerial agency problems. In concentrated companies, the majority owners do not have any incentive to protect minority interests. Majority owners have two ways to benefit: they can increase share price, in which case they will have to share the gains with minority holders (which might still be worth it) or they can exclusively benefit from their role as managers. Empirical data shows the more the mismatch between control and ownership (cash flow) rights, the lower the firm is valued. (Claessens, Djankov and Lang 2000) CPR notes- 'as suggested by the head of research in a Thai brokerage house: "there is in practice no clear divide between investment and consumption in Thailand... For example, one very clear example of overinvestment has been in five-star or equivalent hotels. Every family business empire feels it just has to have one, and to out-do its friends or enemies in outfitting it luxuriously."' (CPR 2000)

'Tunnelling is defined as the transfer of assets and profits out of firms for the benefit of their controlling shareholders.' (Johnson, La Porta, Lopez-de-Silanes and Shleifer 2000) Tunnelling could be said to be an extreme form of the corporate agency problem. The transfer of assets and profits out if the firm can be both legal and illegal. Legal systems that do not have strong protection of minority shareholders or creditors can actually allow legal tunnelling, e.g. the issuance of new shares at a discount to a select group or a sale of company assets at a discount.

One explanation for the suddenness (magnification) of the crisis is the fear of tunnelling. The reasoning is that, while the firm is profitable and these gains are reflected in the share price, owner/managers have an incentive to keep increasing firm profitability, however, as the economy downturns, there is an increasing incentive for

owner/managers to gain privately at the expense of the firm. (Johnson, Boone, Breach 2000) Therefore, companies are fine when the going is good, but bad effects (loss of profitability) are exacerbated because investors fear tunnelling. Note also that agency effects also apply if a firm nears bankruptcy. As for the case of banks, owner/managers have little to lose when a company nears bankruptcy and therefore have an incentive to take high risk/high return projects.

A study by Mitton supports the case that corporate governance played a significant role in the Asian crisis. In a cross-firm (rather than just cross-country) study, Mitton found that corporate governance, as measured by three factors, disclosure quality, ownership concentration, and diversification, had a clear impact on the extent to which companies were affected by the crisis, with companies with better governance of course showing much better stock performance both during the crisis and recovering from the crisis. (Mitton 2000)

In summary, one can say the Asian crisis was caused by imprudent banks lending to irresponsible companies. However, it is clear that one cannot simply blame the managers of these banks and companies or even simply point to Asian business culture as the culprit. Many of the infrastructural defects (ownership concentration, high debt, inadequate prudential norms, susceptibility to tunnelling) were due to institutional underdevelopment, most of which, it will be argued in this paper, can be traced to the legal framework.

Disputing LLSV

As happens when two established branches of learning meet, law and economics have always had uneasy relations. Doctrinal legal scholars, in keeping with implicit tradition, assume omnipotence for the law. Neo-classical legal scholars, assuming equal omnipotence for the (free) market, regard law as usually merely a reflection of the market (Posner) and, when not, a hindrance. This is of course a caricature of the situation, but one, unfortunately, not far from the truth, at least as it stood a decade ago. Now, however, law and economics has become a rather prominent area of study and with more scholars trained in both disciplines, such lines are quickly dissolving.

Most of law and economics is an attempt to use economic logic to explain legal decisions. (See generally, Posner 1992 and Cooter and Ulen 2000) A rarer, but increasingly important field, is a study of how law affects economic decisions. Roe's work on corporate governance is one of the key statements in the field. Corporations in most countries in the world have concentrated ownership; only the US and UK have significant numbers of corporations with dispersed ownership (or Berle-Means corporation- Berle and Means 1933). Roe finds the explanation for the more or less exclusively American rise of the Berle-Means corporation in a (relative) peculiarity of US law, the Glass-Steagall act which basically prevents financial institutions from holding large blocks of shares and to a general suspicion of financial institutions in general. Arguing from cross-country data, Roe basically argues that evidently concentrated ownership is the norm and therefore it must be Glass-Steagall and other anti-financial institution laws that are dispersing ownership in the US. (Roe 1994)

A clear influence on the Roe hypothesis was the interest of American corporate governance scholars at the time in German and Japanese governance systems. Part of the poor US economic performance was blamed on complacent managers who were not being adequately disciplined by shareholders because, so the argument goes, shareholders were too dispersed and therefore could not (because no one shareholder wanted to bear the cost of uniting the group) or had no incentive (because whatever gains one shareholder achieved would be shared among all shareholders) to group together to discipline the managers. Suggestions for improvement included increasing the influence of institutional shareholders and leveraged buy outs (LBOs) which would concentrate ownership and streamline cashflow. (Generally Jensen and Meckling 1976, more specifically Jensen 1993)

But, as many commentators pointed out at the time, while it was true that the US corporate governance system was flawed, it was not clear that the Japanese or German system was any better (an argument more than borne out by subsequent events). In fact, analytically, (such supporters argued) the US system made more sense. As corporations increase in size, individual shareholders become unable to afford large blocks of shares (as Berle-Means argue). From a neo-classical economic standpoint, most clearly stated by Easterbrook, such levels concentration would be costly because diversification reduces risk. Therefore, an efficient economy would be diversified. (Easterbrook 1997) The Easterbrook argument appears to be substantiated by the fact that American corporations have tended to be dispersed even after the removal of the Glass-Steagall provisions. Another interesting counter to the Roe argument is the fact that while the UK does not have a Glass-Steagall act, it still has dispersed ownership (though less than the US).

Probably the most significant papers in the field in recent years have come from a team of economists. La Porta, Lopez-de-Silanes, Shleifer and Vishny (henceforth referred to as LLSV) have published a series of papers demonstrating the importance of legal rights to corporate financing. Their basic methodology, as set out in LLSV 1997 and 1998a, consisted of grouping countries according to their legal origins (common law, French, Germanic and Scandinavian), rating the countries according to a basket of rights deemed to be protective of minority shareholders and creditors, and correlating them with data on ownership concentration, initial public offerings, and valuation of the capital markets (while controlling for population, GNP, and GNP growth). They found common law systems most protective of both shareholders and creditors and countries of French legal origin least protective, with German and Scandinavian origin countries in between. They also found correlations between a) the depth and breadth of capital markets (as measured by market capitalisation and IPOs) in these countries and b) ownership concentration and the protectiveness of their laws, with countries with better investor protection having deeper and broader capital markets and less ownership concentration. (LLSV 1998a, 1999, 2000) These studies have been quite influential, with researchers extending the basic framework into the emerging Eastern European states (Pistor 2000) and using the LLSV legal ratings to explain comparative developments in financial intermediation (Levine 2000).

The LLSV conclusions that legal origins affect current levels of investor protection that in turn affect capital markets are more or less undeniable. But the empirical side of the LLSV studies is not nearly as rigorous as could be desired.

LLSV methodology. Admittedly, law and corporate governance is a relatively new field and therefore not very well defined. This, however, causes serious trouble when empirical research is done, as exemplified by the LLSV studies.

- Legal origin groupings. The demarcation between different legal families is not very clear-cut, not least because many countries adopt laws from more than one source. LLSV do not distinguish different sources of law. LLSV 'classify a country on the basis of the origin of the initial laws it adopted rather than on the revisions'. (LLSV 1998a: 1119) But even this is problematic. For example, LLSV classifies Thailand as a common law origin country, explaining (in a rare case where explanation is actually given) that 'Thailand's first laws were based on common law but since received enormous French influence'. Which far understates the case. Thailand is today a civil law, statute-based country with most of its commercial laws modelled after German and Japanese codes. The common law influence is negligible. A proper grouping of legal origins cannot be so general and would have to identify the origin each particular law in a country with the added caveat that that law might not necessarily be applied in the same way as in its country of origin.

LLSV construct two legal indexes: what they call a) anti-director rights and b) creditor rights.

- The anti-director index. The anti-director index is a sum of the following (that is, the presence of any of the following adds one to the index): 1) one-share,

one-vote, 2) voting by mail, 3) registration of shares before voting, 4) cumulative voting or proportional representation, 5) litigation against management or the option to sellback shares to the company in certain circumstances, 6) pre-emptive rights in a public offering and 7) 10% or lower percentage of shareholding to call an extraordinary shareholders meeting. LLSV do not justify the selection of these 6 factors as an indication of a country's anti-director or minority protection stance. Note also that laws that allow companies to opt out of these requirements do not count toward the index. An argument can be made that, of the six, 1, 2 and 3 are unimportant. Also, because the factors are not weighed, it perhaps obscures the relative importance of certain factors. An odd absence from this list is also the issue of voting requirements for corporate decisions. Black and Gilson (1998) make voting requirements the essence of their proposals for a corporate law protective of minority rights and it does make sense that the most direct measure of how protective a law is for minorities or shareholders against managers is what decisions the management can undertake without consulting the shareholders.

- The creditor rights index. The creditor rights index is a sum of the following: 1) a company cannot file for reorganisation unilaterally, 2) there is no automatic stay on secured assets in a bankruptcy or reorganisation, 3) secured creditors can enforce security before all other creditors and 4) compulsory ejection of management in a reorganisation. Again, the selection of these four factors is not rigorous justified. LLSV themselves point out that 2 and 3 are extremely rare. It is not very clear why 4 would be a definite right in favour of

the creditor (it is certainly a right against the debtor, but could count against the creditor as well). Wood (1997) provides a much more detailed analysis of comparative creditor protection (and discriminates jurisdictions more finely: traditional English, American common law, mixed Roman/common law, Germanic-Scandinavian, mixed Franco-Latin/Germanic, traditional Franco-Latin, emerging jurisdictions, Islamic, and unallocated) and characterises jurisdictions by its approach to the pari-passu rule in bankruptcy. Jurisdictions where courts are more likely to disturb security in a bankruptcy are pro-debtor. The LLSV factors do not take into consideration- a) how likely or how effective a reorganisation is in a jurisdiction and b) how security is to be treated (pace Wood) in the event of a bankruptcy except to extent of factors 2 and 3 which are rare.

LLSV (1998a) also mention 'conspicuous omissions' from their data set: 1) merger and takeover rules, 2) disclosure rules, 3) security exchange regulations, and 4) banking and financial institution regulations. It is odd that LLSV have claimed so much explanatory power for their thesis when these four arguably important factors have been excluded from their study (and indeed other have argued that these four laws are more important than the commercial laws, as will be mentioned in greater detail).

On a more fundamental level, the LLSV reasoning from laws to corporate governance runs: 'Because legal origins are highly correlated with the content of law, and because legal families originated much before the financial markets have developed, it is unlikely that laws were written primarily in response to market

pressures. Rather, the legal families appear to shape the legal rules, which in turn influence financial markets.' (LLSV 1999a) This in itself is a questionable argument. If we assume, as LLSV do, that laws were transplanted 'through a combination of conquest, imperialism, outright borrowing, and more subtle imitation', then we could say that if that law was transplanted because of a) conquest or imperialism, it is clear that colonisation brings with it much more than a legal system- it is certainly not much of a stretch to imagine an entire social and economic system was transplanted along with the legal system or b) borrowing or imitation, then presumably the transplanting country must have reasons for choosing that particular set of laws, not least of which could be the underlying financial conditions. Not to mention a much more interesting question is- why would a country retain a set of laws that damage its economy ?

LLSV results. LLSV measure the effects of law on the following measures: 1) market capitalisation, as measured by average percentage of common shares not owned by the top three shareholders in the ten largest domestic firms in a country (a questionable measure), 2) initial public offerings in the period 1995-1996 (not a representative data set) and 3) debt in firms.

- Market capitalisation. LLSV report their result as 'common law countries provide companies with better access to equity finance than civil law countries'. (LLSV 1998a: 1137) More accurately, however, common law countries provide companies with a higher percentage of external financing than civil law countries. External market capitalisation is not a measure of access to equity finance. A better measure would be cost of equity- that is, the price at which a company can issue equity relative to its value (which, even

then would be an incomplete measure). If, as LLSV claim in a later paper (LLSV 1999a), the data shows instead 'that countries with poor investor protection typically exhibit more concentrated control of firms than do countries with good investor protection', it must be pointed out that concentration of control has as much to do with the level of concentration that is required for control as it is with the benefits of control (which would increase with poorer investor protection).

- Initial public offerings. The data set is clearly not representative. Different countries go through phases of high initial public offerings (for example, Germany in 1998-9 experienced a high IPO during the launching of the Neuer Markt).

- Debt financing. LLSV could not find a systemic difference in debt financing in countries of different legal origins. They reach the conclusion that 'large publicly traded firms get external debt finance in almost all countries, regardless of legal rules'. This conclusion, however, ignores several considerations: a) is there a difference in the level of collateral in different jurisdictions ? b) is there a difference in the rate of interest (cost of capital) in different jurisdictions ?

- Enforcement. LLSV also report that two of their measures, efficiency of judiciary and rule of law, are also strongly correlated to legal origin and to market capitalisation. 'Efficiency of judicial system' is 'assessment of the

"efficiency and integrity of the legal environment as it affects business, particularly foreign firms" produced by the country risk rating agency Business International Corp. It "may be taken to represent investors' assessments of conditions in the country in question".' 'Rule of law' is 'assessment of the law and order tradition in the country produced by the country risk rating agency International Country Risk (ICR)'. There is no explanation for the methodology by which either measure is arrived upon. Also, rule of law, which is quite a strong part of the LLSV argument (particular in LLSV 1999) because it is strongly correlated with market capitalisation, does not appear to have a direct bearing on commercial practices in a country. In other words, a country with weak government could have a low rule of law rating. There appears to be no intrinsic link between rule of law or efficiency of the judicial system and legal origin and no argument is given by LLSV in support of such a link. (There is however a strong correlation between high GNP and good rule of law and efficiency of judicial system.) Any attempt to correlate rule of law and efficiency of the judicial system with legal origins should at least analyse the procedural rules of a legal system to see how they could impact the rule of law or efficiency of the judicial system.

Reasons. LLSV (1999b) give two tentative reasons for why common law countries are more protective than civil law countries.

First is the judicial or 'smell test' reason, which LLSV attribute to Coffee (1999)- which is that common law judges are more likely to look beyond the letter of

law to see the real impact of a corporate action and are therefore more likely to stop tunnelling. However, it is far from clear that common law judges are more pro-minority shareholders than civil law judges, nor is it clear that they should be. Most civil law jurisdictions do have minority protection provisions and these provisions are not particularly narrowly written. In fact in the Johnson, La Porta, Lopez-de-Silanes and Shleifer (2000) article on tunnelling, they mention cases of minority v. majority shareholders that reach the courts in civil law countries but are ultimately rejected. What the examples demonstrated, though, was that in these countries laws did exist that allowed minorities to seek legal redress against majority shareholders and the decisions by the courts in favour of the majority shareholders was not based on a overly literal interpretation of the law, but an interpretation of the law that agreed with the defendant majority shareholders.

Second is the argument in LLSV (1999a) that states have a greater role in regulating business in civil rather than common law countries. This seems to be departing from the legal origin argument, as state involvement does not have to be intrinsic to a legal system. Not to mention it is an argument with a strong neo-classical economics feel to it. Even so, this is far from a general hypothesis, there appears to be no systematic correlation between state involvement and legal origin (or even colonialism). For example, Malaysia and Singapore, both British colonies and common law systems, have two of the most interventionist governments in East Asia.

Conclusions. The LLSV argument can be separated: 1) legal origins influence current law and 2) improved legal protection leads to better capital markets. The first conclusion, thus separated, is rather trivial. A rather more interesting question would

be regarding the countries that do not follow (one could say transcend) the standards of their legal peers. If we take as granted (as LLSV do) the fact that legal standards were transplanted for no inherent reason, then an interesting result would be to identify countries that do not conform to the norm of their legal origins and identify reasons.

The second conclusion is rather more interesting. Note, however, that there is no necessary reason to link it with the first conclusion- it could be that good legal protection regardless of legal origin leads to stronger capital markets. LLSV methodology has two fundamental flaws, however- a) it is not clear which improvements really make a difference in capital markets- the method of summing precludes precision in causation and obscures which variables really matter and b) it is not clear that higher external market capitalisation indicates a healthier capital market, much less a stronger economy.

In general, it is the implicit assumptions in LLSV that damage their results. Regarding ownership concentration, LLSV assume that better minority protections (anti-director rights) would lead to more willingness on the part of minority shareholders to hold shares. However, this disregards one other fundamental factors of concentration- the level of concentration that is required for control. That is, in addition to the benefits of control (control premium), one has to factor in the levels required for control (which are again dictated by law- and totally ignored by LLSV). One would expect jurisdictions in which the shareholding requirement for control is high to have high concentration. Therefore, a better measure for minority rights would be the disparity between the price paid for controlling shares and minority shares, or,

in other words, the control premium- and not the general level of concentration in a country. (Modigliani and Perotti 1998)

As for creditor rights, LLSV assume that better creditor rights would lead to increased lending in a country. However, it is not the amount of lending that would be affected by creditor rights, but the cost of the lending. Creditors will charge higher interest rates or require more collateral to compensate for the higher possibility that they will not be repaid. Therefore the measure of a country's creditor rights should be measured by its cost of debt, not by its amount of debt.

A more fundamental disagreement comes from Easterbrook (and the Chicago School in general) who would argue that the less restrictive the laws the better. A market with LLSV rules would not run efficiently because it would restrict the options available to companies. But a compromise can perhaps be sought in Easterbrook's statement:

'When capital markets are efficient, the valuation process works better; when markets are less efficient, some substitute must be found- law, perhaps, or the valuation procedure of banks.' (Easterbrook 1997: 29)

Other commentators point out that the LLSV argument appears in a historical vacuum. Coffee (2001) and Cheffins (2000) report that in the US and UK respectively, capital market development came when law enforcement was not particularly efficient. Rather, in both countries non-governmental securities commissions arose that guaranteed a level of quality in the capital markets. Rajan and Zingales (2000b) mention that in the period before the First World War continental

stock markets were more vibrant than the US stock market, and only went into decline following a period of controlling external capital flows (even though the commercial laws stayed more or less constant).

It is clear that other, non-legal, factors affect capital market developments as well. Coffee (2000) reporting on the relative success of the Czech stock market as compared to the Polish stock market, countries with similar commercial laws but the Czech with more stringent securities regulations, supports the thesis that capital market regulations and enforcements are more important than commercial laws. Rajan and Zingales (2000) believe the political structure in an economy is as important an impediment as any other structural impediment. Berglof and von Thadden (1999) point out that non-legal structures may develop to limit expropriation, such as social norms or worker participation.

While the LLSV papers have been important, it is clear that an analysis of the interaction between law and corporate governance requires a more detailed and nuanced conceptual structure.

Appendix: Goals of Corporate Governance

What is the goal of corporate governance ? This very fundamental question has proven to be one of the most problematic in the entire field. One could say at its most basic corporate governance is about ensuring that a company is run properly. To determine this, however, one must have a view as to the goals of companies in the first place.

What does the corporation do ? Who does the corporation serve ? These are interlocking questions that need to be answered simultaneously. There are two main viewpoints in this matter: a) shareholders and b) stakeholders.

Shareholders

The classic economics answer. The firm serves the shareholders and its goal should be profit maximisation. The reasoning behind this is, if current shareholders in the firm are not making the firm maximise profit, the firm would be worth more to people who will make the firm maximise profit. That is, the non-profit maximising shareholders should rationally sell the firm to profit maximisers. (See, for example, MasColell 1995: 152-154.) Note, though, that this is a normative not a positive argument

The "only protection" argument. Most economists have argued that the corporation should serve shareholders alone. The argument is that other stakeholders have their own specific devices for ensuring equity: for example, creditors have collateral and workers have unions. Shareholders, on the other hand, have no other way to ensure a

return on their investment other than board representation (Williamson 1985, Grossman and Hart 1992).

Shareholder value. An addendum to this is what has been termed the "shareholder value" movement. Stewart argued in The Quest for Value that focusing on shareholder value (essentially returns to equity- as opposed to sheer profits) resulted in better stock price performance as well as better company performance in general. (Stewart 1990) This viewpoint has proved very influential. The push towards this perspective is a result of the general perception that American companies during the 1980s were focusing on increasing profits and market share without adequate concern for cost of capital (e.g. Jensen 1990).

The "implied contract" argument. As an argument for a single board (as opposed to a German dual board) system, these arguments are valid. Problems arise, however, when proponents attempt to extend shareholder-only protection to other corporate actions, such as takeovers, and insist that the legal system view corporate actions only from the viewpoint of shareholders (e.g. Shleifer Vishny 1998). While we could concede that the company board should maximise shareholder value, it is no so clear that the legal system should maximise shareholder value as well.

If we interpret the shareholder value argument to mean that shareholders, beyond their legal right to board control, should also have rights against company actions that prejudice them, then it is equally equitable that other stakeholders (e.g. employees) have an implied right in their contracts with the company as well. In other words, if a shareholder has an "implied" contract with the company that the company

will not allow itself to be acquired below a certain value, then one can at least claim employees have an "implied" contract with the company that the company will not allow itself to go bankrupt.

Shareholder value and short-termism. Another argument against the shareholder value approach is that it tends to push the company towards short-term behaviour. This type of behaviour is typified by leveraged buy-outs (LBOs), selling off assets to "improve the bottom-line", employee layoffs, and reducing R&D. (Kennedy 2000) An important facet of shareholder value in practice is that it relies on the stock market as the measure of performance. The question of whether the stock market is an adequate measure of corporate performance is an important one and will dealt with in detail later.

Stakeholders

The stakeholder viewpoint takes a broader view of the company. It starts from a more general question: what is the role of corporations in a society ? A basic answer would be that it is a medium for different parties to interact. In this viewpoint, the role of the corporate board, in fact, the very reason for a corporate board, is to mediate between different interests (e.g. Blair 1997) Note that there is actually no overt conflict between this and profit maximisation. Interest mediation can very well be instrumental to company survival. (Fligstein argues that in practice, companies aim for survival, not value maximisation. Fligstein 2001) One could boil this down to a question of perspective- shareholder value as a stated goal tends toward more short-

term while viewing the company as a interest mediator sets its priorities toward the long-term.

Bottom line: a divided company benefits noone. But- bottom line- a company beholden to everyone is beholden to noone. (Stiglitz 1990, Jensen 1999) We are back to the essential problem of corporate governance: agency. While it is clear that focusing on shareholder value is not the solution to all problems (at least in part due to inadequate definitions of "shareholder value"), giving management the leeway to entirely set their own agenda can lead to management abuses of company capital. However, while it is not advisable to group defences against managerial rent-seeking under the sole umbrella of "shareholder value", many devices due exist to curb management excess. It is the interaction of these "constellations of interests" that control companies. (Scott 1998)

Chapter 2:
Ownership Concentration and Minority Shareholder Rights

Introduction

It is no longer fashionable to consider economies either socialist or capitalist. The trend has turned to distinctions between shades of capitalism. Scholars, however, persist in going beyond simple description and often offer judgments on the different systems, at times with an obvious bias. The current split can crudely be characterized as such: on the one hand those that believe the Anglo-American economic system best (or at least better than the rest) and those who believe that European (or at least certain European) and Japanese systems just as efficient as the Anglo-American system. These judgments are not without historical bias- it is the flourishing economy of the moment which tends to be touted as the "best" system. (Lester Thurow among others proclaimed the Japanese system superior in 1990; right on the cusp of its subsequent decline, one might note.)

Distinctions between economic systems can be made in many ways. Labour markets, sources of capital, degree of regulation, etc., all play their part in how an economy is organized. Of these however, one empirical element that stands out is the difference in the manner of shareholder ownership. One of the major differences between the Anglo-American economic system and virtually everyone else is the pattern of shareholder ownership. Anglo-American companies tend to have dispersed shareholders (roughly meaning shareholders holding insufficient shares to control the company) while companies in other systems tend to have block holdings, that is, companies have clear owners (La Porta, Lopez-de-Silanes, and Shleifer 1999). Scholars arguing for the superiority of the Anglo-American system often implicitly

and sometimes explicitly assume the efficiency and naturalness (one could almost say inevitability) of dispersed share ownership. They argue that, as diversification is the most efficient means of mitigating financial risk, shareholders- in a free, efficient market- would choose to have small holdings across many companies. Also, block holdings also impede liquidity- which is also a risk. Block holdings exist because: a) shareholders mistrust managers to the extent that it is in some shareholder's interest to seek the power to control managers directly through share voting or b) block shareholders derive supra-normal profits (beyond other shareholders) from controlling the blocks (known in economic parlance as rent seeking). In other words, systems other than the Anglo-American suffer from inadequate shareholder protection in one or both of the two forms: either insufficient manager control or inadequate minority shareholder protection or both.

This discussion has been afloat for some years now and one of the strongest reasons proposed for the distinction has been that law is the decisive factor. The LLSV papers argue (or at least imply very strongly) that a) ownership concentration is a key distinguishing feature of economic systems and b) legal protection of minority rights is at the core of why this is so. This chapter argues that the LLSV reasoning and conclusions are too simplistic: a) LLSV does not devote enough attention to the causes of concentration (other than poor governance) and b) as a result of their methodology (as discussed above), LLSV adopt a view of law that does not take into account many of the realities of law.

Let me make it clear now that I do not dispute strongly the central argument of the LLSV papers- that there is a correlation between law and share ownership. Rather

I am attempting to correct two misconceptions, which could prove vital in a policy context, that a) concentration is to be avoided and b) legal protection of minority shareholder rights is the solution.

What we shall also explore in this chapter is the dynamic response of the market to laws and their consequences. There are many plausible reasons for ownership concentration, aside from poor corporate law. Some of the proposed reasons, such as a young equity culture (it takes time for companies to acquire dispersed ownership) and taxes (some tax systems discourage sales of shares by majority shareholders), would lead to the conclusion that improving corporate law might not change ownership concentration at all. Even more complex is the question of causation: do failures in governance lead to calls for stronger corporate law (e.g. Enron and Sarbanes-Oxley)? That is, it is possible that economies that have developed their own methods for dealing with managerial wrongdoing (such as ownership concentration, bank control, state influence, or strong norms) rarely have cause to radically change their corporate laws. Perhaps most important of all is the question: what is the consequence of ownership concentration? The obvious negative effect would be that majority shareholders have increased opportunity to expropriate the minority. However, if this is the major negative consequence, shouldn't we rather look at a direct measure of majority influence (such as the control premium)? At the end of this chapter, we will examine how high control premiums might be detrimental to an economy.

This chapter, then, is structured around three notions: (1) concentration is not necessarily a negative phenomenon. There are valid, efficient reasons why

concentration should exist. As Berglof and von Thadden (2000) argue, the very fact that most countries do not have widespread dispersed ownership already casts doubt on the importance of their assessment of investors protection. Also, they point out that LLSV do not distinguish between types of capital providers, whereas in actuality, the type of block holder (whether family, institutional or foreign for instance) has a large bearing on its governing (or expropriating) function. (2) Legal protection of minority rights, when examined in detail, does not appear to be the panacea LLSV make it out to be. Minority lawsuits have been a subject of much legal academic skepticism over the years. (3) A much better test of shareholder protection than concentration is the control premium. However, high control premiums cannot be considered undesirable a priori. The conclusion of this chapter will be that shareholder rights must be examined from a broader perspective and strengthening shareholder rights might require more radical steps.

I) Is Law the Answer ?

Every financial investment involves one fundamental uncertainty: how much can the manager of your money be trusted ? No matter how one aligns the incentives of managers and shareholders, there always remains the possibility that managers will simply use the money entrusted to them for their own self-interest. The LLSV answer is that law is the central constraining influence. As Shleifer and Vishny (1996) write: "The reason we do not observe managers threatening shareholders and being bribed not to take inefficient actions is that such threats would violate the managers' legal "duty of loyalty" to shareholders."

> When investor rights such as the voting rights of the shareholders and the reorganization and liquidation rights of the creditors are extensive and well-enforced by regulators or courts, investors are willing to finance firms. In contrast, when the legal system does not protect outside investors, corporate governance and external finance do not work well. (LLSV 1999a)

Recent empirical work on legal protection of outside shareholders indicates better legal protection of outside shareholders is associated with (1) more valuable stock markets, (2) a larger number of listed firms, (3) larger listed companies in terms of their sales or assets, (4) higher valuation of listed firms relative to their assets, (5) greater dividend payouts, (6) lower concentration of ownership and control, (7) lower private benefits of control and (8) higher correlation between investment opportunities and actual investments (Shleifer and Wolfenzon 2000).

II) Does Poor Investor Protection Lead to Ownership Concentration ?

A central tenet of modern finance theory is the importance of diversification. Diversification reduces unique risk. Every company has risks unique to its own situation that may be avoided by investors by diversifying their investment portfolio (Brealey and Myers 2000). Every investor should therefore rationally have a diversified portfolio. This concept is closely tied to the notion of an efficient market. In an efficient market, information about the company is (more or less) instantaneously incorporated into the share price, so there is no advantage to be had from any special arrangement with the company.

There are, however, two ways in which concentration can be profitable: (a) if it reduces agency costs or (b) if the concentrated shareholder derives private benefits of control.

Limiting agency costs. One way of limiting agency problems when legal protection is deficient is by concentration of ownership. When ownership of shares is dispersed and legal protection is unreliable, shareholders face two connected problems when attempting to constrain managers: (a) the cost of collective action and (b) free riders. It is difficult for any one shareholder to organize other shareholders together (collective action cost) especially when the gains from such actions are shared with all other shareholders (free riders). Concentration avoids these problems altogether by having a single shareholder with enough voting power to constrain management on its own and holding enough stake in the company to have an incentive to act against management.

Private benefits of control. Another result of poor protection of shareholders that can lead to concentration is if the controlling shareholder can derive benefits from that control. That is, controlling shareholders of the company may be able to use the company's resources to enrich themselves to the exclusion of other shareholders. Bebchuck's (1999a, 1999b) "rent-seeking" model has entrepreneurs retaining control of their company in a public offering in order to retain private benefits of control.

In summary, Easterbrook (1997) writes: "With efficient markets, there is no money to be made by holding undiversified blocks in public corporations. Competition bids down the price of securities so that the excess risk created by the lack of diversification is not compensated." He continues: "We should therefore expect nations with more efficient capital markets to have less concentration of ownership, and this is exactly what occurs."

II.1) Reasons for Concentration.

This characterization of concentration is too negative. There are, in fact, several efficient reasons why corporations should be closely held. It seems more than a little unfair to characterize corporations everywhere in the world but the US and UK (and quite a few in the US and UK) as a result of a failure of the capital markets.

Attenuation of Agency Costs. Agency costs exist in every economy. In the US itself, there are advantages to concentration. US studies have observed an inverse U-shape correlation between share price and concentration. That is, compared with similar companies, companies with a wide discrepancy between ownership and control have depressed share prices. Companies on either end of the spectrum, that is, low concentration or high concentration are treated similarly by the market (see, for example, McConnell and Servaes 1990 and Morck, Shleifer and Vishny 1988). This would seem to indicate that even in the paradigm case of LLSV, the United States, concentration is regarded by the market to reduce agency costs.

Information Asymmetry. More generally, it is a well-established tenet of finance theory that external equity is the most expensive form of financing (Myers and Majluf 1984). A common explanation of this is that external equity involves the greatest information asymmetry. In an external equity offering, the best informed party (the managers) are offering the least informed investors (unlike banks, they do not have the opportunity for due diligence) a stake in the business. External investors

should then rationally discount the value of the equity offered to take into account the risk from the information asymmetry.

Empirically, one phenomenon that appears worldwide is the underpricing of shares in an IPO (initial public offering). That is, shares sold in an IPO are usually sold at a lower price than what they are worth. While academic explanations of this are as yet not wholly satisfactory (see the discussion in Jenkinson and Ljungqvist 2001), one possible interpretation is that a system that focuses on more direct communications, such as relationship banking, might provide for lower cost of capital, especially in businesses where information asymmetries are acute.

Acute information asymmetry appears naturally in two instances: (a) early in the firm life cycle and (b) in developing countries. It is a well-established empirical fact that entrepreneurs typically get financing from internal sources (e.g. friends and family) (Myers 1999, Van Osnabrugge and Robinson 2000). This is because an entrepreneur has no track record he can prove to investors and, at the early stages, no revenues to indicate the prospects of the business. This is related to development as firms in developing countries are, almost by definition, earlier in their life cycles than firms in developed economies. Khan (2000) reports that family businesses were necessary for capital accumulation in the early stages of Asian economic development. Reliance on the family form could, however, (and to some extent, has) become a liability later.

Empirical findings corroborate the necessity of concentration in developing countries quite strongly. Firms with higher ownership concentration had better

performance during the crisis (Mitton 2000). However, this concentrated ownership had to be external, that is, unrelated to management. Subsequent country specific studies seem to confirm this: in Thailand the presence of controlling shareholders is associated with higher performance (note: not share price, but business measures such as return on assets and sales-assets ratios). Again, however, there is a negative effect when the controlling shareholder is involved in management (Wiwattanakantang 2001).

Integration. Another possible cause of concentration is the control of a company by another, that is, corporate integration. A standard reason for ownership is when the performance of management is not observable (or, more generally, non-contractible) (Williamson 1985, Hubbard 2001). The classic instance of this is the 'make or buy' decision, where a firm has to decide whether it should rely on a company on its value chain (e.g. its supplier or its distributor) or whether it should engage in that activity itself. The prevailing wisdom is that when contractual arrangements may not be sufficient for the company to trust its supplier or distributor, the company should pursue that activity itself, which might involve merging or acquiring the supplying or distributing company.

Path-dependence. Even if we consider dispersed ownership more efficient than concentrated ownership, there might be other incentives besides incompetence and self-interest which keeps ownership from becoming dispersed. In contrast with a simple economic model that systems move towards "efficiency", it is worth noting that some economists believe that some less ideal structures have a tendency to persist in the real world. Economic decisions are made to maximize efficiency at that

moment, not to maximize efficiency as a general standard. In the context of governance systems, even disregarding rent-seeking behavior, it is possible that sub-optimal systems persist simply because it is efficient for economic actors to maintain them that way, that is, the gain from changing the system is not worth the cost required to change the system (Bebchuck and Roe 1999, Roe 1996).

Political Economic Reasons. Coffee (1999b) hypothesizes that causation might be even more straightforward. It could simply be, he argues, that some countries have laws that are designed to resolve conflicts between majority and majority shareholders and other countries are more geared towards resolving conflicts between managers and shareholders. Naturally, firms would gravitate towards the form that is better protected in their system. An explanation for this is that different countries are politically controlled by different interest groups seeking to entrench its own agenda.

Roe (1994) argues that, in America, managers have influenced the political system to prevent shareholders from acquiring power. This influence is seen generally, where there are laws that discourage block ownership (such as laws that limit shareholding by banks and financial institutions) and more specifically when (particularly during the 1980s) managers were mostly successful in campaigning for laws that would make takeovers more difficult.

On the other side of the coin, Pagano and Volpin (2000) suggest that European political systems might have contributed to high worker protection and low investor protection. In their model, entrepreneurs strike deals with workers to ensure employment protection in return for low external investor protection. The political

side of the argument is (a) in a society where most of the population gain income from work rather than equity holdings, there is a stronger political will for employment protection than shareholder rights and (b) a deal between entrepreneurs and workers is more likely to emerge in countries with coalition governments than countries with a two party system, because a coalition is more likely to occur between parties representing entrepreneur and worker interests than one of two competing parties both aiming to capture a general consensus. In an Asian context, Claessens, Djankov and Lang (2000) raise the possibility that these dominant families become so powerful in Asian economies, they influence the political system to act in their favor (in part by preventing laws that could diminish their dominance, such as minority protection).

Taxes. A interesting anomaly to the LLSV argument is the case of Canada. While Canada and the US are very similar institutionally, Canada has a much higher degree of concentration. Brown, Mintz, and Wilson (2000) argue that part of the reason could be that Canadian tax law encourages firms to stay private, as capital gains taxes are higher in Canada (a disincentive to sell shares) and privately held companies receive retained business income tax treatment.

Investor Preference. Others factors retarding the extension of securities markets can be found when examining the underdevelopment of corporate bond markets. In a study of East Asia, Shirai (2001) found that the major problems were (a) underdeveloped government bond markets and (b) underdeveloped institutional investors and (c) risk-averse households. It is the latter two that are of interest to us. It could be that households in less-developed economies simply cannot afford to take risk and therefore prefer to hold their savings in banks. This in turn leads to the

absence of institutional investors who are primary participants in capital markets both in the US and UK.

Excessive Minority Protection. Directly contrary to the LLSV hypothesis, concentration could occur because legal conditions are *too* protective of minority shareholders. That is, if controlling shareholders are impeded or are excessively forced to share gains with minority shareholders, then an optimal choice for an entrepreneur in a public offering might be to limit external shareholding to a socially suboptimal minimum (Bebchuck and Zingales 1996).

II.2) Is Concentration Undesirable ?

It has also been argued that, besides being a reflection of poor protection of shareholders, concentration in itself can also be detrimental to an economy. Economies with high ownership concentration are likely to have underdeveloped stock markets, as shares are not as liquid as economies with dispersed ownership. This has two effects: (1) firms are more likely to be bank-financed than equity financed (because equity financing is harder to access) and (2) firms are not able to rely on stock market signals (whether their shares go up or down) to assess their decisions.

Problems with bank-financing. Bank financed systems tend to have 'relationship lending', where banks have long term exclusive relationships with the firms they finance. However, it is precisely these relationships that may have contributed the Asian Financial Crisis because the banks were insufficiently alert to

problems inherent in the companies. "Essentially, the arm's length capital was lent to a relationship-based system that did not have the adequate price signals to deploy the massive inflow of capital properly." (Rajan and Zingales 1999)

Absence of market signals. Proponents of the market-based system (such as Rajan and Zingales 1999) would state two major strengths of a system where the capital markets evaluates a company (through share price): (a) firms can use the market as a gauge of the soundness of their business decisions (as the market is a strong tool for aggregating information) and (b) having a share price that reflects company value allows for incentive systems strongly tied to firm value (such as stock options).

In fact, one argument (which could be read as a corollary to the Easterbrook argument) is that systems are starting to converge toward an Anglo-American (dispersed) model (see, for example, Gilson 2000, Coffee 2000, Hansmann and Kraakman 2000a, Coffee 1999a). Hansmann and Kraakman (2000a) believe the principal reason for such convergence is an emerging normative consensus of the firm as a shareholder value maximizing vehicle. This consensus has been propelled by the spread of academic discipline of economics and finance, the gradual diffusion of ownership in developed countries and the influence of capital providers from the US and UK. Interestingly, Coffee (2000) and Gilson (2000) argue that such "functional" convergence could appear without convergence in the local law ("formal convergence").

An alternative viewpoint that has not been pursued much in the literature (oddly, considering concentrated ownership is the rule rather than the exception) is that it is dispersed ownership rather than concentrated ownership that requires explanation. One, previously mentioned, is that of Roe (1994) that argues that dispersed ownership in the US might have arisen as a result of interest groups that sought to (a) reduce the power of banks and financial institutions and (b) entrench managers. Another argument is that dispersed ownership could be a check on any one group of shareholder dominating the corporation (Bennedsen and Wolfenzon 2000)

How Much Concentration ? One problem with the entire hypothesis that concentration would be higher in countries with worse investor protection is the issue of the amount of the concentration required for control is ignored. This problem is particularly perilous in empirical work (see, for example, Lamba and Stapledon 2001), where the researcher attempts to demonstrate that the worse the investor protection, the higher the concentration. Whether the thesis to be proven is the 'agency cost attenuation' thesis (LLSV) or the "rent-seeking" thesis (Bebchuck), what has been ignored is that the entrepreneur only has to retain *sufficient* shares to retain control (what Scott (1997) terms 'minority control'). The level of share-holding retained has less to do with the level of private benefits but rather the amount required for control. "The lowest level of shareholding at which minority control becomes possible is dependent on the way in which the remaining shares are distributed. Where a minority shareholder is confronted by other minority shareholders who can mobilize a countervailing block of shares, their minority control is precarious or non-existent; but if all the remaining shares are widely dispersed among a large number of small shareholders, the minority shareholder is less likely to face any serious opposition."

(Scott 1997). In other words, the more dispersed share ownership is, the smaller the block required for control.

II.3) Results of Concentration

But ultimately, concentration must be evaluated on its effects. This can be observed on two levels: (a) on a intra-country level, by comparing between the performance of companies with dispersed and concentrated ownership and (b) by a cross-country comparison.

Intra-National Comparisons. On a theoretical level, there is a tradeoff in ownerships structure- highly dispersed corporations are susceptible to managerial misconduct and concentrated corporations are susceptible to majority expropriation. As mentioned above, Mitton (2000) and Wiwattnakantang (2001) find that concentration improves performance in Asian countries. In the USA, Demsetz and Villalonga (2001) find no significant relation between ownership structure and firm performance. This study confirms the hypothesis of Demsetz (1983) and Demsetz and Lehn (1985) that ownership structures are endogenous, that is, firms select the ownerships structure that is most suited to their needs.

Bank vs. Market Systems. Comparing performance results of entire countries is problematic. So many factors contribute to the performance of an economy, it is difficult, if not impossible, to determine which factors are decisive to that performance. Studies have, therefore, been of two types, either of a theoretical nature or of a specific area of performance.

Specific Comparisons. As a large part of corporate governance is the ability and willingness of shareholders to constrain management of companies, one proxy for the effectiveness of corporate governance is to test the correspondence between corporate performance and managerial pay or the speed in which management is replaced. Studies have shown, however, that sensitivity of pay and dismissal to performance is similar in the US, Germany and Japan (Kaplan 1994a,b).

Another comparison (which has bearing on the Asian Crisis) is the level of risk found in different systems. Claessens, Djankov and Nenova (2001) find that firms countries that are less protective of investor rights and bank-based are riskier than firms in investor protective, capital market based countries (as measured by cash-flow volatility, leverage and liquidity, and interest coverage, in other words, bankruptcy risk). However, bank-based countries tend to have higher intertemporal smoothing, which offsets bankruptcy risk (that is, profits from good times are used to smooth losses in bad times), resulting, for example, in the oil crisis of the 1980s affecting Japan and Germany less than the USA (Allen and Gale 2000a). That is, the higher level of risk might be immaterial.

Perhaps some kinds of investments are possible only in capital-market based economies. Extrapolating primarily from the US experience, Gilson and Black (1999) argue that venture capitalism requires an active, extremely liquid stock market (though it has been pointed out that the UK stock market is similarly active to the US but lacks a corresponding venture capital industry- see Mayer 2001).

Theoretical Comparisons. As mentioned above, proponents of capital-market based systems believe that one of the greatest strengths of capital markets is the market signals that could provide a guideline to managerial decision-making and managerial compensation.

But these benefits are questionable: (a) On the role of the market as an evaluator, Stiglitz (1994) writes: "managers do not look to the stock market to determine whether another blast furnace should be built, or whether further exploration of oil should be undertaken. The stock price is relevant- they do look to the effect of their decisions on the stock market price. But it does not, and *should not*, drive their behavior. It simply provides information that is too coarse to direct investment decisions." (italics added). (b) As for share price performance as an indicator of management performance, Richards (1998) points out that share prices move, not in line with performance, but with "performance *relative to expectations*". This is because share prices reflect shareholders' expectations of a company. If a company expected to do extremely well merely does well, the share price will fall; similarly, a company expected to do poorly but manages to produce mediocre performance will have a rise in share price. "The obvious conclusion is that managerial reward should be based more on internal investment returns than on share-price performance." (Richards 1998)

Moreover, it has been argued, it is this very adherence to market signals that is a defect in capital-market based economies. Markets can and are, quite often, wrong (for example, capital markets responded well to Marconi's various high-tech acquisitions before their subsequent collapse two years later). Also, some academics

believe that capital markets are motivated by a shorter-term focus. German and Japanese companies are also reputed (by some) to be better at long term focusing (see, for example, Clarke and Bostock 1995). (Although American commentators point out that US stock markets have taken to biotech companies, which are not at all short term prospects.) And as argued earlier, it is optimal for companies which require higher trust or information flows to gain financing through tighter integration than a market system (Myers 1999).

II.4) A More Nuanced View

Current research seems to settling on a position that, in all financial systems, banks and capital markets both contribute in their own way to economic development. Neither is conclusively superior (see Allen and Gale 2000, and, generally, Demirguc-Kunt and Levine 2001). It is not enough to simply distinguish a system as a market or bank based system. One must examine more concretely what monitoring mechanisms are at work in that system.

Types of Owners. Even among concentrated owners, there are some that act as better monitors than others. Khanna and Palepu (1999) observe that in India foreign institutional investors are better monitors than domestic institutional investors, that is, companies owned by foreign institutions tend to perform better. They find additionally that groups (affiliated companies) are harder to monitor because of transparency problems. Khan (2000) points out that, among East Asian countries, even though Hong Kong and Singapore have large family dominated firms, these firms are strongly

governed by the presence of banks and foreign investors (and in the case of Singapore, government presence).

Divergence of Ownership and Control. Perhaps instead of focusing on the fact of concentration, it is more fruitful to focus on the circumstances in which control occurs without any corresponding incentives toward value-maximization. This is the case when the controllers of the company, whether they are managers or owners, have such a limited stake in the company they have a stronger incentive to enrich themselves than the company. Claessens, Djankov, Fan and Lang (2000) find that it is the discrepancy between cash-flow rights and control rights that creates the strongest negative valuation.

Carlin and Mayer (2000) conjecture what may be the most reasonable conclusion we can reach on current data: "In high GDP per capita countries, growth of equity and high skill dependent industries is assisted by information disclosure, which encourages investment on R&D and through concentration of ownership, which provide commitments to other stakeholders. In contrast, in lower GDP per capita countries, banking systems are important in promoting bank finance dependent industries and dispersed ownership is required to control agency problems in skill-intensive and equity financed industries."

III) Shareholder Protection

What sometimes happens in a theoretical discussion of the effects of shareholder protection is we often lose sight of what, concretely, we are talking about.

What do we mean when we say shareholder protection ? There are two levels of protection: (1) protection of shareholders from managers and (2) protection of minority shareholders from the controlling majority. The LLSV thesis suffers from not making this distinction. On a theoretical level, we should expect to see ownership concentration is managerial control is weak in order to prevent managerial predation, however, if minority shareholder protection is weak, we should expect concentration to be heavily penalized by the market and therefore more dispersed ownership. As things stand, the simple fact of concentration does not prove much in the way of shareholder protection.

To examine shareholder protection in more detail: Protection from managers commonly takes the form of (a) separate boards and (b) director's duties. Minority protection takes the form of (a) voting rights, (b) higher disclosure standards and (c) derivative suits.

III.1) The Importance of Legal Shareholder Protection

The problem with the notion that 'law matters' is: as investors should rationally punish firms they do not trust, corporations have an incentive to make themselves trustworthy. That is, even without legal support, corporations should be finding ways to present themselves as reliable investments to shareholders. Easterbrook and Fischel (1991) downplay the importance of substantive legal rules, raising the possibility for firms to opt out of the formal legal rules (though their particular example, that of using the corporate charter as a binding contract is somewhat suspect).

As LLSV (1999b) themselves admit: "Given the ambiguity of the theory, the answer to whether contracts, court-enforced legal rules, or government-enforced regulations are the most efficient form of protecting financial arrangements is largely empirical."

If we examine each legal mechanism for shareholder protection in detail:

Independent Directors. Independent directors are believed to act as important monitors of management. Especially now following the Enron debacle, there are increasing calls to increase the number of independent directors on boards and to increase their influence. However, empirical evidence does not seem to unequivocally encourage this. This is how Romano (1999) summarizes the US experience: "No matter what variable is used measure performance, virtually all studies find no significant relation between performance and board composition". Romano ascribes

this to the "optimizing governance choice" hypothesis in which firms balance insider and outside directors to reach a balance between directors with requisite expertise and outsiders that can mitigate agency costs. Studying the result of shareholder activism in the USA, Romano (2001) finds that "shareholder proposals substantially directed at improving corporate governance by reforming board composition, repealing takeover defenses and altering executive compensation, confidential voting has no significant impact on voting outcomes." In fact, one study even finds a negative correlation between performance and board independence after controlling for other governance devices (Agrawal and Knoeber 1996). This does not mean that board composition is irrelevant, however. Romano also reports that event studies appear to indicate that "outsider boards take greater charge in extraordinary event or crisis situations and enhance shareholder value".

One fundamental problem with relying on independent directors is incentives. Independent directors are typically given a fixed pay. As they do not receive any gains when the firm does well and are not penalized when the firm does badly, there is little incentive for directors to try very hard to steer a company. In line with the Romano (1999) study, independent directors should only become serious involved with a company's management when there is the possibility than an event may remove them from their directorship.

Voting Rights. Black and Kraakman (1996) proposed a system (based on studies of emerging capitalist economies) they call "self-enforcing". This system focuses on corporate decision-making processes such as mandatory cumulative voting for the election of directors and strict levels of shareholder approval for the disposal of

assets. If judicial intervention is not reliable, the argument goes, then a more effective form of control would be to make self-serving decisions difficult to execute in the first place.

This is, however, a rather radical solution, as such restrictions to voting could impede normal business transactions. Acquisitions, for example, would be very costly with the level of control required.

Accounting and Disclosure. Rahman (1998) demonstrates that accounting standards were not up to International Accounting Standard level in the countries involved in the Asian Financial Crisis. What is interesting though is that in the three countries most strongly affected by the Crisis, Indonesia, Thailand and Malaysia, there were several companies that opted to disclose related lending and borrowing. Firms with better disclosure standards had significantly better stock price performance during the Crisis (Mitton 2000) The question should then be: why didn't all firms adhere to a higher disclosure standard ?

Securities Regulation. Coffee (2001b) notes that legal rules, that is law in H.L.A.Hart sense of the term, are not necessary for the development of strong governing institutions. In fact, as he points out, the London and New York exchanges, which provide the backbone of the Anglo-American governance system, were largely self-regulated until quite recently. Roe (2000) even argues that the 1933 and 1934 acts in the US were little more than a codification of New York Stock Exchange practice. On the UK side, Cheffins (2000) corroborates this strongly, making the case that it

was primarily the London Stock Exchange and the "shared values" of " the City" in general that inspired trust in UK companies and not law as expressed by judges.

It could be that regulators (in this context, securities regulators) are more important than judges in governing companies (Glaeser, Johnson and Shleifer 2001). As mentioned above, strict securities regulators appear to have been more important in the development of the US and UK capital markets than judge-enforced law. A popular example of how this type of protection is this comes from the contrasting privatization experience of Poland and the Czech Republic. Even though Poland and the Czech Republic have similar corporate laws, upon privatization of state enterprises Poland instituted: (a) high disclosure standards, (b) an SEC-like agency, (c) disclosure of ownership of shares beyond certain thresholds, (d) a requirement that any shareholder acquiring more than a specified level of stock must bid for the remaining shares and (e) National Investment Funds (NIFs) which held controlling blocks of shares in the privatized companies. All of these, so the argument goes, prevented Polish companies from being taken over by rent-seekers who would then proceed to "tunnel" resources from the firm (which was the case in the Czech Republic) (Coffee 1999b).

The positive impact of US securities laws is itself in question. There has been an ongoing debate among US academics whether mandatory disclosure had any significant change on the stock market (the argument begins with Stigler (1964) arguing that the law has no impact on returns and continues with, for example, Seligman (1983) disputing this result). The argument against the necessity of mandatory disclosure is that companies have an incentive to reveal information to the

public (to lower cost of capital) and, as the production of information has its costs, will drift towards an optimal level of information revelation on its own (see, generally, the discussion in Romano (1998)).

It is, anyhow, clear that a securities law is not sufficient for a well-functioning securities market. For securities market to flourish, many factors need to work in unison. Not only does there need to be strong regulators, there must also be strong supporting institutions: accountants, financial analysts, lawyers, investment funds, rating agencies, etc. (Black 2000) Needless to say, such institutions take time to develop.

III.2) Derivative Suits

The traditional judicial remedy for shareholders seeking redress against corporate officials is to bring a suit against management in the name of the corporation. This is called a "derivative suit" under American law because the shareholder derives the right to sue from the corporation and any recovery from the action accrues to the corporation (Klein and Coffee 1996). The English version of this is the rule in *Foss v. Harbottle*[2].

It has been alleged that derivative suits are quite difficult to bring in both American and English courts. Both courts appear to regard the possibility of nuisance suits ("strike suits" in American legalese) as an important concern. Legally, this is because the courts consider that legal recourse will be given to plaintiffs only if there

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[2] (1843) 2 Hare 461

is reason why the corporation cannot solve the problem under its own devices. Under Delaware law (where most American corporations are incorporated), derivate suits are allowed only if "demand is excused", i.e., the board has been shown to inadequately respond to shareholder demands. In *Foss v. Harbottle*, Wigram VC stated that minority shareholders must demonstrate that they have exhausted any possibility of redress within the internal forum and, even more strongly, that the court will not intervene where a majority of shareholders may lawfully ratify irregular conduct. The logic (following Jenkins LJ in *Edwards v. Halliwell*[3]) seems to be that, if the company is the 'proper plaintiff' then the company should have the right to decide whether or not to bring the suit. As the law allows the majority to decide in the company's stead, it follows that the decision to bring the derivative suit to court must first be ratified by the majority shareholders.

Under Delaware law, in order for shareholders to file a derivate suit against management of a company, the plaintiff must create a reasonable doubt that (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment. Demand may be excused under Delaware law only if the plaintiff can prove that "the majority of the board personally benefited from the challenged transaction or was otherwise subject to a legally disabling conflict of interest" (Klein and Coffee 1996). A standard procedure for combating these allegations is to appoint independent directors to the board. An even more comprehensive and easier solution is to appoint a "special litigation committee" specifically to handle the matter. As presumably everyone on the committee is independent, demand has to be made to the committee and will not be

[3] [1950] 2 All ER 1064

admitted to court (see the discussion in Mitchell 2001). As Mitchell rather dramatically puts it: "We might as well not have fiduciary duty at all." American economists appear to have far more confidence in the American legal system than American legal scholars do.

English law has similar barriers. Lord Davey in *Burland v. Earle*[4] held that the 'proper plaintiff' principle may be excused only where "the persons against whom relief is sought themselves hold and control the majority of shares in the company and will not permit an action to be brought in the name of the company" and "the acts complained of are of a fraudulent character or are beyond the powers of the company." In earlier judgments, this test of 'wrongdoer control' was stated as at least 51 percent of voting shares.[5]. As mentioned above, ownership in companies is rarely as concentrated as 51 percent and it is possible to control companies without that degree of ownership. Subsequent English cases have expanded the exception to Foss v. Harbottle to include "sufficient control to prevent what would otherwise be a majority from authorizing the action, or where they control the board and are thereby in control by mean of proxies."[6] While this is clearly an improvement on the 51 percent rule, it still confers a burden of proof on the plaintiffs to prove "sufficient control" which would be difficult, especially if management does not "control" the board.

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4 [1902] AC 83

5 *Pavlides v. Jensen* [1956] Ch 565

6 *Prudential Assurance Co. Ltd. v. Newman Industries Ltd.* (No.2) [1982] Ch 204. See also the discussion in Boyle (2002)

Boyle (2002) writes: "It is generally considered that the two most significant barriers to successful shareholders' proceedings (especially in the case of derivative suits) are (a) the difficulty of obtaining, in advance of litigation, adequate evidence to support alleged wrongdoing (even where this is strongly suspected); and (b) the difficulty posed by the great expense of such civil litigation (without any hope of direct personal benefit)." Adding to the problem of expense, Boyle goes on to note, even with the introduction of the Conditional Fee Agreements Order 1998, "since the proceeds of a derivative action must accrue to the company as nominal claimant, it will inevitably be argued, should the point arise, that it is not open to the plaintiff shareholder in a derivative action to bargain away any part of the proceeds of a successful judgment." Generally, however, the option of conditional fees should be open to those pursuing an 'unfair prejudice' action, which is emerging as an alternative to derivative suits under English law. (This will discussed in detail later.)

Conditional fees, on the other hand, should not be taken as an unequivocal blessing. Klein and Coffee (1996) point out that these can lead to collusive settlements, where the defendants strike a deal with the plaintiff's attorney where a low recovery is exchanged for high attorney's fees. The results of this are two-fold: (a) it can lead to a proliferation of attorney actuated nuisance suits and (b) the attorney has incentives to collude (or compromise, if you will) because the attorney gets paid for a settlement but not if there is an adverse verdict. This appears borne out by empirical studies (see, for example, Macey and Miller 1991, Romano 1991). Derivative suits do not have a significant impact on share prices (and thus no direct gain to shareholders). Gains from winning a derivative suit appear to accrue primarily to attorneys. The evidence from Japan appears even more damaging- while the

incidence of derivative suits rose dramatically following a reduction in filing fees, there appears to be no improvement in share prices (West 2001).

However, this does not mean derivative suits are ineffectual. Even though gains from derivative suits may be not be observable in the actual instance of a suit, some effect can still be observed indirectly. Holderness and Sheehan (2000) point to evidence that, in 86 percent of US corporate reorganizations, minority shareholders receive at least as much per share as block sellers, which amounts to a wealth transfer from majority owners to minority shareholders. Holderness and Sheehan conjecture that this is because it is cheaper for majority owners to buyout minority shareholders directly than to risk SEC regulations. They contrast this with New Zealand, which is far less protective of minority shareholders, where minority shareholders receive substantially less in reorganizations than large-block shareholders.

Nevertheless, an alternative means of judicially constraining management has become available under English law. Section 459 (1) of the Companies Act 1985 allows members to petition the court if: the company's affairs are being conducted in a manner which is unfairly prejudicial to the interests of its members generally or of some part of the members or that any actual or proposed act or omission on its behalf would be so prejudicial. This remedy appears to avoid the traditional problems of the derivative suit: (a) Lord Hoffman made it clear in *O'Neill v. Phillips*[7] that the section would include any action which "equity would regard as contrary to good faith" and (b) as mentioned above, conditional fees are admissible in an unfair prejudice petition.

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[7] [1999] 2 BCLC 1

Intriguingly, especially in contrast to the LLSV thesis, Boyle (2001) recommends French and German solutions to derivative suits. Both France and Germany posit a sliding scale of shareholding required for a shareholder to bring a derivative action; the higher the amount of capital, the lower the percentage of shareholding required. Additionally, in direct contrast to US and UK law, French law disallows (a) any provision in the company's constitution requiring plaintiffs to obtain authorization from shareholders' meetings, (b) any general meeting to pronounce on the desirability of the suit or, most significantly, (c) any resolution passed by a general meeting to release or discharge directors from liability or breach of duty[8]. It would appear, on paper at least, it is easier to bring a derivative suit in France and Germany than it is in the US and UK.

III.3) The Hayek Hypothesis

If substantive law is not the essential difference, then where could the difference be ? LLSV (1997, 1998) hint that the answer might lie in legal origins. They argue that legal systems of common law origin are more protective of shareholders than those of civil law origin. This is not original with LLSV. Hayek (1960) believed the common law tradition superior to the civil law tradition because the common law is more protective of individual rights. A straightforward correlation appears to confirm this: common law countries experienced more economic growth than civil law countries in the last four decades (Mahoney 2001). Glaeser and Shleifer (2001) advance a thesis that English law (and consequently all common law countries)

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[8] Article 246 and 246 (2) of the Law of 1966

is more protective of property rights than French law (and consequently all civil law countries). This stems, they argue, from the historical fact that, as French feudal lords were roughly equal in power to each other, it was prudent for them to "delegate dispute resolution to the sovereign". In contrast, English feudal lords, wary of the power of the King, preferred to resolve disputes locally. This set the tone for civil law systems to be more forgiving of state intervention than common law systems and thus to the result that civil law systems are less protective of property rights than common law systems.

However, this suggestion is perhaps the most questionable of the LLSV proposals. LLSV provide no empirical or theoretical arguments about how the actual workings of the common and civil law contribute their effectiveness (a detailed comparison of attitudes towards statutory interpretation, for example). In the last few years, there have been several studies examining other factors that may explain the differential between civil and common law countries. Three members of LLSV themselves have conducted a study comparing labor laws against legal origin as explanatory variables (Djankov, La Porta, Lopez de Silanes, Shleifer and Botero 2004). While they still conclude that legal origin is the stronger explanation, there are other studies with the opposite conclusion (Roe 2003, 2005, see also Dyck and Zingales 2004).

The Historical Record. To argue, as LLSV do, that legal origin is the significant factor in shareholder protection, is to ignore great deals of surrounding historical circumstance. Most countries received their legal systems from colonization. Colonization, it is obvious, involved much more than simply an import of the legal

system. Colonial powers had a great deal of influence on the economic and political structures and even on the culture of the colonized countries. It is difficult to say that it is the legal system that has resulted in the corporate structure.

In a European context, the thesis that common law systems have the strongest financial markets is simply historically incorrect. Rajan and Zingales (2000) point out that Continental financial markets prospered in the early years of the 20th generally but tapered off after the First World War. They propose that it is the political climate of the country which is the key factor that then goes on to influence the financial climate. But empirically it does seem to have an impact.

Also, it is obvious that there are other ways of interpreting the historical record. De Soto (2000), for example, examines the development of American property law in detail and reports the chaotic state of property rights (despite the application of English property law) up to the early part of the 19th century. It was only after Congress began recognizing the 'extralegal' settlement of property (that is, the way the people themselves organized their property rights) that American property rights could begin to fuel rapid economic growth. It would appear that legal origin is less important than how that legal system is adapted to local circumstance.

Legal Transplants. Another interesting thesis is that laws only work when there is an underlying demand for them. By contrast, laws that are transplanted (copied from another country) without regard for local conditions tend not to be effective. Berkowitz, Pistor and Richard (1999) estimate that transplanted laws are 33 percent less effective (the "transplant effect"). In some countries, transplanted laws

can even have a negative effect in countries where those law clash with the underlying cultures and traditions. Attempts to transplant western forms of corporate law into China have resulted in perverse interpretations of those laws while neglecting the fact that traditionally, Chinese family law had much the same function as corporate law in the west (in the context of "clan corporations") (Ruskola 2000). As Aoki (2001) puts it: "sustainable legal rules for corporate governance may be understood as the codification of an equilibrium arrangement in response to certain institutional environments (e.g., codetermination in Germany)".

China is an interesting case of a country that has weak legal protection and yet has been able to attract substantial foreign direct investment. It appears that informal connections (*guanxi*) have been able to take the place of legal protection to a significant extent (Wang 2001). There is, however, the argument that it is precisely the lack of legal support that limits the potential of investment in China, as there are several well-documented cases of foreign investors failing in China because local commitments were not honoured (Studwell 2002).

Effectiveness of Enforcement. It is obvious that for a law to work, there must be effective enforcement. A study of legal change in transition economies appears to indicate that changes in corporate law (that is, law on the books) have significantly less impact than changes in the effectiveness of legal institutions (Pistor, Raiser, and Gelfer 2000). (They also find that the only legal index that has a significant positive impact on capital market development is securities regulation.)

A Clear Exception to the Hayek Hypothesis. Perhaps the most intriguing piece of empirical evidence to emerge is the results of Nenova (2000)'s cross-country analysis of private benefits of control. Even though common law countries again outperformed German and French civil law countries, Scandinavian law countries outperformed all the others. As Scandinavian law resembles the civil law tradition more than the common law tradition and does not appear to strongly protect shareholder rights, Coffee (2001a) among others has suggested that other factors might be more significant in explaining the difference between countries, in particular, social norms.

The Bottom Line: Competition. Ultimately, corporate governance should be thought of as a system allowing the optimal allocation and use of resources. As such, it should be recognized that the primary incentive and indeed the strongest governing device for firms is product market competition. If a firm is not efficient, it will lose market share and be less profitable. Competition is the most effective mechanism for ensuring resources are used efficiently (Allen and Gale 2000b).

IV) Pro Ration: A Key Issue

If we take the viewpoint that there are justifiable reasons for ownership concentration, how then can we measure the impact of shareholder protection on companies ? We have to examine a much more direct result of poor minority rights: the control premium. The control premium is the difference in share price between a controlling block of shares and an non-controlling block. The value of a controlling share will be higher when the benefits of the control are higher (Barclay and

Holderness 1989, Zingales 1998, Modigliani and Perotti 2000). This is empirically tested by comparing the price of a normally traded with the price of share when it is bought for purposes of control. The value of control in Italy is 30 percent of the market value of equity (by contrast, it is four percent in the US) (Zingales 1994). (Note, however, Pratt (2001) estimates control premiums at far higher at four percent.)

If we take into account the existence of control premiums we can make two observations: (a) the share price of a company incorporates a pricing of confidence in its controlling shareholders (and/or management) and therefore, (b) minority shareholders should be most concerned when there is a change in control, that is, when there is a takeover. That is, the rule whereby any shareholder that accumulates a certain amount of shares (ranging from around 15 to 25 percent depending on country) must offer to purchase all remaining shares at a fixed price (the 'tender offer' rule) is justified, because minority shareholders should have a right to cash out when the controller of the company changes. Arguably, as derivative actions and unfair prejudice petitions are usually applied only to private companies, takeover laws are more important in protecting minority shareholders in general. In the UK, this is governed by the City Code, which is not law. (Singapore and Hong Kong have similar, non-legal takeover regulations.) As securities regulations was not law until not long ago in the USA, perhaps one can question whether regulations have to legislated to be effective (in other words, does it really matter if it's law?).

IV.1) The Position Under English Law

Whether or not one agrees with Richard Posner's portrayal of common law judges as economic analysts of law, one must at least agree that his work illustrates the uncanny concordance between judges' and economists' perception of the key issues of a case. In fact, one could say judges, being less removed from the actual circumstances, are in a superior position to assess the essence of a case than academics. English case law in minority rights is a case in point. As the case law has progressed, the issue has gradually focused on what we have discussed above: pro ration[9].

The "overwhelmingly usual remedy" for an unfair prejudice petition is a buyout of the petitioner's shares under Section 461 (Boyle 2002). The general stance on valuation appears to be that of Nourse J who mentioned in *Re Bird Precision Bellows* that there are no rules of "universal application to questions of this kind" [10]. In practice, however, judicial opinion seems to closer to the position in *O'Neill v. Phillips* that a "reasonable offer" under Section 459 is one in which the valuation is on a pro rata basis without a minority discount unless there are "special circumstances"[11]. Examples of what these "special circumstances" might be appear to turn on a distinction made by Nourse J in Re *Bird Precision Bellows* between shares acquired in "quasi-partnership" and shares acquired from another. Shares acquired in quasi-partnership must be valued pro rata unless the petitioners have "acted in such a way as to deserve their exclusion from the company"[12]. This principle has been applied by

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9 Another key issue in unfair prejudice valuations, which we regrettably will not consider here, is the date on which the shares are valued. The issue has been extensively considered in the Court of Appeal case Profinance Trust v. Gladstone [2002] 1 WLR 1024

10 [1984] Ch 419 confirmed by the Court of Appeal: [1986] 2 WLR 158

11 [1999] 2 BCLC 1

12 [1984] Ch 419

Jacob J in *Re Planet Organic* where he ruled that preference shareholders in that particular case were not quasi-partners (no management duties and less risk than primary shareholders) and had acted to deserve exclusion from the company (attempting to vote out management) and therefore were subject to a minority discount[13]. Interestingly, American courts, in applying the American version of the 'unfair prejudice' rule (shareholder oppression), have also been basically reluctant to allow minority discounts (see Pratt 2001)[14].

The reasoning in all of these cases have more moral than economic. The emphasis in assessing 'fair value' appears to be on 'fair'. Nourse J argues that "it would not merely not be fair, but most unfair" that a minority shareholder whose interests have been unfairly prejudiced should be bought out on "any basis which involved a discounted price"[15]. The court is artificially limiting itself when it casts the argument in those terms. There is no need to divide the choice into simply pro rata on one hand and discounted on the other. If we consider that the result of the unfair prejudice is that the petitioner has lost value in some way, the legal remedy should be one of simple restitution: the prejudiced party should be paid the value of his shares had the prejudicial act not occurred, or more accurately, if it had been impossible for the prejudicial act to occur. If the court then wants to add an punitive disincentive for controlling shareholders to prejudice the minority, then such punitive damages can be added...

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13 [2000] 1 BCLC 366

14 In fact, American courts almost never apply minority discounts. The usual reasoning given is that allowing the discount would "inevitably encourage the oppressive majority conduct, thereby further driving down he compensation necessary to pay for the value of the majority shares." (Friedman v. Beway Realty Corp., 661 N.E. 2d 972: 977 (N.Y. 1995))

15 *Re Bird Precision Bellows* [1984] Ch 419 confirmed by the Court of Appeal: [1986] 2 WLR 158

A better reason for applying pro rata valuation has been given in the Court of Appeal's decision in *Virdi v. Abbey*[16], where the courts ruled that if a petitioner is entitled in principle to just and equitable winding up, an offer by the majority shareholders to buy his shares at fair value could be reasonably refused. The court stated explicitly that the fair value of the shares as valued by an accountant would include a minority discount, but the petitioner was entitled to a pro rata valuation as he would have received in a winding up. In order to prevent a petition for a winding up, it makes sense for the petitioner to receive an equivalent amount to what he would receive in a winding up. This is eminently reasonable considering that part of the reason for the Section 461 remedy is to avoid companies winding up in the first place. However, in the same judgment, Balcombe LJ observed that the courts have shown a general inclination toward pro rata valuation in both sections 459 and 122 (1) (g) (just and equitable winding up).

The "quasi-partnership" principle is also suspect from an economic point of view. Whether or not the shareholder was present at the time of the founding of the company and whether or not he had managerial functions has little bearing on how much his shares are worth. By a similar token, a shareholder who pays good money for the shares should not be punished any more for an unfair prejudice than a founding shareholder. The essential question should be: how much did they pay for their shares? Whether in a company-founding context or simply from trading, rational decision making would dictate that a minority shareholder would pay less for his stake

16 [1990] BCLC 342

than a controlling shareholder. Any attempt at rendering a 'fair' value should reflect this.

A rather more consistent way of reasoning for not applying a discount in a "quasi-partnership" situation would be: if the nature of the unfairly prejudicial act is such that the minority shareholder, who used to have a managerial, i.e. "controlling", role in the company, is now deprived of this managerial ability, then the proper restitution for such an act would involve the valuation of the minority without a discount, because originally the minority shareholder was, as a matter of fact, also a controlling shareholder.

IV.2) Does the Control Premium Matter ?

Fairness. The implicit viewpoint behind the 'fairness' argument pursued by the courts is that, as shareholders are owners of the company, shareholders should therefore own as much the company as their 'share' in the company. However, it is easy to see that ownership rights in the firm are very different from property rights as used elsewhere. Ireland (1999) calls shareholder ownership a "myth". Penner (1997) notes this equation of ownership with income as a modern development in the idea of property, commenting further that the idea of property as a "thing" is rather distant when it comes to shares and a company. Any notion of fairness should take into account that shares of a company are not purchased at the same price.

It's Only Redistribution. One assessment of the control premium is that it is just a case of redistribution, that is, no value is lost, it is just that company profits go

into the hands of the controlling majority disproportionately. If there is no firm monitoring system in place, outside equity providers will rationally discount the value of the shares for the probability that firm assets will be expropriated (Myers 1998). The empirical evidence of control price differentials confirms this. If no value is lost, merely redistributed, and all the affected parties have priced their stake accordingly, there should be no fundamental problem with control premiums.

Additionally, one must bear in mind that one result of a strong enforcement of pro ration is that companies will be forced to acquire other companies entire. As mentioned above, there are valid reasons of takeovers- a major one of which is the "make or buy" decision. In order to prevent disruption of business it sometimes makes sense for companies to control other companies along their value chain. (See Williamson (1985) and Hart (1995).) If these acquiring company is not allowed to control the acquired company for its own benefit, then the appropriate response would be for the acquiring company to acquire all the shares in the acquired company. This, however, would exclude shareholders who might be willing to invest in a subsidiary with a stable relationship with a parent company. The question is, then: is it proper for the courts to deny minority shareholders the right to participate in the subsidiary?

Or to take another viewpoint, granting minority shareholders the right to participate pro rata when a control block is transferred might produce suboptimal effects, as the participants in the sale would not be able to benefit fully from it. The effect of having to share the gain from such a transfer could have two results: (a) such transfers would not be undertaken even if it were socially optimal to do so or (b) in order to prevent minority shareholders from impacting such transactions, the

entrepreneur would issue a suboptimal decreased amount of external equity (Bebchuck and Zingales 1996).

Legitimate Expectations. Shares are priced according to certain assumptions investors make about the actions of management. Shares have returns above the risk-free rate partly because the actions of management are uncertain. Here we need to combine two economic paradigms of the firm: the firm as a 'nexus of contracts' and shareholders as residual risk takers. If we consider the obligations of the firms as contractual obligations (economists call this view the 'nexus of contracts' theory of the firm), then we have to ask what the implicit terms of these contracts are. The rights of shareholders are particularly incomplete: shareholders bear the residual risk in the firm and therefore should have residual control rights (Grossman and Hart 1986, Hart and Moore 1990, Hart 1995). However, once we recognize that minority shareholders do not have control rights, we should ask: what level of risk should they be susceptible to? In other words, what expectations can a minority shareholder reasonably have?

The English courts have conceptualized personal interests that shareholders have in firms additional to their general protection under company law as 'legitimate expectations'[17]. However, recent judgments have shied away from this concept as it appears too susceptible to liberal misuse. Jonathan Parker J has observed that the application of 'legitimate expectations' in the context of a publicly listed company would 'in all probability prove a recipe for chaos' and specifically denies that minority shareholders could have expectations based on the Listing Rules, the City

17 See e.g. *Re Kenyon Swansea Ltd* [1987] BCLC 514

Code or the Cadbury Code[18]. In *O'Neill v. Phillips*[19], Lord Hoffman writes: "The concept of a legitimate expectation should not be allowed to lead a life of its own, capable of giving rise to equitable restraints in circumstances to which the traditional equitable principles have no application". Joffe (2001) adds: "It follows that, in the future, the term 'legitimate expectation' should be avoided and that some care must be taken with regard to its use in the cases decide prior to *O'Neill v. Phillips*".

This rejection of the concept of 'legitimate expectations' is somewhat regrettable, but perhaps understandable as "the courts rarely use the language of implied terms in justifying a finding of legitimate expectations. They talk rather vaguely of expectations and understandings without articulating their theoretical basis" (Ryan 1992). As Ryan notes, the courts do not examine the particularly context of the case, but rather construct 'legitimate expectations' based on hypothetical reasonable minority shareholders. If shareholder expectations are to be protected, these should expectations formed on statements released by the company, for example, in its offering prospectus or annual report. It is shareholder expectations based on these public statements that should be considered legitimate and protected by the courts.

IV.3) The Problem with High Control Premiums

The problem of control premiums is not that they have disadvantaged minority shareholders (they should have discounted accordingly). However, this does not mean

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18 *Re Astec (BSR) plc* [1998] 2 BCLC 556

19 [1999] BCLC 1

that high control premiums do not negatively impact an economy. High control premiums can create at least four negative effects: (1) lower overall investment, (2) greater exodus of capital in a crisis situations, (3) it could divert effort away from increasing productivity, and (4) it could disturb the allocation of resources in an economy (by restricting the uses of funds).

Lower Overall Investment. When the benefits of a company are strongly concentrated with its block shareholders, the company is less able to seek external equity. That is, while the value of company is unaffected, the source of new capital funding the company must come either internally or from debt. This could reduce the amount of capital the company could otherwise have mobilized (Modigliani and Perotti 2000). Also, when there are fewer external shares trading in the stock market, this reduces liquidity in the stock market (Bolton and Von Thadden 1998). Perhaps more detrimentally, however, the predominance of companies where controlling shareholders derive most of the gains from a company could result in adverse selection against companies favorable to external shareholders, that is, investors might not be able to distinguish between companies with high benefits of control from companies where wealth is evenly distributed between shareholders, which would lead to the share price of the latter type of company being unfairly depressed by the market. This could, in turn, lead to lower investment in the whole country (Rueda-Sabater 2000).

Higher Risk in Crisis. If it is perceived that controlling shareholders can derive private benefits of control, then in crisis situations, there is the risk that the controlling shareholders might use that power to tunnel resources away from the

company. External investors would then have strong reason to exit the company when it is in financial trouble (Johnson, Boone, Breach and Friedman 1999).

Productivity Diversion. There are two ways of characterizing this problem: (a) allowing controlling shareholders to expropriate creates conflicting incentives. If we assume that controlling shareholders have the power to manage the company, then the discounting of share values by minority investors would, instead of spurring management to improve the company, provide even stronger incentives for controlling shareholders to expropriate (Bebchuck and Jolls 1999). (b) In a firm where expropriation is possible, the controlling shareholders will be dividing their efforts between maximizing firm value and devising methods of expropriation.

Restricted Resource Allocation. In two ways: (a) because established firms are likely to be more trustworthy (have better reputations) and are more able to provide collateral, established firms are able to obtain financing at significantly lower costs than entrepreneurs, which might lead to a restriction of competition (Stultz 2001). (b) The general public are only given a limited ability to participate in equity-funded projects and thus are restricted to debt-funding. This limits the amount of risk-taking the general population might wish to undertake given the opportunity. This could have macro-implications, as there is evidence that liquid stock markets and banking development strongly contribute to economic growth (Levine and Zervos 1998).

V) Solutions and Suggestions

Self-Binding. Corporate governance is at its core a question of trust. It does not matter who has control as long as others have enough knowledge of what will be done with that control (and can price their participation accordingly). As we have discussed above, companies have an incentive to signal their trustworthiness to the market. What is required is a system that allows them to credibly do so.

Therefore, perhaps the most direct way to dealing with governance problems is to ask management or, as the case may be, majority shareholders, to bind themselves. This has wider implications. The approach that a company should always maximize (solely) its shareholder value misses one of the vital characteristics of a corporation: company management exists to act as an intermediary (financial, informational, etc.) (Blair and Stout 2001, Spulber 1999, Blair 1995)[20]. In fact, if we consider the value of the corporate form as precisely the separation it allows the corporate personality from its shareholders, then we must consider what implicit obligations the corporate form has to all its stakeholders (Zingales 2000). That is, from a transactions cost perspective, the primary reason why a firm exists as it does at all is because a bureaucratic structure is more efficient than a contractual one (Williamson 1985, Eisenberg 1999b). It is precisely the fuzziness of the firm's obligations that is its structural strength. As such, management should have credible ways to control themselves to all parties involved. (Although why firms do not adopt stronger self-disclosure remains an unresolved question in financial economics.

A Return to Values ? Another factor in governance, which might be more important than previously imagined, is social norms (Coffee 2001a, Eisenberg 1999a).

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20 For a systems theoric analysis these issues, see Teubner 1988.

One reason (one could say the primary reason) why a company or its management would opt into a more stringent system is simply because it is the social norm to do so. As Cheffins (2001) puts it, one reason for the success for the London Stock Exchange in the early part of the 20th century is the "shared beliefs" of the market participants. Now with newspapers decrying the "crisis of trust" in the American capital markets (The Business, 9-11 June 2002), perhaps norms are returning to the forefront as the likeliest candidate for the past success of the US capital market.

Generally, we can now see that LLSV were perhaps a little precipitate in saying "The successful regulations of the US securities market, the Polish financial markets, and the Neuer Markt in Germany share a common element, namely the extensive and mandatory disclosure of financial information by issuers, the accuracy of which is enforced by tightly regulated financial intermediaries." (LLSV 1999b) Only a few years later, the US stock market and the German Neuer Markt are no longer such good examples of corporate governance. Perhaps it is time we extend our analysis of the problem from its usual suspects (law, regulations, etc.) and focus instead on the fundamentals of what makes capitalism work: trust.

Chapter 3:
The Uses of Debt

Neither a borrower nor a lender be,
For loan oft loses both itself and friend,
And borrowing dulls the edge of husbandry.
Hamlet, Act 1, Scene 3, lines 75-77

Introduction

In the media, the mention of corporate governance is seldom more than a prelude into a blaming game. This even extends to whole countries: when an economy which is deemed to be dominated by its banks is not running well, it is due to the inefficiency of the banking system, conversely, when an economy fueled by equity stumbles, one blames the myopia of the stock market. The problem is many of these statements do not come with adequate analyses into the tools these corporate governors have at their disposal and therefore cannot give a fair appraisal of whether these tools are being misused.

The use of debt has always been regarded with suspicion, reaching far back into history[21]. Two fears are associated with the use of debt: first is the traditional businessman's advice to avoid debt, presumably because repayments will hinder growth and one runs the risk of losing the entire business and second, the association of debt with relationship lending. In an analysis of the Asian financial crisis, Rajan and Zingales (1999) write: "[Banking relationships] have a downside in that they do not rely on price signals. The consequence has been a widespread and misallocation of

21 . "[T]he condemnation of usury stems from the earliest times. Aristotle remarks how strongly and justifiably it was disliked in his day, and comments that money was not intended for this, but for buying and selling; usury merely produced money out of money and so of all ways to wealth was the most unnatural. Amongst the ancient Jews, usury was not only hateful and unnatural, it was a sin specifically condemned by God." (Kerridge 2002: 15-16)

resources." The perils of debt even apply at a macroeconomic level. Warburton forwards a thesis "that both citizens and governments have become heavily addicted to borrowing and no longer care about the consequences" (Warburton 2000: 19) and "over-emphasis, to the point of obsession, on the inflation objective has blinded governments and their central banks to the risk of widespread debt default by borrowers." (Warburton 2000: 261)

This chapter will be divided into four sections. The first will be an overview of the literature on capital structure, as the theoretical framework presented will be the foundation of the arguments to follow. Secondly, I will explore how relational banking mitigates many of the factors that weigh against debt in the choice of capital structure. That is, relational banking reduces bankruptcy costs and informational asymmetry. The third section will be an argument defending the institution of secured credit which will lead into an analysis of the English floating charge and recent amendments to it.

I) Capital Structure.

Capital structure, or the balance between debt and equity financing in companies, has been one of the central issues in corporate finance from the very beginnings of the field. It is therefore no surprise that there should be interest in how capital structure varies from country to country.

Recent research into comparative financial systems has hypothesized that the common division of financial systems into bank-based and market-based systems

could be caused by weaknesses in the legal framework of bank-based systems. As Modigliani and Perotti (2000) put it: "Securities are standardized arm's length contractual relationships, and their associated investor rights depend largely on security laws; proper enforcement depends on the quality of the legal system. Thus an inadequate legal framework impairs the development of securities markets, allowing expropriation of small shareholders and bondholders. As a consequence, bank lending emerges as a more viable and reliable form of intermediation." More specifically and perhaps more interestingly, La Porta, Lopez de Silanes, Shleifer and Vishny (henceforth LLSV) find that countries with French and Scandinavian legal origins have low levels of both debt and external equity financing when compared to countries with English legal origins; countries of German legal origin have lower external equity levels but higher debt levels than English legal origin countries (LLSV 1997).

Prasad, Green and Murinde (2001; henceforth PGM) make the important point, however, that it is not easy to generalize about comparative capital structure. PGM note that:

a) While, generally, countries can still be categorized as "high leverage" (Japan, Germany, France and Italy) or "low leverage" (Canada, the UK and US), there are many qualifications to such a categorization. Countries can change categories depending on how leverage is calculated and capital structures can change (sometimes radically) over time.

b) Developing countries (which therefore, should have less developed financial systems and be bank reliant according to Modigliani and Perotti) show no absolute preference, as a group, for debt or equity.

It should also be noted that these differences in capital structures between countries do not seem to have a direct impact on economic growth. Despite the fact that countries of French legal origin are restricted to mainly private capital and countries of German legal origin to debt capital and countries of English legal origin having access to both debt and outside equity capital (LLSV 1997), their economic performance in the long run has not been that dissimilar.

> In terms of prosperity creation (i.e. growth rate of GDP per capita) the US and Europe have been so similar over the last twenty years that if you want make either a pro-European or pro-American case, you simply have to pick your start and end dates with care. And once you've picked your comparison years, what you end up with is one continent just a few tenths of a per cent ahead of the other. (Turner 2001) (Keeping in mind that, on the European continent, only the UK and the Republic of Ireland are of English legal origin.)

We could perhaps ask at this point: what are the essential differences between debt and equity? The fundamental differences are obvious; creditors are paid before shareholders in bankruptcy (priority), debt is paid in fixed amounts, ordinary shares are allowed voting rights, etc. But beyond all of this, it is possible to argue that both debt and equity are, at core, an infusion of credit for a return. Different variations in securities erode the differences between debt and equity; there are intervening levels of priority between secured debt and ordinary shareholders, convertible bonds capture both the security of debt and the upswings of equity and not all shares have voting rights. As Allen and Gale (1994: 351) put it: "The fact the debt and equity are not the only securities that firms use to finance their activities, and the constant introduction

of new forms of securities, suggest that a more fundamental question than "What is the optimal debt equity ratio?" is "What are the optimal securities that should be issued?".

(Intriguingly, however, corporations tend to use fairly straightforward debt and equity. Use of alternative financial devices is limited. (Copeland, Weston, Shastri 2005: 617) Fama and Jensen (1983) propose that the separation of claims into only debt and equity makes sense because creditors (low risk bearers) can rely on shareholders (high risk bearers) to monitor the corporation, thus reducing monitoring costs and lowering the cost of risk bearing.)

Theories of Capital Structure

Arguments about D/E ratios tend to obscure one consideration: rationally, companies should choose to fund themselves using the lowest cost of capital. That is, they should use debt if debt is cheaper and equity if equity is cheaper. If we take an international comparative viewpoint, the question then becomes: is cost of capital cheaper in market-based systems than bank-based systems? This is a difficult question to answer. The general view appears to be that the cost of capital in Japan was lower than the US in the 1970s and 1980s but was been more or less equal in the 1990s. (Frankel 1993: 60-1) Both the cost of debt and the cost of equity was cheaper in Japan (although the calculation of real interest rates was complicated by the requirement of borrowers to place "compensating balances" and the measurement of the cost of equity is always debatable.) (Argy and Stein 1997)

However, measuring cost of capital directly is even more problematic than measuring capital structure. Ando, Hancock and Sawchuk (1997) present a painstaking and admittedly tentative study in which they conclude that "the cost of capital in Japan is somewhat lower than that is the United States, although not by a very large margin." They also argue that "this lower cost of capital was probably generated by a very high and continually rising price of land".[22]

We will now explore theories of the balance between debt and equity, starting with areas not normally covered by finance theory and then into standard models of capital structure.

I.A) Macroeconomic Effects

There have been, oddly, very few studies of comparative macroeconomics and capital structure. Changes in inflation can affect debt and equity prices (in opposite directions) in two ways. (A change in interest rate has an inverse relationship to bond prices, that is, bonds go up as rates fall and go down and rates rise. Stock returns, however, show no clear correlation with interest rates. Lowering interest rates could be taken as a harbinger of future growth, causing stocks to rise, or an indication of

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22 For those interested in the technical details of Ando et al's conclusions, this is their summary of their earlier work in field: "while, in the U.S. , the accounting measure and the market measure of capital appeared reasonably close to each other when they are averaged over a fairly long period of time, in Japan the market measure appeared to be noticeably higher than the accounting measure. The market measure of the cost of capital appeared similar for these two countries, and therefore the accounting measure of the cost of capital in the U.S. looked noticeable higher than that in Japan. [Ando et al] explored a number of potential causes of this pattern and suggested as a plausible hypothesis a role played by the extraordinarily high price of land and continual real capital gains corporations in Japan enjoyed by their ownership of land. Since such capital gains are not included in the measurement of earnings by firms, if these gains are in fact recognized by market participants and taken into account in valuing corporate shares, it may explain the discrepancy between the accounting and market measures of the cost of capital, hence the difference between the cost of capital in the U.S. and in Japan in terms of its accounting measure." (Ando, Hancock and Sawchuk 1997)

economic sluggishness, causing stocks to fall. Interest rate changes should not affect stock prices in the long run. See, for example, Kettel (2001), chapters 5-7 or Van Horne (2001) chapters 4, 6 and 7.)

a) Rational Inflation Discounting. "In contrast to bonds, equities are real assets. A real asset is one that is capable of protecting the owner from inflation. Bonds cannot do this because the sums involved are fixed, whatever happens to the general level of prices. Companies, on the other hand, can raise prices to compensate for increases in their costs (subject to competitive and other influences, of course) and generally have a fighting chance of raising profits and dividends in line with the general level of prices. In fact, dividends have generally risen higher than inflation and it is this, as much as anything, that underpins the case for equity investment." (Golding 2003: 50) It should follow, therefore, that investors in countries which are subject to high inflation should prefer equities. This point, however, has two caveats: i) equities can only be expected to beat inflation in the long term, short term effects can affect earnings and ii) there are inflation-adjusted bonds, they are just not as common as regular bonds.

b) Irrational Discounting or The Modigliani-Cohn Effect. If we assume that households and firms do their financial planning in nominal, rather than real, terms (that is, without taking inflation into consideration), then we can expect major miscalculations to occur. In particular, accounting profits would systematically understate economic profits. Therefore, shares would be undervalued. (Modigliani and Cohn 1979) The reverse could also be true; if inflation rates fall and this is not taken into due consideration by investors, share prices could be systematically overvalued.

McCauley, Ruud and Iacono (1999) argue that this "reverse Modigliani-Cohn effect" could be one of the causes of the US stock market boom of the 90s.

I.B) Mispricing

Another factor in the pricing of securities is simply mispricing. Kaplan and Stein (1993) argue that the debt-heavy financial structures (particularly in leveraged buyouts) prevailing in 1980s US corporations were the result of a systematic overvaluation of high-yield bonds. Many recent financial collapses have also been blamed on mispricing of securities (one famous exposition is Robert Shiller's Irrational Exuberance (2000). See, generally, Hunter, Kaufman and Pomerleano 2003).

The majority of work in this field has been based on psychological deviations from rationality (summarized in De Bondt and Thaler 1995). While such work in behavioral finance is fascinating, more research must be done in regard to the specific institutional settings that affect decision-making (the social psychology counterpart to the psychology, as it were). A pressing question concerning financial markets is: why aren't there rational market participants restoring rationality to the market simply by profiting off the irrational investors? De Bondt (2003) offers this argument:

> A pure arbitrage opportunity does not exist unless it is certain that share prices will eventually revert to their fundamental underlying values. However, to affect prices, investors with superior forecasting ability or with inside information must assume increasing amounts of diversifiable risk. In practice, arbitrageurs face financial constraints (Shleifer and Vishny 1997). Second, it many be rational for these traders to ride the trend rather than to go against it. Third, the resilience of a bubble may stem from the inability of rational arbitrageurs to coordinate their selling strategies. Fourth, a market may rational

> launch itself onto a speculative bubble with prices being driven by an arbitrary self-confirming element in expectations. (Tirole 1982)

An interesting addition to this field is what Cochrane (2003) calls "irrational *trading*, but not irrational *valuation*" (emphasis in original). This would include Cochrane's own thesis of the tech-stock bubble as a result of a "convenience yield". That is, when there is a large amount of trading due to wide differences of opinion in a given stock (or class of stock), then if the amount of shares is limited, the share price could be driven up. (Cochrane 2003) Cochrane also cites a model by Ofek and Richardson (2001) who explore a similar argument that short sale constraints prevent pessimists' views from being expressed.

The problem with theories of mispricing, particularly theories that impute irrationality is that they explain too much. Any deviations from what would appear in hindsight to be rational or correct valuation can simply be explained as irrational. As Cochrane (2003) points out: "being *wrong* once is not the same as being *irrational*" (emphasis in original). A theory of mispricing should be specific enough to detail the circumstances in which such a mispricing would occur and the manner and magnitude it should have. Current theories are simply not exact enough.

In summary, even though some argue (very likely, rightly) that securities in many periods are mispriced (e.g. McCauley, Ruud and Iacono (1999), who argue that capital structure in the USA can be explained in large part by an overvaluation of bonds in the 1980s and an overvaluation of stocks in the 1990s), it is very difficult to take mispricing into consideration for a theory of comparative capital structures. Mispricing is hard to rigorously identify and, vitally for a comparative theory, we do

not have a theory of mispricing exact enough to allow us compare causal conditions for mispricing.

I.C) Standard Theories of Capital Structure[23]

The modern theory of capital structure begins with Modigliani and Miller (1958, 1963, henceforth MM). MM proposition I: "The market value of any firm is independent of its capital structure". That is, under ideal market conditions (e.g. frictionless trading, borrowing at the risk-free rate, no taxes or bankruptcy costs, etc.), it should not matter what mix of debt and equity the firm is financed with. Miller analogized the matter to the slicing of a pie; no matter how a pie is sliced, it remains the same size. But first, we need a quick introduction to the concept of risk-return.

The Risk-Return Tradeoff. The risk-return tradeoff is one of the fundamental building blocks of finance theory. The intuition is simple: investments which are riskier should provide a higher return. Projects which provide returns that are inadequate to the risk will be ignored, while projects with above-market returns should be bid up by the market (a concrete example would be: a) an entrepreneur who learns that she can lower returns to her investors and retain her projects attractiveness or b) a stock which is outperforming expectations will eventually rise to a level where it is no longer possible to profit from it). A reasonable efficient market will therefore converge on an

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23 This is not meant to be a rigorous discussion of the topic. Proofs and further elaborations on the assumptions of these arguments can be found in most finance textbooks. See, e.g., Brealey and Myers (2000) or Copeland, Weston, and Shastri (2005)

equilibrium level of risk-return in projects. All projects should be on what can be thought of a Capital Market Line (CML). [24]

MM prove their argument with an arbitrage argument. In a simplified form, the argument is simply this: imagine there are two firms with equivalent cashflows and risk, one of which is financed only by equity (firm A) and the other financed by a mix of debt and equity (firm B). If the value of firm A is deemed to be lower than the value of firm B (or vice versa for that matter), then it would be possible to get a higher return on firm A (because the price of firm A is lower than firm B, even though the value- that is, the cashflows, at equivalent risk- are the same). The market should eliminate this difference by arbitrage.

Risk-return is also at the core of MM proposition II: even though the value of the firms stays the same, the addition of debt to the capital structure of a company will cause the rate of return on equity to rise. This is because of priority. As debt holders get paid before equity holders, if cashflow falls below the level of debt payments, equity holders will not get paid at all. Shareholders are more at risk from falling earnings than debt holders. Priority acts as a kind of risk-shifter. Therefore, to compensate shareholders for the extra risk, share returns in a debt-financed company should rise.

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[24] Current finance theory takes this idea one step further and speaks of a Security Market Line (SML). This takes into consideration that fact that risk can be lowered by diversification, and, therefore, the risk of a security has to be measured against general market risk. This measure of risk is called beta and can be defined as the covariance between the return on the security and the market portfolio divided by the variance of the market portfolio.

Once the idealized conditions of MM are relaxed, however, many factors come into play in determining capital structure. The following is a quick review:

Corporate Taxes. Interest payments are deducted from a company's profits before taxes. Which means that payments to bondholders are not subject to tax (at a corporate level), whereas payments to shareholders (whether as dividends or capital gains) are pre-taxed. Debt, therefore, acts as a kind of "tax shield". As a result of this, debt should be cheaper than equity as a result of debt having a dual function as a tax shield. (MM 1958, 1963)

Personal Taxes. However, in many jurisdictions, personal income taxes are lower for capital gains than for interest income. Additionally, capital gains taxes can be deferred (that is, one can opt not to sell the shares). This means that for the final beneficiary, the effects of corporate and personal taxes can cancel each other out; debt is not taxed at corporate level, but is more harshly taxed at personal level. (Miller 1977) The advantage for debt is therefore uncertain, depending on the exact amount of taxes at each level. (Brealey and Myers 2000 note that the current US tax regime gives the edge slightly to debt.)

Other factors also mitigate the value of debt as a tax shield. First of all, the firm needs to be profitable in the first place in order to require a tax shield at all. Also, there are many other methods to reduce taxes, e.g. depreciation, pension fund contributions, etc. Interest tax shields are therefore more valuable to certain firms than others.

Bankruptcy Costs. The higher the amount of tax a firm carries, the more susceptible it is to bankruptcy. If cash flows of the firm fluctuate to a level where it cannot make its interest payments, the firm becomes bankrupt. But we have to be careful about what we regard as the cost of bankruptcy. We must distinguish between financial distress and operational distress (in practice, the two are difficult to separate). Just because a firm is financially bankrupt does not necessarily mean that there is anything wrong with its fundamental business. If all that happens in a bankruptcy is that control of the company passes from the hands of the shareholders to the bondholders, the value of the company is unaffected. Even in the case of liquidation, "liquidation (dismantling the unprofitable firm) is a capital budgeting decision that should be considered independent from the event of bankruptcy (transfer of ownership to creditors)." (Haugen and Senbet 1978) If the process of bankruptcy itself causes a reduction in the value of the firm, participants in the bankruptcy process (i.e. creditors and shareholders) have an interest in preventing the bankruptcy from happening, that is, they should "avoid the costs associated with formal reorganization, should they be greater than the costs of informal reorganization." (Haugen and Senbet 1978) In a rational market, therefore, bankruptcy costs are significant only when debt restructuring is costlier than formal bankruptcy.

Bankruptcy costs can be direct or indirect:

Direct Bankruptcy Costs. These are the obvious costs of bankruptcy: lawyer's and accountant's fees, other fees, administrative costs, etc . Warner (1977) measures these direct costs and comes to the conclusion they are trivial (5.3% at the time of bankruptcy). Later studies have shown some variation in the magnitude of these costs,

e.g. Gibbs and Boardman (1995) found that bankruptcy costs amounted to 3.5% in the case of the Eastern Airlines bankruptcy case and Bradbury and Lloyd (1994) found that bankruptcy averaged 14.3% for New Zealand small businesses. The conclusion would seem to be that direct costs of bankruptcy are too low to substantially impact capital structure, except perhaps in small firms (assuming bankruptcy costs are similar in small or big firms, these costs would weigh more on small firms).

Indirect Bankruptcy Costs. However, if we measure the decline of a firm's profits and share prices during a bankruptcy, we see dramatic differences. Altman (1984) notes the presence of what might be termed business disruption costs: a) lost investment opportunities, these include investments that may not be possible in bankruptcy due to the higher cost of credit as well as investments passed up by shareholders because gains from the investment will accrue directly to creditors (Myers 1977), b) losses from "bankruptcy stigma", that is, loss of profits or sales due to the fact that a firm in, nearing, or even newly out of bankruptcy is perceived (quite rationally) to be less reliable. "Indirect bankruptcy costs are not limited to firms which actually do fail. Firms which have their high probabilities of bankruptcy, whether they eventually fail or not, still can incur these costs." (Altman 1984)

Altman (1984) proxies indirect bankruptcy costs by estimating expected profits for the period up to three years prior to the bankruptcy (using two measures: a regression procedure and analyst forecasts) and comparing these expected profits with actual profits (or losses). He found bankruptcy costs exceeded 20% in some of the firms measured and ranged from 11-17% overall. Opler and Titman (1994) test for indirect bankruptcy costs by comparing the decline of high-leverage firms with low-

leverage firms during a downturn. They found that sales and market value of high-leverage firms both decline an average of 26% more than low-leverage firms.

It is possible to see taxes and bankruptcy costs as the two balancing forces in a firm's capital structure. (Leland 1994, Leland and Toft 1996) Sometimes taxes/bankruptcy costs and competing agency costs (explored in the next section) are held as competing equilibrium theories of capital structure. There is no reason why both (or rather all three) factors should not be at work at the same time. In fact, one reason why a definitive theory of capital structure is proving so elusive might be because there are too many factors to be captured in an empirical test.

Agency Costs. Whenever a firm acquires external financing, there is always the issue of how much the investors can trust the managers (or in the case of debt, also how much the creditors can trust the shareholders). These costs can take the form of investors monitoring the managers or actions that the managers need to take in order to assure investors that their investment will not be abused. The risk that investors face from improper actions from managers will be reflected in a higher return, that is, a higher cost of capital. Both debt and (external) equity incur agency costs. These have been explored in some detail in an earlier paper and so will be dealt with only cursorily here[25].

Agency Costs of External Equity, or conflicts between shareholders and managers.

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[25] This discussion will follow the useful outline given by Culp (2001).

a) Perquisite consumption by managers. When there is a separation of ownership from control (that is, when the entire firm is not held and run by the same party), managers have an incentive to divert some of the resources of the firm for their own benefit. This is because profits of the firm do not accrue directly to the managers. (Jensen and Meckling 1976) This agency cost can be alleviated in some part by incentive devices such as share options (keeping in mind of course that the concordance of interests is never complete). (Bebchuck 2002)

b) Free cash flows and overinvestment. The problem of perquisite consumption becomes exacerbated in companies that have high levels of cashflows and few (positive NPV) investment opportunities. Managers could use these cashflows in unproductive ways, simply to increase the size of the firm and aggrandize themselves. (Jensen 1986, Stulz 1990)

Agency Costs of Debt. One way of controlling the above agency costs of external equity is by issuing debt. Debt reduces the amount of cash managers have at their disposal and adds an extra monitor of managerial behavior. However, debt also has agency costs.

a) Asset substitution. When the debt burden of a firm is high, shareholders have an incentive to take high-risk projects rather than low-risk projects, even if the NPV of the high-risk project is lower[26]. Shareholders only stand to gain if the payoff

[26] Roughly, if the payoff for a high-risk project is high but unlikely and the payoff for a low-risk project is low but relatively certain, to the extent that, once probability is taken into account, the low-risk project is more valuable than the high-risk project, then the low-risk project has higher NPV (net present value).

of a project exceeds the debt burden of the firm because creditors have priority over the cashflows of the firm. (Fama and Miller 1972, Fama 1976, Easterbrook 1984)

The timing of investment decision is important. If creditors are aware of the shareholders intent to take the higher-risk, lower NPV project, they would buy out the shareholders in order to benefit from the higher NPV project. In practice, covenants and reputation discourage managers from blatant asset substitution. Corporate law in many countries also protect against this by stipulating that managers should act in the interest of creditors rather than shareholders when a firm is near insolvency. (Under English law, the position is uncertain as to when the responsibility of directors to creditors begins. See Finch (2002), pp. 504-520.)

b) Underinvestment or debt overhang. This is related to the problem of asset substitution and is the situation when the firm is debt-laden and has a positive NPV project with a payoff that only covers debt payment (no return to shareholders). The shareholders will then have no incentive to pursue the project. (Myer 1977)

Information Asymmetry or Pecking Order Theory. Pecking order theory posits that firms prefer their choice of financing in this order: retained earnings (internal equity), debt and then external equity. The less investors know about the prospects of the firm, assuming they are rationally risk-averse, the more skeptical they should be. The firm obviously has the best knowledge of its own prospects so retained earnings are the cheapest form of financing. Debt financing, because it a) is based on fixed payments (rather than residual claims), b) has priority and c) is sometimes secured, requires less detailed information (is less risky) than external equity. External equity is heavily

reliant on information, but, even with disclosures under securities law, is at a disadvantage to the other forms of financing and is therefore riskiest and should be the most expensive. (Myers 1984, Myers and Majluf 1984)[27]

Conclusion. There have been a substantial number of studies attempting to verify different aspects of capital structure theory. These, taken as a whole, have been markedly inconclusive. The general gist of the theories appear to be correct (debt is cheaper than equity), but the specifics of each theory have not been clearly borne out. (PGM 2001 and Copeland, Weston and Shastri 2005: 604-611 provide able summaries of the empirical research.)

The theoretical side of the field is still developing, e.g. Leland (1998) has a combined model of taxes, bankruptcy and agency costs as well as a preliminary of the possible effects of risk management (hedging), Ju, Parrino, Poteshman, and Weisbach (2002) demonstrate that in a dynamic model, where firms can change their capital structures, transaction costs may play a significant factor in capital structure and the work of Welch (2002, 2003) indicates that stock returns may be the fundamental determinant of capital structure changes.

II) Relational Banking

Relational banking, that is, lending by banks with close ties (long term relationships or shareholding) to their borrowers, is looked upon with some suspicion.

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[27] A similar theory is signaling. One signaling story is: managers of firms can choose to send signals to the marketplace by issuing debt or paying dividends. These signals cannot be replicated by failing firms because they do not have the cashflow. (Ross 1977) Another story is that firms can be evaluated by how much owners invest in their own firms. If we assume that owners have the best view of the prospects of their firm, then the fact they choose (or not) to invest in their own firms is an indication of the quality of the firm. (Leland and Pyle 1977)

These practices are regarded as corrupt or "crony capitalism". And no doubt, in many circumstances, related lending should be avoided. However, relational lending does have its advantages[28].

In countries where equity control is weak and there is a risk of misuse of free cash flow (such as in transitional economies), then it may be the case that debt is the superior constraining device on management. (Baer and Gray 1995) Historically, even in the two countries where relational lending is least pronounced, the US and UK, relationship lending was widespread. (Lamoreaux 1996: 6-8) Lamoreaux points out that, in conditions of credit and informational scarcity, often the only method to mobilise credit is through reputation. Banks in the 1800s functioned rather like "investment clubs". But just because most funds were made available by reputation did not mean that a) investors in the banks were at risk (Lamoureaux writes: "Because the practice of insider lending was common knowledge, purchasers of bank stock knew that they were for all practical purposes investing in the enterprises of the institution's directors." (Lamoreaux 1996: 52) or that b) outsiders were denied capital (outsiders simply faced more stringent requirements. Lamoreaux 1996: 52-70). In fact, the reason why the practice of insider lending eventually disappeared was because of an increase of credit in system, to the point where there were not enough insiders to use the capital. This then led to the emergence of banking professionals with objective criteria for credit extension, which then gradually became the standard upon which all loans had to meet. (Lamoreaux 1996: 89-118)

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28 It is interesting to note that the prototypical relational lending system, the Japanese main bank system, occurred more or less as a result of historical forces rather than as a "natural development".

There are studies that show that there are advantages to relational lending in the US even today (Petersen and Rajan 1994, Gande, Puri, Saunders and Walter 1997), particularly in small and medium sized firms before they enter the capital markets. Relational lending can be used to overcome many aspects of informational and agency costs:

Asset Substitution. Because, as discussed above, the presence of debt in a firm's capital structure gives the firm's shareholders an incentive to select lower value (NPV) projects to the detriment of debt holders, some firms (without sufficient "reputational assets") may not be able to issue debt in the capital markets. These firms, however, should still be able to obtain a loan from a bank provided the bank can monitor the firm enough to avoid asset substitution risk. (Diamond 1991, see generally Freixas and Rochet 1997: 32-40)

Certainty of Credit. A firm may have to make an unobservable investment in order to prepare itself for a project. If, however, the firm is uncertain about obtaining the funds to finance the project, it may choose not to pursue the investment. A stable relationship with a bank will guarantee a source of financing that allows the firm to make the efficient investment. (Boot, Thakor and Udell 1991)

Liquidity Constraints. An associated point with the previous one is: firms with relationships with banks appear to be less liquidity constrained than independent firms. (Hoshi, Kashyap and Scharfstein (1993) provide evidence from Japan, Elston (1995) provides evidence from Germany)

(Hoshi 1995) This certainly lends credence to the theory of Bebchuk and Roe that corporate governance

Tacit Knowledge. Even without transaction costs and all possible attempts to reduce information asymmetry, there are still advantages to relational lending. Aoki (2001) notes that *tacit* knowledge ("less standardized, unquantifiable knowledge") is of foremost importance in developing economies in general and in new firms or firms in new industries even in developed economies. The relationship between bank and lending gives the bank borrower-specific information that allows the bank to properly assess the project. (Bhattacharya and Chiesa 1995)

Reduction in Bankruptcy Costs. Firms which a strong relationship with a bank may be able to avoid bankruptcy in the event of financial (rather than operational) distress. The bank will essentially privatise the bankruptcy process, thus eliminating indirect bankruptcy costs altogether. (Sheard (1994) studied Japan and Ferri, Kang and Kim (2001) studied Korean companies during the crisis)

This system is mutually beneficial, as the "a portion of the anticipated cost savings is passed on to the main bank itself, well before failure occurs. This is why, in spite of the anticipated special burdens that fall on the largest debtholder should a firm fail, each lender to a large, important Japanese firm covets the position of main bank." (Flath 2000: 283-284)

Interestingly, this protection from bankruptcy does not occur in the German system. Whereas, in the Japanese system, the main bank will assign its own employees to the bankrupt firm and restructure the debt itself. (Sheard 1994), German

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is path dependent. (Bebchuk and Roe 1999)

banks have not shown a willingness to intervene in an industrial crisis (Canals 1997). Across the board, however, "bank-related firms are 75% less likely to file for bankruptcy than firms without ownership times to a bank." (Claessens, Djankov and Klapper 1999)

Problems

Despite all the above advantages, however, relational banking has several inherent faults:

Soft Budget Constraints. Because a banking relationship is exclusive, banks may abuse this power by allowing firms too much credit. As these banks know they have priority rights over the firm in a quasi-bankruptcy (one that never goes to court, that is, a bailout), they do not have an incentive to monitor the firm beyond the point where the assets of the firms impact its bankruptcy value. (Dewatripont and Mashkin 1995)

Misvaluation of Projects. Financial intermediation implies that the financial intermediary has some advantage over the market in the valuation of firms. However, the financial intermediary itself (in this case, the bank) has no market signals to rely on. The only market signals it has are at one remove: a reaction from its depositors or shareholders, neither of which is usually in an informational situation to assess its prospects adequately. This means that banks can be very wrong in valuing firms. (Rajan and Zingales 1999)

Monopoly Rents. The bank can use its power over the firm to extract rents over it. This could have a restrictive effect over the size of firms. (Aoki 2001) There is also legitimate concern over banking concentration. If there are too few banks in an economy, then there could be a lower amount of credit available to firms. However, empirical research seems to indicate that, while banking concentration does lower the amount of credit, a concentrated banking sector does a better job of funding capital intensive industries. (Cetorelli and Gambera 1999)

Conclusions

The core problem behind relational lending is this: who controls the banks? It is precisely the role of bank as an intermediary that is its strength and its problem. The bank is assumed to have better knowledge of the company than the market, but it is precisely because the market cannot properly assess the performance of the bank that causes the mistrust of relational lending.

Relational banking is then an issue of a shift in control. Control (and risk) is partially taken away from the shareholders of the firm and put in the hands of banks. But can they be trusted? Who is monitoring the monitors? To put the problem another way: a) do depositors have the ability to evaluate the bank? and b) are regulators motivated or informed enough to control wayward banks?

III) How Strongly Should Secured Credit be Protected?

There is an ongoing argument in the Law and Economics literature about the efficiency and desirability of secured credit, which has been responsible, at least in part, for the Cork Committee report's[29] recommendation than 10% of the net realisations of assets subject to charges be made available for distribution among unsecured creditors and has led, in turn, to the institution of such a re-distribution in regard to floating charges in the Enterprise Act 2000 (EA). This section will argue that many arguments against secured credit are based on misunderstandings (some of which are misunderstandings of other arguments against secured credit) and will attempt to establish parts of the arguments, both for and against secured credit, on a firmer base. For the most part, these arguments can be considered a generalization and extension of the arguments put forth by Mokal (2002).[30]

This section will develop four arguments: 1) that many attacks on secure credit stem from a mischaracterization of the nature of secured credit, in particular, a) most attacks underplay or ignore entirely the property aspect of secured credit, focusing on the priority aspect and b) part of the justification of secured credit arises from inefficiencies in the usual de facto alternative to secured credit, *pari passu*; 2) an analysis of the "uneasy case" for secured credit, that is, that accusation that secured credit diverts value from unsecured creditors[31] must answer the question: which party is the most efficient bearer of the relevant risk?; 3) on the other hand, the argument that secured credit is not only not detrimental to unsecured creditors, but is usually

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29 *Insolvency Law and Practice, Report of the Review Committee* (Cmnd 8558, 1982)

30 In part because Mokal (2002) focuses more on relating empirical evidence to these arguments while the arguments in this paper focus on presenting the theoretical argument in a rigorous form.

31 The term "uneasy case" comes from the strongest and most general statement of this line of argument, the seminal article Bebchuk and Fried (1996).

beneficial to them (Schwarcz's "easy case"[32]) is overstated: there is always a tradeoff between secured and unsecured credit; 4) the two proposed new alternatives to secured credit, adjusting priority and partial priority, produce different results and should not be considered too similar.

This section will extend current arguments in several ways. Starting from the observation that practice in capital structure has tended towards more diverse kinds of security and priority structures, such as sophisticated securitizations (e.g. CDOs) and debt-equity hybrids, the first series of arguments will be a defense of secured credit. An argument will be presented that demonstrates that Schwartz's (1989) argument that priority provides protection for prior creditors can be extended the other way, that is, priority may sometimes be required for previous investors to make an efficient investment. One corollary of this is that Schwartz's proposal that prior creditors be given automatic priority is flawed. More generally, it will be argued that the market for securities in general follows the rules of all markets: supply and demand. The customization of securities can create value because of the different preferences and capabilities of investors. The second half of this section will be a refutation of attacks against secured credit. In general, most arguments against secured credit focus on the possibility that the debtor firm will abuse other creditors. However, any misconduct of the debtor firm will adversely affect its shareholders. This section will accordingly argue that only in rare cases, specifically in some tort cases, should secured creditors be subordinated to unsecured creditors.

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32 Schwarz (1997)

One way of generalizing the question of secured credit is to look at it as the problem of how incentives are skewed under limited liability. The nature of limited liability is such that risks that should fall to the company owners are externalized. Limited liability essentially creates a structure in which risks are limited, but returns are unlimited. This creates an incentive for owners of the firm to take on more risk than they would otherwise. However, this system of shifting risk from the entrepreneur onto the society at large has proven to be an essential tool for capitalist investment. In a similar way, security in credit is a method of parceling risk down the credit chain. The question then is: what is the value of this risk parceling? A tentative answer, to be examined further in this chapter, is that this parceling of risk allows each participant to better isolate, understand and hedge against that risk. The cost of allowing this risk parceling is that some element of risk falls upon the true non-adjusting creditor, the tort victim. To compensate for this, perhaps some kind of institution is needed, such as tort insurance.

III.A) The Efficiency of Secured Credit

Some commentators start with the argument that there is no efficiency case for secured credit in the first place. They base their arguments on the MM hypothesis discussed earlier. In a perfect market, choices in capital structure are neutral; there is no net gain from different choices of capital structure. However, perfect capital markets do not exist. This section will demonstrate that there are at least some cases where the use of secured credit is efficient.

The case for the efficiency of secured credit usually starts at the issue of reduced interest. Secured loans are generally cheaper (that is, given at a lower interest rate) than unsecured loans. However, the reason why these secured loans are cheaper is usually explained simply by saying that they are "lower risk" (Bebchuk and Fried 1996: 857, Schwartz 1984: 1054). This can lead to a fundamental misunderstanding of the nature of secured credit:

> Secured creditors will charge lower interest rates because security reduces their risks, but unsecured creditors will raise their interest rates in response because security reduces the assets on which they levy, and so increases their risks. The interest rate reductions are precisely matched by interest rate increase; hence, *the firm makes no net gain from granting security.* (Schwartz 1984: 1054. Emphasis added.)

A deeper analysis of these issues is required. Secured credit has two prominent features: property and priority (Adler 1997). Both of these features contribute to why secured credit is used, but in subtly different ways.

The Property Aspect of Security. Taking security over a property constitutes taking a proprietary interest in that property. The property is then encumbered and cannot be disposed without the consent of the secured creditor (except in the case of the floating charge, which is unique in many respects). Upon bankruptcy, any proceeds from the property must first be used to satisfy the debt to the secured creditor (either through direct possession or a court-led bankruptcy process). (See, for example, US UCC articles 9-201 or, under English law, *Swiss Bank Corporations Ltd. v. Lloyds Bank Ltd.*[33])

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33 [1982] A.C. 584. Also see, generally, Goode (2003: 12-30)

While it is clear that priority is necessary for the property aspect of security, the property aspect is a major factor in its effectiveness. This is because the proprietary right secured creditors possess translates into a lower likelihood of loss in the case of bankruptcy. There are at least two reasons for this: a) Creditors may have a informational or transactional advantages on the property over the company as whole. If creditors are able to assess the value of the property more readily than they assess the value of the company, they will be able to lend at a lower interest rate on the basis on the property rather than the company. Creditors may derive this ability for several reasons: i) they could have special knowledge about that type of property (perhaps from long experience in the field), ii) they could have a mechanism that allows them to monitor the firm more effectively than other creditors (perhaps from being a major player in the that field)[34], or iii) they could be hedged against the risk that property presents. b) Creditors with a proprietary interest are in some jurisdictions allowed to foreclose on the asset without court intervention (a "repossessory right"). This allows them to opt out of the bankruptcy process, which is usually costly (see above on bankruptcy costs). It also allows creditors the threat of repossession, which should allow them the ability to influence debtor behavior even before insolvency (Scott 1986: 950). In other words, security can lower information asymmetry, lower agency costs and act as a basis for risk-diversification.

To clarify the point and distinguish it from the argument of Levmore (1982), one can express it thus: security creates value because is separates different areas of risk, thereby allowing specialization. To see this, one can examine the popular market structures:

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[34] For the two above points, see Jackson and Kronman (1979), Scott (1986), Schwartcz (1989) and

1) Mezzanine debt. Mezzanine debt is subordinated debt that ranks lower than senior debt but is higher than equity. It is generally unsecured. Mezzanine debt has been growing popularity. It is a) non-dilutive to equity and b) offers high returns, thus appealing to non-bank institutions, such as insurance companies and hedge funds. The market for mezzanine debt demonstrates that demand-side diversity can create value- once we step outside an MM world, the separation of capital into low-risk debt (asset-backed, which can be bank-financed), high-risk debt (unsecured, which appeals to investment funds) and equity (which owners may not want diluted) can itself create value.

2) Loan securitization. Collateralized Debt Obligations (CDOs), Collateralized Mortgage Obligations (CMOs) and Collateralized Loan Obligations (CLOs) are three of the fatest growing markets in securities (Fabozzi 2004). These structures work on the principle that the assets securing the loans are similar to be priced statistically (but are diverse enough to represent the risk of that asset market). This is particularly clear in the case of CMOs: instead of creating a basket of personal loans, which would be very risky to price (as in case of credit card loans), the separation of person's mortgage makes it possible to create a security class which can be priced according to asset price fluctuation (and prepayment risk, but that is another matter).

Baird (1994)

Once it is recognized that risk-separation can confer value due to the normal forces of supply and demand, one can see that it is not generally true that the amount of interest saved from lower interest rates from secured credit will simply be offset by higher interest rates from unsecured credit. The net amount of interest a debtor will pay if financed with a mix of secured and unsecured debt will depend on the proportion of debt taken under each rate of interest. Once the MM assumptions are relaxed and secured debt can be considered to add value to capital structure (that is, it is cheaper than unsecured debt), it is easy to construct a case where the combined interest in a mixed secured/unsecured debt financing is cheaper than a pure unsecured financing. That is, while unsecured creditors will indeed raise their rates in the presence of a secured creditor, the *net* amount of interest burden the firm will bear may decrease. A numerical example will illustrate this (see Appendix A).

Bebchuk and Fried (1996: 916-917, echoed by Finch 1999: 653) deny the efficiency benefits of the proprietary right advantage by characterizing the benefit as "monitoring-coordination". They focus on the fact that, in actuality, the gains from allocating specific asset risk to the creditor most able to handle those risks do not occur because most borrowers only have one "sophisticated" creditor capable of monitoring the firm. However, the efficiency argument for proprietary rights does not even require more than one creditor. As in the example in Appendix A, borrowing costs even from a single creditor can be decreased by allowing a security interest, as long as the borrowing cost (risk) for the asset is lower than that of the company as a whole.

The Bebchuk and Fried (1996) argument also ignores an alternative response to information asymmetry: credit rationing. Credit rationing occurs because creditors cannot simply raise rates to compensate for higher risks. If creditors, responding to the uncertainty deciding between good and bad borrowers, raise interest rates in response, this can have the effect of chasing good borrowers from the market (the interest demanded becomes too high for the project). (This is called "adverse selection".) It then becomes more efficient to invest in acquiring information rather than compensating for risk through raised interest rates.[35]

It is important to note here that any informational, hedging or agency benefits *should* accrue to either the secured creditor or the debtor. From an economic perspective, this is obvious; any agreement between two parties that benefits a third party is a classic "free-rider problem" and the parties will endeavor to the best of their abilities to internalize those benefits[36]. The social efficiency benefit of proprietary rights do not arise primarily from the fact that the monitoring of the property decreases agency costs (any gain from agency cost reduction should be internalized into the transaction) but rather from the allocation of the monitoring cost to the most efficient monitor[37].

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35 This is the classic argument of Stiglitz and Weiss (1981). It is mentioned by Mokal (2002).

36 See, on this point, Levmore (1982).

37 This is different from the point raised in Finch (1999: 653) of situations where unsecured creditors may be better monitors (cf. Triantis and Daniels 1995). In the case of the debtor company as a whole, it is certainly possible (in fact, it is probably true) that the secured creditor is not the ideal monitor, however, the whole point of the above argument is that secured credit allows the efficient allocation of monitoring duties. The secured creditor is given the part it is best suited to monitor.

The Priority Aspect of Security. Even without asset-specific benefits, security can still be efficiency enhancing. This is due less to any inherent benefit to priority and more to the inefficient effects of the default alternative to security, the *pari passu* regime[38]. In *pari passu*, creditors are considered equal in insolvency and will be paid pro rata, according to the amount of their claim. This can lead to inefficiency because creditors are not rewarded for the specific increase in the value of the firm that came from their contribution, but must share in the effect of the total financing of the firm. That is, creditor returns are diluted by other creditor claims. The interesting thing about this argument is that it can apply to both the case of a preceding creditor and a subsequent creditor. (This is an extension of Schwartz (1989), where the argument is only applied to preceding creditors. However, based on only one side of this argument, Schwartz argues for a rule giving initial creditors who hold substantial debt priority. However, as the second example demonstrates, this can lead to underinvestment, as there can be cases where subsequent creditors will suffer from a dilution of returns. Any scheme that would require later creditors to have to request permission from initial lenders would have to face the problem that the initial lender would have to be compensated for that permission. This, however, does not interfere with Schwartz's proposal that negative pledges be fully-effective. This author agrees with that view.)

Consider the following examples[39]:

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38 It has been argued that *pari passu* cannot be taken as the fundamental rule of insolvency because there are so many exceptions to it (Mokal 2001). See Finch (1999: 421-449) for a discussion of exceptions to *pari passu*. These arguments, however, do not affect the examples or the argument behind them: the value of an unsecured creditor will be diluted by another unsecured creditor.

39 These examples are an adaptation of those used in Roe (2000: 229-233).

Case 1- The firm is financed by a loan of $200, which will be invested in a project with 50% chance of returning $340 and a 50% chance of returning $100. This project has a return of $220, so it is an efficient project. With the first financing in place, the firm now has a project that requires an additional $100 of financing for a project that give the firm a 50% chance of returning $100 and a 50% chance of returning $560. This project will increase the value of the firm to $330 (from $220, for a $100 investment), so it is also an efficient project. However, the return to each individual financier is as follows.

First project:

	Creditor 1	Shareholders	Company Value
Failure	50 (50%*100)	0	
Success	150 (50%*300)	20 (50%*40)	
Total Value	200	20	220

Second Project:

	Creditor 1	Creditor 2	Shareholders	Company Value
Failure	25 (50%*100/2)	25 (50%*100/2)	0	
Success	150 (50%*300)	100 (50%*200)	30 (50%*60)	
Total Value	175	125	30	330

We can see in the second project how the *pari passu* system amounts to a reduction of creditor 1 claims, such that its investment no longer becomes viable. One way to prevent this problem is for creditor 1 to take security so that subsequent creditors cannot dilute its return. Would it be efficient then for the firm to give priority according to the order of investment[40]? The answer is no, because this could lead to underinvestment, as in the next example.

Case 2- The exact reverse position is also possible. In this situation, the firm has a first financing of $100, which has a 50% payoff of 0 and a 50% payoff of $220. Later on, the firm then has a project which require a financing of $200 and will raise firm value to a 50% chance of $100 and a 50% chance of $560. This is efficient, because it will raise firm value by $210 (for a $200 investment).

First project:

	Creditor 1	Shareholders	Company Value
Failure	0	0	
Success	100 (50%*200)	(50%*40)	
Total Value	100	20	120

Second Project:

	Creditor 1	Creditor 2	Shareholders	Company Value
Failure	25 (50%*100/2)	25 (50%*100/2)	0	
Success	100 (50%*200)	150 (50%*300)	30 (50%*60)	
Total Value	125	175	30	330

In this case, creditor 2's return will be too low for it to invest. The firm will then lack the means to finance an efficient value-increasing project. Once again, one way for the firm to provide the proper incentives to the second creditor would be for it to give security.

If creditor 2 were granted security, the payoffs for the second project would look as follows.

Second Project (with secured second creditor):

	Creditor 1	Creditor 2	Shareholders	Company Value

40 See also Finch (2002: 487-8), who points out that having debt ranked chronologically could be inefficient because creditors will seek more "estate-avoiding measures" which will both be expensive in their own right and raise the cost of debtor assessment for subsequent creditors.

Failure	0	50 (50%*100)	0	
Success	100 (50%*200)	150 (50%*300)	30 (50%*60)	
Total Value	100	200	30	330

We can see that in both examples, the dilution from *pari passu* can lead to an unfairness to the first creditor or underinvestment for the company. Security (or at least subordination) is one way to deal with these problems. It is also clear that the unsecured creditor, whether in case one or two, must be compensated for the risk posed by the value diversion in insolvency when secured credit is given. Between them, however, the first case can be resolved through contractual means such as a negative pledge or a subordination agreement. The second case is harder to resolve contractually because there is no incentive for creditor 1 to subordinate itself.

Conclusions. We can see that there are at least two efficiency benefits to secured credit.[41] In general, shareholders will use the security device for the two purposes above, a) allocation of asset to the most efficient assessor or monitor or b) prevention of claim dilution in insolvency, simply because it is their best interest to do so. (Bebchuk and Fried (1997) raise examples of how secured credit can be used inefficiently, which will be discussed in the next section.) However, the main source of contention is- since secured credit can clearly be used by subsequent creditors to prejudice the preceding creditors- how can preceding creditors be compensated for the risk? An efficient scenario would have the preceding creditors including the risk of subsequent creditors (whether secured or unsecured) into their claim, leaving the firm the option of an efficient later granting of security. There are two cases where expropriation may occur: a) when there are involuntary creditors (then it does not

41 These two are the most demonstrable of the efficiency claims of secured credit. Most claims are variants of these two arguments.

matter if they are preceding or subsequent, the presence of any other creditors will decrease their return involuntarily) or b) when the preceding creditor has not priced the risk of additional creditors into the original agreement (that is, the preceding creditor is incapable of such an inclusion).

III.B) The Case for the Inefficiency of Secured Credit

There are three separate types of arguments for the inefficiency of secured credit: a) the presence of secured credit provides an incentive for shareholders to use security interests inefficiently, b) the use of secured credit itself creates costs and c) secured credit can be used to divert value away from unsecured creditors to secured creditors (while rewarding shareholders in the process). While the last case can be dealt with by the general argument that unsecured creditors can protect themselves from this value erosion, the first two case are more serious as they are arguments that the loss from the secured credit contract is less than the gain to all parties (and therefore, no amount of adjusting from anyone will make it worthwhile).

The Costs of Security Interests. Bebchuk and Fried (1996: 895-904) examine five efficiency costs that arise from secured credit. Secured credit 1) increases the use of inefficient security interests, 2) increases the use of security interests, when covenants might be more efficient, 3) distorts investment decisions by the borrower, 4) leads to suboptimal use of covenants by the secured creditor and 5) leads to suboptimal enforcement efforts by the secured creditor. I will group the first two inefficiencies as one set, because they rely on a similar premise: they involve the borrower and the secured creditor expending resources "inefficiently encumbering an

asset merely to transfer bankruptcy value from nonadjusting creditors" (Bebchuk and Fried 1996: 896-7)[42]. I will also group the latter three inefficiencies as one set, again because they rely on a similar premise: the secured creditor, insulated from loss by the security, will have no further incentive to affect the firm's decisions beyond the scope of its security (Bebchuk and Fried 1996: 897-903).

i) The inefficient use of security interests. Bebchuk and Fried (1996:896-7) use a clever example to demonstrate their point. To facilitate the discussion, their example will quoted at length.

> [S]uppose that firms borrows $1 million each from three sources: Bank, a nonadjusting creditor, and an adjusting creditor. Suppose further there is a 5% chance that Firm will fail by the end of the year and leave $600,000 of assets to its creditors. Assume that to obtain a security interest in the $600,000 worth of assets, Bank would be required to spend $2000, and that use of the security interest would affect neither the probability of Firm's failure nor the amount of assets that would be available to Firm's creditors in the event of default. Thus, creating the security interest would be inherently inefficient because it would reduce the total value captured by all of the parties by $2000.
>
> [...] Now consider the case in which the security interest would confer full priority on Bank's claim against the Firm. Under a rule of full priority, the security interest would reduce Bank's risk of loss by $20,000 and would increase the other creditors' risk of loss by $10,000 each. Since Bank would incur $2000 in contracting costs in connection with the security interest, and its risk of loss would be reduced by $20,000, it would charge Firm $18,000 less in interest while the adjusting creditor would charge Firm $10,000 more in interest. Thus, full priority will give Firm an incentive to create an inefficient security interest merely to transfer value from its nonadjusting creditors. (Bebchuk and Fried 1996: 896-7. Footnote omitted.)

The cleverness of this example lies in the fact that, because the loan to Bank is made at arm's length value and a full year before the bankruptcy, it does not fall under

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42 The covenants case is simply an extension of the general case. The secured creditor and borrower have an incentive to use security even though covenants will yield a higher return to creditors with no reduction of value to shareholders.

the two main legal provisions designed to protected creditors in bankruptcy: preference law or fraudulent conveyance provisions[43]. However, it is possible to note there are two logically separable actions in the example given: a) the taking of the new loan and b) the cost of creating the security. There is nothing inherently inefficient in the new loan or the security interest because, in this example, the Firm is receiving the attendant reduction in interest rate (at an efficient discount) it should be getting from granting the security. It is the cost of creating the security interest which is inefficient, since it does not improve the prospects of the Firm.

The key point here is one which is not even mentioned by Bebchuk and Fried. In normal circumstances, the shareholders are the residual claimants of the firm; they receive their share after unsecured creditors have been paid. Therefore, any value they divert away from unsecured creditors will simply be paid out of the shareholders' portion. Shareholders have an incentive (in fact, they have the best incentive) to pursue efficient, firm value-maximizing behavior; they receive only the residual value of the firm. In Bebchuk and Fried's example, this would mean that, if the firm does not go bankrupt, the $2000 cost will accrue to the shareholders.

The only case where shareholders would engage in this kind of value-destroying activity would be where the firm is near or in insolvency. It is precisely these cases where shareholders no longer have an incentive to maximize the value of the firm that laws are required that make clear that the duties of the directors are

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43 Under US law, s. 547 (b)(4)(A) of the Bankruptcy Code allows the trustee to avoid any transfer of an interest of the debtor in property on or within 90 days before the filing of the bankruptcy provision. S. 548 of the Bankruptcy Code allows for the avoidance of any transfer that is given for "less than a reasonably equivalent value". Under UK law, the time span for avoiding preferences is six months

toward the company (which when the firm is insolvent more or less means the creditors) rather than toward shareholders[44].[45]

Security is not a necessary component of debtor misconduct near insolvency. In fact, it is possible to come up with an example where the debtor can act to the detriment of secured creditors as well. Take this (admittedly somewhat contrived) example under English law: A car manufacturing firm has a creditor secured with a floating charge and a trade creditor (a steel recycling plant). The firm is in dire need of cashflow and sells unassembled auto parts to the steel plant at arm's length value. The firm then receives cash, the trade creditor gains a normal profit from the deal, and the floating charge holders loses, that is, the firm would be worth more in insolvency if it had kept the auto parts and assembled them into cars (though that would have taken too much time for the firm). The cashflow keeps the firm afloat for another ten months, thus avoiding preference laws. As the deal was made at an arm's length value, it avoids fraudulent conveyance provisions as well. This transaction then manages to accomplish the exact opposite of the Bebchuck and Fried example: it is a deal that profits the unsecured creditor and harms the secured creditor. However, the point is that the deal was not made to defraud the secured creditor, it was simply *a poor business decision*. There should indeed be laws to prevent debtors from engaging in value-destroying exercises, but this has nothing inherently to do with secured credit.

(section 240 (1) (b) of the Insolvency Act) and because the transaction is for fair value, it would avoid section 238, 339 and 423 (1) of the Insolvency Act.

44 In the US, this would be the rule in Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corporation, 1991 Del. Ch. LEXIS 215 at n.55 (see Roe 2000, 491-295), though the position is not uncontroversial. In the UK, this would covered by s. 212 of the Insolvency Act. However, s. 212 is procedural and does not provide a cause of action.The exact extent of the duty is still a matter of much dispute, however. (See Finch 2002: 499-520.)

ii) Incentives to monitor the borrower. The second contention by Bebchuk and Fried is that the possession of a security interest will lead to lowered monitoring of the firm (Bebchuk and Fried 1996: 897, 900-903). The secured creditor has no incentive to monitor the value of the firm beyond its security interest. It is possible to imagine a scenario where the use of covenants or a keener screening of the firm would result in a lower risk of loss. In other words, if the creditor had not received the security interest, it would have been forced to carefully assess the prospects of the firm (or follow its actions closely) and therefore prevent the firm from wasting the lent money (either by not lending the money or taking prompt preventive action when an inappropriate use is found). The use of the security interest in these cases is then socially inefficient[46].

The problem with the contention is this: creditors have incentives to monitor only to the extent of their risks. What this argument says is essentially that risk to creditors should be increased so that they would have more incentive to monitor. Shareholders are the ultimate risk bearers of the firm as they are the residual claimants. Any risk that is not borne by the creditors is passed on to the shareholders. Also keep in mind the intrinsic link between risk and return; we can see that increasing the risk of the loans will have to result in increasing returns to the loans as well. One way of looking at capital structure is by noting that capital structure is a means of dividing risk between different capital providers. Even unsecured creditors, because they have priority over shareholders, do not have to monitor firm value below a certain level.

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45 This point is also made by Schwarcz (1997: 437).

One may, however, distinguish between two different kinds of monitoring: the monitoring of business decisions, where it can be agreed that shareholders are best suited, and the monitoring of shareholders' misuse of assets to the detriment of creditors, where the shareholders cannot be trusted. The absence of security would create a situation where all creditors, instead of only the unsecured, would have to monitor the shareholders of the firm. However, this would only improve efficiency if it was contended that the secured creditors, i.e. banks, are more efficient monitors of the firm than unsecured creditors. From an efficient market point of view, this seems strange. The most efficient monitors of the firm should already offer to monitor the firm. To put it another way, if there were an institution that could monitor the firm more efficiently than any unsecured creditor, then that institution should offer to guarantee the debts of the firm to the unsecured creditors for the price of the interest rate spread. If what is implied in this argument is that if only secured lenders were reduced to the level of unsecured lenders, unsecured lenders would be able to benefit from the increased monitoring then this would clearly create a "free-rider" problem. What would be the incentive for banks to choose to monitor for the benefit of all creditors?

In summary, the only way for all capital providers to be full monitors of the firm is for all capital providers to be shareholders. The very existence of capital structure means that some capital providers will have stronger incentives to monitor the firm than others. Unless there is some element that results in the erosion of the incentive to maximize firm value (like proximity to bankruptcy as discussed above),

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[46] Manove, Padilla and Pagano (2001) is a formal version of this argument, which clarifies the issues

shareholders are the proper monitors of the firm. Creditors should be compelled to monitor the firm to the exact amount they are at risk.

In an attempt to test the "lazy bank" hypothesis, Padilla and Requejo (2001) tested for average default rates where creditor rights are more strongly enforced, reasoning that stronger enforcement of security would lead to lower screening and therefore higher debt default rates. Their results were ambiguous (although it must be admitted that there are many practical difficulties in this kind of testing).

The Plight of the Nonadjusting Creditor. There are four groups of creditors that cannot simply adjust interest rates to compensate for the addition of a secured creditor: a) involuntary creditors (more or less tort claimants), b) the Government, c) imprudent creditors (whether because unable or incompetent), and d) prior voluntary creditors. (Bebchuk and Fried 1996: 882-891) These are creditors that are exposed to the risk that their returns in bankruptcy will be affected by secured creditors without their consent.

i) Involuntary Creditors. Tort creditors can have their claims substantially reduced by the presence of a secured creditor in the tortfeasor's capital structure[47]. There are two scenarios: a) the tortfeasor can use the instrument of secured credit to transfer value away from the tort creditor to the secured creditor and b) the fact that the secured creditor does not share in the loss of the tort means that the firm can deny the risk of committing a tort by issuing secured credit. Both arguments turn, however,

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nicely.

on the question: how much should secured creditors (or any creditor for that matter) share in the risk of a tort?

The two scenarios are a little different. In the first case, it can be assumed that the incoming creditor is aware of the outstanding tort debt the borrower owes. While there may still be efficiency gains from allowing the firm to borrow secured, it is clear that both parties to the transaction will be aware that it amounts to a reduction of the value of the tort creditor's claim. There is definitely a strong argument that the tort creditor should be given super-priority over all adjusting creditor claims. A super-priority claim at least over all subsequent creditors would make more sense than giving the tort creditor a pro rata claim because even the addition of unsecured claims would dilute the tort creditor's claim.

The argument that the tort creditor should be given some kind of super-priority over even preceding creditors' claims is a little different. The argument behind this would be that secured creditors should take some risk of the firm subsequently committing a tort. Allowing the firm to insulate part of its capital structure from tort risk would result in the firm being able to procure capital at a risk level lower than the firm's actual risk (Bebchuk and Fried 1996: 898-9). The fear, in this situation, is of a purposely undercapitalized firm, financed principally with debt, for the purpose of engaging in risky enterprise.

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47 See LoPucki and Whitford (1993) where, in two of 43 bankruptcies, tort claims amounted to more than two-thirds of the unsecured claims against the company. See also LoPucki (1994) for more cases of tort claims in bankruptcy.

It is clear that if a firm is explicitly and, more importantly, provably, financed with that purpose in mind, then the creditors should be as liable for the tort as the shareholders. The question, however, is how much should secured creditors (or if super-priority to tort creditors is given, all creditors) be responsible for the actions of the firm? Or, are creditors really able to prevent a firm from committing torts? The argument for tort creditor super-priority would be that firms that are more susceptible to tort risk (or firms that exhibit risky behavior) would face more expensive financing and therefore firms would have an incentive to restrain their risky behavior. However, if creditors have little influence on the actions of the firm (which is generally the case in reality[48]) then the result of tort creditor super-priority would be an increase in information asymmetry and agency cost, which could to lead to credit rationing, as mentioned above[49]. One way of asking the question: what if the firm was equipped primarily through leasing? That is, imagine a manufacturing company with no assets, with all its equipment leased from an affiliate company. If this firm engages in risky enterprise, should the tort debt rank above the leasing debt? It seems rather arbitrary to have a creditor of the firm have to take a tort risk, unless they can be deemed to have been partially responsible. Why should a secured creditor be considered more responsible for tort than any other kind of creditor?

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48 Under US law, lender involvement to firm activities can lead to their loans being equitably subordinated (the "Deep Rock" case: Taylor v. Standard Gas and Electricity Corporation., 306 U.S. 307 (1939)) or they might face lender liability (e.g. State National Bank v. Farah Manufacturing Company., 678 S.W. 2d 661 (Tex. App. 1984). Under French law, article 180 of the Bankruptcy Law (the '*comblement de passif*') holds that the "managers" of the company may be liable for any shortfall in paying off creditors; these "managers" may include banks acting to enforce covenants in loan documents. (See Norton Rose 2000: 129-130.)

49 Alternate arrangements to internalize tort risk might be more appropriate, such as mandatory tort insurance for companies, as mentioned by Finch (1999: 656-7).

ii) The Government. The government's claims over a firm are "set by statute without regard to a firm's capital structure" (Bebchuk and Fried 1996: 884) and therefore, the government's tax and regulatory claims might be subordinated to secured creditors in the event of bankruptcy without the government having adjusted for it. This is a bit of an artificial problem, as there is nothing to prevent the government taking security or even just legislating for super-priority. There would seem to be nothing conceptually wrong with having creditors take into consideration the borrower's governmental liabilities before lending. However, giving the government priority over secured creditor has caused some problems in transitional economies (e.g. Hungary and Poland), as it reduces the ability of borrowers to borrow on the basis of collateral, particularly in cases where the government is the primary creditor of the company (Baer and Gray 1995: 23).

iii) The Imprudent. These fall in two camps: a) those that cannot afford to take subsequent creditors into consideration (the creditor could be too small or the deal might be too small to make such a calculation worthwhile) and b) those that simply lack the capability to make such a calculation (such as newcomers to the market). In a situation where creditors are aware that a secured creditor could be added to the capital structure of the debtor, unsecured creditors can protect themselves by including the cost of the risk of that future secured creditor into the current price they charge the debtor. However, Finch (1999: 651-2) gives three reasons why this might not be possible: 1) That sector of trade might be too unstable and therefore, instead of developing seasoned creditors who are able to properly price the risk of a new secured creditor, that sector will have a constant influx of new traders who are

systematically punished[50]. 2) Small, unsecured creditors might not be the most efficient bearers of the risk, as they are the "least able to manage, absorb and survive financial risks and shocks". The risk should be borne by the party most able to manage it. 3) Having the small, unsecured creditor bear the risk might be socially inefficient. Finch (1996: 652) gives the example of a carpentry company which is more efficient (for carpentry) than a multi-national company, but, if forced to account for the default risk of the customer, will have to charge higher rates than the multi-national (who is able to take security), thus losing efficient business.

Addressing these arguments one by one: 1) There are some sectors where information and agency problems are so acute that government intervention is necessary. Consumer investment is one of them. There does seem to a "constant flow of new suckers" who are willing to invest in ponzi schemes and indeed these cases of market failure need to be handled through strict regulation. It would appear, however, that these cases of market failure are the exception rather than the norm and, while it can be argued that secured credit exacerbates these market failures when they exist, the existence of these cases do not make for a general case for weakening the institution of secured credit.

2) One would expect that in a free, open market economy, risk will be borne by those who can most efficiently bear that risk, simply because it would cheaper for them to do so than other parties. In fact, as I argued earlier, secured credit (in its property aspect) is one method to accomplish that allocation of risk. There seems to be

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50 As LoPucki (1994: 1956) has it: "With a constant flow of new suckers and poor information flows there is no a priori reason why the markets for unsecured credit cannot persistently underestimate the risk, resulting in a permanent subsidy to borrowers."

an implication in Finch's argument that banks are better able to bear default risk than small traders. This would be too broad an assertion. Banks are, by their very nature, very risky enterprises. One primary aspect of banking is the conversion of illiquid assets into liquid assets, which combined with another aspect of banking, the fact that banks are heavily financed with callable debt (deposits), make banks prone to crises (i.e. bank runs). (Goodhart et al., 1998) A market-based solution to risk-allocation would involve more methods of isolating risks (maybe trade creditors can securitize their debt) rather than reducing these methods.

3) If the small trader is less able to handle risk than the multi-national (resulting in the multi-national able to offer more competitive prices), then it would seem that, generally, the multi-national is the more efficient company for this market. There are many instances where size offers efficiency advantages. This is true in many industries. It is difficult for new entrants to enter, let's say, the publishing business, because they do not have the distribution networks of the established players (or the mobile phone business, because they do not have access to stores). These examples abound in the real world. While the notion of a level playing field is very attractive, abolishing (or weakening) secured credit in order to reduce the advantage the big player has over the small player is tantamount to reducing both of them to same level of inefficiency. As mentioned above, it would perhaps be wiser to work for a market solution, if necessary aided by government funding.

iv) Prior Voluntary Creditors. As has been stated several times in the course of this section, prior voluntary creditors should raise their current price to compensate for the possibility of the addition of secured creditors to the debtor's

capital structure. The more interesting question is: is this an efficient state of affairs? After all, it could be the case that the debtor has no intention of pursuing secured credit. They would then be unnecessarily penalized. But- the debtor can commit to limiting its future borrowing, whether through a negative pledge or granting the prior creditor itself security. In a way, one could view the premium charged by prior voluntary creditors as an option for the debtor to subsequently pursue secured credit.

Conclusion. A perusal of the empirical evidence would seem to indicate that concerns about debtors using secured credit to expropriate returns from unsecured creditors is exaggerated, if not entirely misplaced. As Mokal (2002) notes, large firms (which are most likely to have involuntary creditors) are the firms most reluctant to borrow on a secured basis. More directly, Schwarcz's (1997: 470) research indicates that trade creditors tend to give *better* trade terms to firms in danger of insolvency when they receive additional, secured financing. One can also note that between debts of similar standing (as measured by credit ratings), creditors charge lower interest rates for uncollateralized loans rather than collateralized loans. John, Lynch and Puri (2002) argue that this is because creditors are aware that collateral carries in itself agency costs (debtors have an incentive to misuse the collateral). The implication would be that, given an equivalent choice, creditors would choose to lend unsecured rather than secured.

III.C) Does Secured Credit Benefit Unsecured Creditors?

So far, we have argued that secured credit has at least some efficiency benefits and that, in most cases, concerns about harm that can be done to unsecured creditors through secured credit is misplaced. Schwarcz (1997) takes this one step further. Schwarcz argues that, as debtors tend to issue secured credit as a last resort (that is, when it is in danger of insolvency) and insolvency is costly, the very fact that the secured credit loan gives the debtor the liquidity to avoid insolvency provides a benefit to unsecured creditors. In other words, Schwarcz claims that secured credit is Pareto efficient, that is, it benefits all parties. Schwarcz cites two pieces of empirical evidence to support his claim: a) an informal eight year study of troubled companies that had acquired secured financing had 14 of the 20 companies showing an increase in share price, 3 showing little or no price change, 1 showing a decreased rate of price fall and 2 showing a small price decrease, b) as mentioned above, trade creditors appear to give better terms to debtors after they have received additional secured financing (Schwarcz 1997: 467-471).

Schwarcz appears to argue that additional secured financing will benefit unsecured creditors at least in most cases. Schwarcz presents his arguments in rather general terms: "secured debt... *tends* to create value for unsecured creditors as well as for the debtor" (page 430: emphasis added), "A sensitivity analysis demonstrates that a change in the chance of a debtor's bankruptcy will have a much greater effect on whether or not value is taken from unsecured creditors than will a change in other variables." (page 442), "whether or not any given secured transaction is Pareto efficient, the probability is that the *average* secured transaction will be Pareto efficient in that the debtor and secured creditor will benefit and unsecured creditor will not lose (and indeed may gain) value." (page 483: emphasis in original)

With respect, Schwarcz appears to state his argument too strongly. We will use the same equation given by Schwarcz (page 473-474, changing only the variable letters), where the payoff to the unsecured creditor (V) is given by two parts: the return to unsecured creditor should the company survive (R) times the probability that the company will survive (P) and the return to the unsecured creditor should the company go bankrupt, which is calculated as R minus a fraction of R (BR, where B is the bankruptcy discount), times the probability that the company will go bankrupt (1-P). That is, PR+(R-L)(1-P)=V.

As the equation above is a three variable (P, B, R), non-linear equation, it is difficult to describe its behavior in plain English. In fact, the easiest way to understand the nature of the equation is to observe it numerically (as in Appendix B and C). What is observable is that: 1) B and P are both highly significant to the value of the unsecured creditor's debt. It is incorrect to describe one variable as more important than the other, (see Appendix B for details) and 2) Whether the increase in the probability of survival profits the unsecured creditor depends on both B and R, particularly, when the arrangement of B and P is lower than that presented in Appendix C, then the unsecured creditor loses value from the arrangement.

The conclusion here is commonsensical: an influx of new, secured capital might or might not profit the unsecured shareholder, depending on how the three variables change. Any statement on what might "tend to" happen or what the "average" case might be would have to be empirical, not determined a priori. These outcomes are certainly not predicted by Schwarcz's argument. In this case, it might be

said that the equation is a much more exact statement of the conclusions that might be reached than any linguistic generalization.

Nevertheless, Schwarcz (1997) has at least demonstrated that in some cases, the inclusion of a new, secured creditor could profit unsecured creditors. It is then odd that Mokal (2003) does not include even a reference to Schwarcz's argument in his discussion of floating charges. Mokal argues that the real value of the floating charge lies in the capability of the floating charge holder to keep the insolvent company as one complete unit and dissuading other creditors from enforcing their claims against the circulating assets of the company, in other words, the worth of the floating charge is as a "residual management displacement device". As Mokal denies the floating charge has a property-based efficiency benefit (he argues that circulating assets cannot be properly valued or monitored) and since the administration procedure instituted in Enterprise Act 2002 fulfills the role of management displacement, there is no reason to grant *priority* to floating charge holders. From which Mokal then concludes that "there is a strong case for setting at the highest level politically feasible the proportion of property which should go to unsecured creditors, right up to one hundred percent. The floating charge is not relied on for priority, except opportunistically (i.e. ex post), so this would result in some benefit to unsecured creditors and would case no harm to creditors who take security."

Even disregarding the commonsense case of a company's whose assets are primarily circulating (let's say a car dealership), which would benefit from being able to use these circulating assets as security, Mokal ignores the implications of Schwarcz's argument. There is a reason for granting blanket security over the

company's assets, even without the property-based benefits, and that is that the extra financing this blanket priority provides might assist the company in avoiding or at least strongly surviving insolvency.

Empirical evidence for Schwarcz's conjecture can be found in instances of Debtor In Possession (DIP) financing in the US. Section 364 of the US Bankruptcy Code allows for court approval of a special class of creditor given priority over unsecured creditors (and sometimes even equal priority to a secured creditor[51]) in Chapter 11. This is precisely the kind of blanket security, evidently without property-based efficiency benefits, that Mokal argues should not be allowed. However, as Dahiya, John, Puri and Ramirez (2000) report, firms that receive DIP financing are more likely to reorganize successfully than firms that did not receive DIP financing. DIP financed firms also tend to have shorter reorganization periods than non-DIP financed firms. They did not find evidence of overinvestment[52]. This would lend some credence to Schwarcz's argument, although it must be noted that court involvement would mean there is some prior screening for abuse which would be absent in the granting of floating charges.

III.D) Alternatives to Full Priority

Bebchuk and Fried (1996: 904-911) propose two alternatives to full priority: a) the "adjustable" priority rule and b) the "fixed-fraction" priority rule.

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51 Provided that the debtor cannot obtain credit otherwise and the original secured creditor is given adequate protection (s. 364 (d) of the Bankruptcy Code).

52 Intriguingly, they also find that smaller firms tend to received DIP financing more often from prior lenders and that financing from prior lenders or new lenders makes no difference in reorganization outcomes.

Adjustable priority: "Under the adjustable priority rule, claims of nonadjusting creditors would not be subordinated to secured claims with respect to which they were nonadjusting." (page 905) The claims of nonadjusting creditors would be treated as if they had full priority (over the secured claim) and the secured creditor would receive priority over whatever remains. In effect, the dichotomy is not actually between nonadjusting creditors and secured creditors, but between adjusting and nonadjusting creditors (secured creditors are, by definition, adjusting creditors).

Many jurisdictions already allow for the super-priority of tax, social security and employee claims (e.g. France). There would seem to be no conceptual problem (beyond those raised above) to adding tort creditors and other governmental claims to that list. The question, however, is how inclusive the list of "nonadjusting" creditors should be. As argued above, the case for small claims and trade creditors is significantly weaker than that for tort creditors or the government (or even employees, who can arguably be seen as incompetent to protect their own interests).

It is difficult to judge how the granting of super-priority to the government and employees has affected French financing. French business has traditionally relied heavily on government financing (Bertoro 1994, 1997), although the evidence seems to indicate this is changing (Rajan and Zingales 2003). France also exhibits very low levels of court-based bankruptcy, which would indicate a preference for preventive measures or out-of-court restructuring (Banque de France 1999: 41).

Fixed-fraction priority: "Under this rule, a fixed fraction of a secured creditor's secured claim would continue to be treated as a secure claim, and the remainder would be treated as an unsecured claim." (page 909) This is the regime proposed by the Cork Committee and imposed on floating charge holders as a part of the Enterprise Act 2000. The effect of this proposal is relatively clear: secured creditors would simply discount the property charged by the fraction that cannot be secured. The justification for this kind of regime seems rather weaker than allowing nonadjusting creditors super-priority. For one thing, a fixed-fraction regime would not be distinguishing between adjusting and nonadjusting creditors, but between secured and unsecured creditors. If the fixed-fraction regime is justified by the protection it gives nonadjusting creditors, it would be odd to institute a regime that would benefit adjusting, unsecured creditors as well. Finch (1999: 655) rightly points out that a virtue of the fixed-fraction rule is its certainty. However, giving certain, well-specified classes of nonadjusting creditors super-priority is, if anything, an even more certain rule. It would seem that only advantage a fixed-fraction rule would have over a nonadjusting creditor super-priority rule is that the fixed-fraction rule would benefit nonadjusting creditors who cannot be rigorously defined. Who these elusive nonadjusting creditors might be and whether the benefit accruing to them under the fixed-fraction rule is worth the reduction in efficiency (because the fixed-fraction discount on secured credit would proportionally limit both the property-based efficiency benefits (risk allocation) and the protection against *pari passu* dilution, as argued in I.A).

Conclusions

From a pure economic perspective, it would be optimal if a capital provider were awarded risks and returns of the project the capital is meant to finance. That way incentives would be most closely aligned. These structures can be setup transactionally, such as an asset securitization or a project financing. There are also some legal rules that tend in that direction (purchase money security interests under US UCC article 9 or the Personal Property Security Act in Canada)[53].

The problems begin when investment interests are pooled into a single corporate form. As mentioned in section III.A, security can be viewed as a tool for the allocation of risk. If these allocations can bring incentives closer to their optimal case, it adds to efficiency. As mentioned in section III.B, the shareholders of a corporation have incentives to pursue efficiency, as this will tend to contribute to their own returns. However, there are cases where these incentives can break down and they should be guarded against. Turning the situation the other way, there is the question of how much creditors should be responsible for the risk the corporation takes. This is a difficult question to answer. I have raised doubts as to how efficiently secured creditors can deal with these agency costs. This paper has argued, nonetheless, that there might be a case for giving super-priority to some nonadjusting creditor claims particularly in cases where they would be readily calculable and certain.

53 Although these are not without their own problems, particularly concerning proceeds from the sales of these assets. See Walsh (2003).

Appendix A: A Simple Model for Lowered Interest Rates

We are going to use a highly simplified model of returns to a loan. A loan is worth to its creditor its probability adjusted returns. A creditor will only lend if the payoff from the loan is worth the risk of what the value of the loan could decline to. Consider a scenario with only two states of the world, where the firm could enter bankruptcy with a probability P_B and return only the amount B, or it could succeed with a probability $(1-P_B)$ and repay (including interest) the amount R. The minimum amount a creditor would lend in this situation would be: $P_BB+(1-P_B)R=L$. To express the same notion another way, the least amount a loan would have to return to induce a creditor to lend a certain amount of money L would be: $R=L-P_BB/1-P_B$. The net amount of interest the loan would have to pay would be R-L.

Now suppose we are in a state where a creditor can choose either to lend on a secured or unsecured basis. This creditor is more certain about the prospects of the security than it is about the prospects of the company as a whole. In particular, the creditor believes that even in a state of bankruptcy, the value of the security will not fall below the amount C. It is clear that if C is lower than B, then R_C, the amount of return required for the creditor to lend the same amount of money will be lower for the secured case.

The question now becomes: are the interest savings from the secured loan simply offset by increased interest rates in subsequent loans (as suggested by Schwartz 1984: 1054)? The answer is: not necessarily. Even assuming that an unsecured creditor will get nothing in bankruptcy if there is a secured creditor, there are still values where the unsecured creditor will rationally lend at a rate where the

combined interest of the secured and unsecured creditor would be lower than the rate of a single unsecured creditor[54].

A numerical example can illustrate this. Give the firm a 50% chance of bankruptcy and a 50% chance of success and let's say it wants to borrow $100. If the firm borrows unsecured, the bank believes that in a bankrupt state, it will recover only $20. The bank will then demand a return of R=100-10/1-0.5=180, that is, $80 worth of interest (80%). However, in a secured state, the bank believes the property will only decline to $40 in a bankrupt state. (This is possible in cases where the firm can incur further debts, such as penalties for breaches of contract. In such cases, the firm can be worth less than its assets.) Let's say that half the amount required is then borrowed secured and the other half unsecured. The secured half will be lent at a rate R=50-20/1-0.5=$60. That is, the firm will pay only $10 in interest (20%). The other half of the loan will be lent at a rate R=50-0/1-0.5=100, that is, the firm will have to pay $50 worth of interest (100%). The combined interest of the two halves of the secured/unsecured loan comes up to $60, which is cheaper than the $80 required in the purely unsecured case.

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54 The mathematical expression for the amount would be: assuming that an unsecured creditor would get nothing in bankruptcy and would have be compensated R_U taking up a proportion (1-S) of the loan, then the equation that would have to be satisfied for the secured plus unsecured loan to be cheaper than wholly unsecured loan is: $\frac{P_b[L(S-1)+C+B]-L}{1-P_b}+SL>0$

Appendix B: Comparing the Effects of B and P

Taking Schwarcz's equation and eliminating some variables, we get:

PR+(1-P)(R-L)=V=PR+R-PR-L+PL=R+PL-L=R+L(P-1)=V, where L=BR.

Keeping in mind that:

P= the probability of firm survival;

R=the promised return to the unsecured creditor;

B=the percentage the return the unsecured creditor will be reduced in bankruptcy;

V=the value of the loan to the unsecured creditor.

We now run this equation through several scenarios, keeping V constant and varying B and P. What we will note from this demonstration is that it is difficult to say what Schwarcz means by saying that P is "more sensitive" than B. If he means, all other things being equal, increasing P by 10 percent yields a greater gain than increasing B by 10 percent he is correct. But this is meaningless- the relationship between the variables is inverse. If he means, all other things being equal, adjusting P by 10 percent makes more difference than adjusting B by 10 percent, then the above chart shows he is clearly wrong. The variables have the same effect, merely in different directions

R	B	P	L		V
100	1	0.5	100		50
	0.9		90		55
	0.8		80		60
	0.7		70		65
	0.6		60		70
	0.5		50		75
	0.4		40		80
	0.3		30		85
	0.2		20		90

	0.1		10		95
	0		0		100

R	B	P	L		V
100	0.5	1	50		100
		0.9			95
		0.8			90
		0.7			85
		0.6			80
		0.5			75
		0.4			70
		0.3			65
		0.2			60
		0.1			55
		0			50

R	B	P	L		V
100	1	0.75	100		75
	0.9		90		77.5
	0.8		80		80
	0.7		70		82.5
	0.6		60		85
	0.5		50		87.5
	0.4		40		90
	0.3		30		92.5
	0.2		20		95
	0.1		10		97.5
	0		0		100

R	B	P	L		V
100	0.75	1	75		100
		0.9			92.5
		0.8			85
		0.7			77.5
		0.6			70
		0.5			62.5
		0.4			55
		0.3			47.5
		0.2			40
		0.1			32.5
		0			25

R	B	P	L		V
100	1	0.25	100		25

	0.9		90		32.5
	0.8		80		40
	0.7		70		47.5
	0.6		60		55
	0.5		50		62.5
	0.4		40		70
	0.3		30		77.5
	0.2		20		85
	0.1		10		92.5
	0		0		100

R	B	P	L		V
100	0.25	1	25		100
		0.9			97.5
		0.8			95
		0.7			92.5
		0.6			90
		0.5			87.5
		0.4			85
		0.3			82.5
		0.2			80
		0.1			77.5
		0			75

Appendix C: Maintaining Unsecured Creditor's Value

In this appendix, we begin with the observation that, one of the ways we can determine the impact of B and P is to keep V constant. This way, we can demonstrate the balance that B and P need to keep in order not to lower the overall value of the debt to the unsecured creditor.

Adapting the equation in Appendix B for B, we get B=(V-R)/(P-1)R, and adapting for P, we get P=(V+R/L)+1.

Keeping in mind that:

P= the probability of firm survival;

R=the promised return to the unsecured creditor;

B=the percentage the return the unsecured creditor will be reduced in bankruptcy;

V=the value of the loan to the unsecured creditor.

Part 1: Keeping V constant, we vary B and observe the value of P.

From the demonstration below, we can observe that 1) any value of P that is above what is shown in the chart (given the other respective values) improves the value of the loan for the unsecured creditor and 2) conversely, any value for P lower than shown on the chart lowers the value of the loan of the unsecured creditor.

Note: In this chart, any value of P above 1 can be disregarded, as the highest probability a firm can go bankrupt is 1, similarly, any value of P below 0 can be disregarded as the lowest probability a firm can go bankrupt is 0.

V	B	R	L		P
100	0.1	100	10		1
90					0
80					-1
70					-2
60					-3
50					-4
40					-5
30					-6
20					-7
10					-8

V	B	R	L		P
100	0.25	100	25		1
90					0.6
80					0.2
70					-0.2
60					-0.6
50					-1
40					-1.4
30					-1.8
20					-2.2
10					-2.6

V	B	R	L		P
100	0.75	100	75		1
90					0.866666
80					0.733333
70					0.6
60					0.466666
50					0.333333
40					0.2
30					0.066666
20					-0.066666
10					-0.2

Part 2: Keeping V constant, we vary P and observe the value of B.

From the demonstration below, we can observe that 1) any value of B that is above what is shown in the chart (given the other respective values) improves the value of

the loan for the unsecured creditor and 2) conversely, any value for B lower than shown on the chart lowers the value of the loan of the unsecured creditor.

Note: In this chart, any value of B above 1 can be disregarded, as this would imply the case of the unsecured creditor getting a better return from insolvency than solvency, similarly, any value of B below 0 can be disregarded, as 0 implies that the unsecured creditor gets nothing.

V	P	R	L		B
100	0.5	100	50		0
90					0.2
80					0.4
70					0.6
60					0.8
50					1
40					1.2
30					1.4
20					1.6
10					1.8

V	P	R	L		B
100	0.75	100	75		0
90					0.4
80					0.8
70					1.2
60					1.6
50					2
40					2.4
30					2.8
20					3.2
10					3.6

V	P	R	L		B
100	0.25	100	25		0
90					0.133333
80					0.266666
70					0.4
60					0.533333

50					0.666666
40					0.8
30					0.933333
20					1.066666
10					1.2

Chapter 4:
Theoretical Foundations for the Enterprise Act 2002

Q: Have you any word of advice for those of us who are not bankrupt?
A: [with that twinkle] Eat your hearts out.

John Updike, The Bankrupt Man

Insolvency studies are a literature of discontent. Nearly every article in the field is centered upon proposals for reform. Bankruptcy laws around the world are particularly susceptible to overhauls (in recent years, Germany, Japan, nearly all the countries affected by the Asian crisis, and now the UK, have substantially reformed their insolvency laws). There is a lack of a clear model for insolvency law. American scholars rail against a "continuation bias" in their system while UK scholars complain of a "liquidation bias", yet so fraught are the issues that neither can simply accept the other system as a model for reform. Into this tangled skein, the UK has now introduced the regime of the Enterprise Act 2002 (the "EA").

The arguments presented in this section will extend previous scholarship by arguing that, not only does the new regime aid rescue in a very limited way (which has been argued by numerous authors, e.g. Frisby 2004), it strengthens the position of unsecured creditors, to the detriment of shareholders and unsecured lenders. This section will also compare the current UK regime to the US regime, demonstrating that the UK regime is less conducive to company rescue, and discussing how the differences in the US and UK regimes contribute to how companies may choose their financing. As many US commentators have argued for a market-based approach to bankruptcy, this section will also discuss these proposals and their viability. The approach taken in this chapter is the viewpoint expressed in the first chapter (as well as demonstrated in the previous two chapters): parties involved in bankruptcy

proceedings will pursue avenues available to them under the bankruptcy system, sometimes in ways unintended by the policy-makers. As will be argued in more detail later, the current UK regime gives great negotiating power to unsecured creditors. This could have the effect of making unsecured debt the security of choice for vulture investors who aim to profit from a debt restructuring. Out-of-court restructurings will also be discussed, along with their inherent limitations given the bankruptcy regime.

The amendments introduced into insolvency law by the EA are meant to "facilitate company rescue and to produce better returns for creditors as a whole"[55], to "address the fear of failure that is a significant barrier to enterprise and help to prevent companies in difficulty from going under unnecessarily"[56]; in other words, to promote "a culture in which companies that can be rescued, are rescued."[57] The essentials features of these amendments are, to begin with, a) strongly restricting the availability of administrative receivership, and, b) in order to establish administration as the primary insolvency regime, easing entry into administration and c) aligning the incentives of the administrator to unsecured creditors, if they are eligible, through a scheme of priorities, a voting process and a procedure for redress if "unfair harm" can be established. Only one of these amendments directly provides for the "rescue" of a company and even that, s. 3 (1) (a) in Schedule B1 of the IA 1986, is strongly qualified (some would say, nearly disqualified) by the requirements it must fulfill. One could then ask: in what way could the EA 2002 be considered to facilitate a "rescue culture" at all? It could be argued that while the EA amendments do not

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55 Hansard, HC Deb 10 April 2002, col. 53 (Patricia Hewitt MP, Secretary of State for Trade and Industry)

56 Ibid., col. 111. (Melanie Johnson, Under-Secretary of State for Trade and Industry)

57 Insolvency Services, *An Update on the Corporate Insolvency Proposals*, January 14, 2002 (website)

legislate directly for corporate rescue, they are designed to weaken the perceived "liquidation bias" in the previous system.

The main charge against administrative receivership is that it is not an inclusive process. As Mokal (2004b: 1) puts it: "the receiver- while regarded as the debtor's agent- owes his primary (in some important respects, exclusive) obligations to the chargee. He may choose to deal with the company or its assets in a way that directly inflicts harm on junior claimants, as long as he acts in good faith in the chargee's interest." Armour and Frisby (2001) have argued, however, that the scope for banks to abuse their power over the administrative receiver is limited because they would an incentive to do so only when they are over-secured and the statistical evidence would seem to indicate that banks tend to be under-secured rather then over-secured. These statistics, even if valid[58], would still not detract from the argument that situations in which receivers are given prejudicial incentives could readily occur under the old regime. Frisby (2004: 253) also points out that, in practice, judicial initiatives have approximated many of the elements of administrative collectivity in receiverships: moratoriums and relief from forfeitures. Indeed, perhaps all that is required is a stipulation that makes receivers accountable to all creditors (West 2001: 176, 177). This is, however, begging the question: if administrative receivership at its best resembles administration, why not simply use administration? The question ultimately rests on efficiency: which procedure produces a better return? And that will have to wait for data. On the basis of principles, though, receivership is a procedure based on the enforcement of a charge holder's property rights in its security and, as such, shows signs that it was not meant to be part of a collective process. If we can

agree that a collective process is what is desired in insolvency, then it would be best to rely on procedures designed directly for collectivity.

On, then, to the new administration itself. The administrator is constrained by a list of statutory objectives he must pursue. As soon as is "reasonably practicable", the administrator must then send out "proposals for achieving the purpose of administration."[59] These proposals must then be voted on by a creditors' meeting (meaning, in practice, unsecured creditors)[60]. (Armour and Mokal (2005) argue convincingly that the administrator's objectives apply only before a proposal has been approved. An approved proposal would act as a "ratification.")

Let us examine both stages of this process. Schedule B1 states the objectives pursuable by the administrator and the circumstances in which they are to be pursued:

> 3- (1) The administrator of a company must perform his functions with the objective of-
> (a) rescuing the company as a going concern, or
> (b) achieving a better result for the company's directors as a whole than would be likely if the company were wound up (without first being in administration), or
> (c) realizing property in order to make a distribution to one or more secured or preferred creditors.
>
> (3) The administrator must perform his functions with the objective specified in sub-paragraph (1) (a) unless he think either-
> (a) that it is not reasonably practicable to achieve that objective, or
> (b) that the objective specified in sub-paragraph (1) (b) would *achieve a better result for the company's creditors as a whole.* (Italics added)

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58 As Mokal (2004a: 9, 2004b: 5) points out, the mean recovery rate of banks do not tell us much about the proportion of debts which are under or over-secured.

59 S. 49 (1) and (5) (a), Schedule B1, IA 1986.

S. 3(1)(a) is the only time company rescue is mentioned in the whole Act. Note too, that the section speaks of rescuing the "company", not the business. Read in conjunction with s. 3(3)(b), the effect is that, companies should be rescued as going concerns only in the event that returns are equal to creditors whether the company is rescued as a going concern or not. That is, if rescuing the company will achieve the best result for creditors, then s. 3(1)(a) is redundant, therefore, the only situation in which s. 3(1)(a) serves a purpose is when two options exist, one involving the rescue the company, the other not, both providing an equal return to creditors, and no other option would "achieve a better result for the company's creditors as a whole." In that case, the administrator should choose to rescue the company. It is hard to see how this portion of the Act can seriously be described as promoting corporate rescue. A wary would-be entrepreneur is unlikely to be much assuaged. It is tempting to say that the law in this case is so subtle it could be described as misleading.

As mentioned above, the administrator should set out a proposal that will then be voted on in a creditors' meeting. S. 52(1) states that a proposal need not be voted on if the administrator "thinks"-

(a) that the company has sufficient property to allow each creditor of the company to be paid in full,
(b) that the company has insufficient property to enable a distribution to be made to unsecured creditors other than by virtue of section 176A(2)(a), or
(c) that neither of the objectives specified in paragraph 3(1)(a) and (b) can be achieved.

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60 Insolvency (Amendment) Rules, 2.40 (1)

However, "creditors of the company whose debts amount to at least 10 per cent of the total debts of the company" (s. 52(2)(a)) can still request a meeting.

What this amounts to is a system in which the residual creditor is given control over the company. If the value of the company is more than the owed to secured creditors, unsecured creditors then have control over the company; if less, the secured creditors have control. (Presuming the valuation is acceptable. Armour and Mokal (2005: 35-37) argue that, even though the IA specifies a subjective measure, i.e. what the administrator "thinks", the valuation must be publicly justified and such a valuation can still be contested in court.)

Note, though, that it is still the residual *creditor* who is given control, never the shareholders, even if the shareholders are the residual *claimants*. Even though schedule B1 gives the company and its directors the right to appoint an administrator, it gives no positive incentives why they should do so (there are punitive incentives in the form of the wrongful trading provisions- s.212 and 214 of the IA 1986). In the, even if unlikely, case that the company is put into administration when its assets exceed its debt (which is possible, given that a default that crystallizes a floating charge need not be concerned the company's market value), then shareholders lose control over whatever value in the company they should still rightfully own. In general, the amendments do nothing to strengthen the status of shareholders or directors in insolvent companies, the people who have the best incentives to rescue the company.

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[61] That is, the 10% ring-fenced fund carveout.

The EA 2002 amendments, then, promote corporate rescue only in an oblique way: by reducing the "liquidation bias" in the old regime. It does this by restricting access to administrative receivership, statutorily making administrators beholden to creditors "as a whole", and allowing the residual creditor control over the company.

But why should we rescue companies at all? What does it mean "to prevent companies in difficulty from going under unnecessarily"? This is a question that goes to the core of modern corporate insolvency law. The standard justification for corporate insolvency law is predicated on the notion that a collective procedure for debt enforcement is more efficient than each individual creditor pursuing its own remedies. When the asset pool is insufficient to pay off all debts, each creditor has an incentive to try to enforce their own debt as soon as possible (which in practice, usually means a sale of the debtor's assets), even though the return to all creditors might be higher under an alternate arrangement. In other words, in Jackson's (1986: 14) classic statement, a collective insolvency proceeding preserves "the surplus of a going-concern value over a liquidation value". A more modern statement of the principle is that an insolvency proceeding should maximize the value of the firm. (Hart 2000) There is also a crucial distinction to be made between "business" and "company" rescue. There might be cases where the business might be best maximized by changing its form and ownership; that is, the company might be worth more broken up or restructured in some other way. The EA, however, is focused on *company* rescue, not *business* rescue.

The stated objectives of the EA, however, appear to go beyond maximizing the value of the insolvent company. While it is understandable that "maximizing value"

isn't as politically marketable as "corporate rescue", it still sometimes sound as if the rhetoric surrounding the EA is similar to that coming from those Baird (1998) terms the "traditionalists", which he contrasts to the "proceduralists":

> In short, the traditional bankruptcy experts believe that: (1) the preservation of firms (and therefore jobs) is an important and independent goal of bankruptcy; (2) contemplation of the rights and needs of the parties before the court matters more than the effect of incentives before the fact; and (3) bankruptcy judges should enjoy broad discretion to implement bankruptcy's substantive policies. The proceduralists, on the other hand, believe that (1) the preservation of firms is not an independent good in itself; (2) ex ante effects are important; and (3) the judge, after controlling for the biases and weaknesses of the parties and resolving the legal disputes, must allow the parties to make their own decisions and thereby choose their own desitines. (Baird 1998: 579-280)

Baird claims to write this as a "neutral observer" (Baird 1998: 574), but his statement of the dichotomy makes the "traditionalists" sound rather irrational[62]. There are other arguments in favor of a "continuation bias". Gross (1997) argues that insolvency laws should take into account community interests. She justifies her argument by a recourse to general principles of altruism. However, as Armour (2001) points out, it is hard to see why altruism should be legislated into insolvency law. It is possible, nonetheless, to extend Gross's argument. It is possible to argue that the impact of a liquidation goes beyond the shareholders and creditors of the firm itself. We could consider the negative effect of a firm's liquidation on the "community" as an externality that should taken into account. The most coherent theory of this kind is an extension of Blair and Stout's (1999) team production theory of the corporate form. LoPucki (2003c) argues that companies cannot be viewed as simply their shareholders

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62 Baird writes: "I attempt to look at this problem as a neutral observer who comes to these questions without preconceptions. Nevertheless, these questions hold an interest for me precisely because I have been involved in these debates for a long time and have been strongly identified with the ranks of those I call proceduralists. Hence I must remind both myself and the reader of the difficulties I face in trying to assume the vantage point of a disinterested observer." (Baird 1998: 574-5)

and creditors. The corporate form derives its value from the fact that it stands as a conduit, an intermediary, between different parties. Part of the benefit of the separation of ownership and control is that the directors are not (or at least should not be) directly pursuing the interests of the shareholders, but rather of the company as a whole. From this perspective, therefore, "all who have made firm-specific investments have rights that need to be accounted for in a collective proceeding".

There are, then, at least two reasons why companies should be rescued. Firstly, companies should be rescued if it can be explicitly proven that preserving the copmany is the optimal method of maximizing its value. Secondly, there might be reasons for an a priori assumption that companies should be rescued- there could be value in maintaining the corporate form that is difficult to demonstrate. But- there is a third reason why companies should be rescued in their original corporate form; the possibility of the survival of the company could be an incentive for the shareholders and directors of the company to enter insolvency voluntarily to preserve the company and for them to cooperate in the restructuring of the company.

The Role of Violations of Absolute Priority

The paradigm case of a country with a "rescue culture" would be the United States of America. Chapter 11 is known for protecting debtors to the extent of violating absolute priority, that is, shareholders are paid even when creditors have not been fully repaid. Absolute priority is the rule that, in bankruptcy, the debtor receives no value until his creditors have been repaid in full, and that junior creditors receive

no value until senior creditors have been repaid in full. It is easy to see why deviations from absolute priority may be harmful; it amounts to the debtor not having to repay part of the loan. This can lead to instances where the debtor has an incentive to abuse the loan proceeds, as, even if the debtor company goes bankrupt, the shareholders will still receive some return (Schwartz 1994) and, possibly, even to a reduction in lending across that jurisdiction as the risk to lenders is increased (Longhofer 1997).

Studies estimate violations of absolute priority (VAP) in American bankruptcies to be around 4-8% (Eberhart, Moore and Roenfeldt 1990, Franks and Torous 1989, Lopucki and Whitford 1991)[63]. But we should first understand that the letter of American law does not directly legislate for VAP. Rather, violations come about as a result of the interpretation and application of the law.

To loosely summarize, the U.S. Bankruptcy Code provides that the court may only approve a reorganization plan that has not been approved by a class of creditors when i) that class of creditors is "not impaired under the plan"[64], ii) the impaired class of creditors will receive property "that is not less than the amount such holder would so receive or retain if the debtor were liquidated"[65] or iii) the court finds that the plan is "fair and equitable" to the dissenting class[66]. The conditions for a plan to be "fair and equitable" are, with respect to unsecured claims, that i) the plan allows the class property of a value equal to the claims and ii) no claims junior to that class will

63 A good summary of empirical studies concerning VAP can be found in Garbade (2001: 99-104).

64 s. 1129(a)(8)(B). The definition of impairment is in s. 1124.

65 s. 1129(a)(7)(A)(2).

66 s.1129(b)(1).

receive any property[67]. The action of a court approving a plan without the approval of a class of creditors is commonly called a "cramdown". Aside from situations where the court undervalues creditors' claims in a cramdown, VAP tend to come in practice from a) creditors essentially paying off shareholders to avoid costly delays in negotiations (Roe 2000: 125-131)- this is a result of Chapter 11 giving voting rights to lower priority claimants, and b) creditors' post-petition interest is not included in the value that is to be matched under the definition of "fair and equitable" (Roe 2000: 373).

Recent academic work has argued that VAP might be beneficial. More than simply being concessions, necessary evils endured for the sake of implementing Chapter 11 voting procedures, VAP might provide positive incentives for debtors. The following benefits have been proposed:

Promote firm-specific investments. When a company is broken up in insolvency, firm-specific value is lost. Knowledge and assets geared specifically to the operation of that company cannot be transferred. Therefore, if the shareholders of a company perceive that the company may be in risk of insolvency, they will avoid making firm-specific investments, such as employee training (human capital investments). Firms may be more willing to make such investments if there is less risk of the firm being broken up in insolvency. (Bebchuk and Picker 1993, Berkovitch, Israel and Zender 1997, 1998)

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67 s.1129(b)(2).

Provide an incentive for debtor to enter insolvency at appropriate times. Managers of a company will always have better information about the company than creditors. However, if it is certain that managers will be ousted in insolvency, managers will have an incentive to postpone the insolvency. They certainly do not have an incentive to enter insolvency at the optimal time (for the creditors). An insolvency system which does not automatically displace managers may provide an incentive for managers to use insolvency procedures to attempt to save the company and encourage information disclosure by managers in general. (Baird 1991, Povel 1999)

Lower incentives for managerial entrenchment. Managers might also attempt to entrench themselves in the firm to improve their bargaining position in reorganization proceedings. (Baird and Picker 1993, Adler and Triantis 2002)

Avoid underinvestment due to debt overhang. This is a standard agency problem of debt, discussed above. If the firm owes so much that any money it makes belongs, in effect, to creditors, shareholders will have no incentive to pursue value-creating projects. This can be mitigated if shareholders are promised a share in the reorganized company. (Berkovitch and Israel 1998, Gertner and Scharfstein 1991)

Deter asset substitution. This is also a standard debt agency problem, also discussed above. Shareholders in debt-laden companies have an incentive to invest in high-risk projects because they do not share the losses. This can again be mitigated if shareholder receive a part of the reorganized company. (Eberhart and Senbet 1993, Gertner and Scharfstein 1991)

VAPs are, in effect, ransoms paid by creditors in order to prevent debtors from injuring the firm. The costs of VAP are obvious: debtors will be able to benefit from reorganization to the detriment of creditors. In fact, VAP should encourage asset substitution because creditors would bear more of the effects of an insolvency than would be otherwise (Jensen and Meckling 1976). This runs directly counter to the proposed benefits of VAP above. The last two alleged benefits are not really benefits at all; they are simply cases where it is as if the company had less debt (because the debt is worth less if absolute priority is not respected).

Such a reallocation of priorities would, in effect, subsidize and encourage risky investments from the shareholders because the debtholders would bear more risk (Adler 1992: 448). Additionally, Bebchuk (2002) argues that "the introduction of AP violations increases the nominal interest rate (to compensate the debtholders for getting less in bad times), and this increase in the nominal rate worsens the further the distortion in favor of risky projects, because such an increase lowers the attractiveness of safe projects more than it lowers the attractiveness of risky projects".

What effect does VAP have empirically? The first question would be whether debt is priced efficiently by the market. In other words, are debtholders being systematically expropriated by Chapter 11? Altman and Eberhart (1994) report two studies that bonds appear to be priced efficiently. One study attempted to test if bonds were efficiently priced at time of default, the results were mixed but the "statistically most reliable sample" supported efficiency. The second study compared senior bonds

with subordinated bonds and found that seniority provided significantly higher payoffs, which would indicate that bonds are efficiently priced at issuance.

The second, more important, question is about the effect insolvency provisions have on capital structure in general. Armstrong and Riddick (2000), in examining the equity returns of firms in six countries (Canada, France, Germany, Great Britain, Japan and the U.S.) find that British firms lose the most value (89%) prior to bankruptcy and American firms the least (61%). Germany and Japan had highly correlated losses in value (77%), which suggests that similar insolvency laws has similar effects. Armstrong and Riddick (2003) argue that liquidation bias in Britain and the continuation bias in the U.S. should cause British equity to be worth less than U.S. equity and provide evidence that British firms do lose more value than U.S. firms prior to an insolvency filing. However, Acharya, Sundaram and John (2004), in a rather more nuanced and sophisticated study, present comparative data between the US and UK demonstrating that, while direct comparisons between the capital structure of these two countries are inconclusive, there is strong support that, in an equity-friendly system, firms with high asset-specificity will employ greater leverage and, therefore, optimal debt levels in any given country would depend on both the bankruptcy code and the asset-specificity of the company. The intuition behind this is the same as the "firm-specific investment" argument in favor of VAP above: a debtor-friendly bankruptcy code would lead to the loss of firm-specific value in the case of an insolvency. Companies with extensive firm-specific assets ('high asset-specificity') would therefore choose low leverage in debtor-friendly environments in order to avoid insolvency.

The studies above argue that bankruptcy codes can affect financial structure. However, causation can be difficult to prove in these cases and there are arguments that have causation running the other way: financial structure could dictate bankruptcy. Armour, Cheffins and Skeel (2002; "ACS") argue that dispersed debt-holding calls for reorganization-oriented bankruptcy rules. The ACS argument begins by noting that, while the UK, like the US, has dispersed shareownership, UK firms tend to have concentrated debt-holders. That is, UK companies tend to be financed by banks rather than by publicly held bonds. The (relatively) small number of banks, in contrast to the large number of bond-holders, and the relative ease with which they can cooperate, is what allows UK companies to be re-organized out-of-court through an informal process known as the "London Approach" (Armour and Deakin 2001). In other words, so far, the UK has not "evolved" a need for a formal reorganization-oriented bankruptcy rules. However, ACS argue further that, as debt in UK firms continue to disperse, the UK might soon require US style Chapter 11 rules.

An argument closely related to the ACS thesis, though it is normative rather than positive, is that presented by Hahn (2004). Hahn argues that the Chapter 11 model, where the managers of the firm are left running the firm during insolvency, is not appropriate for concentrated ownership firms. Firms with dispersed ownership are likely to be run by professional managers, while firms with concentrated ownership are likely to be run by family members. Professional managers "may realistically be expected to successfully manage the reorganizing corporation while complying with its fiduciary duties to the creditors", however, if management and shareholders are effectively the same party (or even the same person), it is unrealistic to expect management to protect the interest of creditors. Another normative model is that

presented by Berkovitch and Israel (1999; "BI"), which is based on information flows, rather than ownership structures. BI note that we can roughly divide financial systems into three types: bank-based (e.g. Germany), market-based (e.g. US) and under-developed. The first two, developed, financial systems are assumed to have good information flow. To simplify the BI argument: 1) in a bank-based system, the banks have such good information that there is no need to pay the shareholders or managers a "bribe" to enter insolvency efficiently, therefore the bankruptcy system should be manager-displacing. 2) in a market-based system, either the creditor or the debtor could be the party that possesses the best information on when to file for insolvency, depending on the informational efficiency of the country. BI argue that managers should be compensated for entering insolvency efficiently according to the probability that debtors could have found out the relevant information. In other words, the less likely it is that debtors could have found out information that would have allowed them to put the company into insolvency efficiently, the more managers should be rewarded for coming forward. Such systems should therefore have both a manager-displacing and manager-preserving code. 3) in an under-developed system, information flows are very poor and BI assume that creditors know next to nothing about the company. Therefore, in this system, managers should gain the full benefit of any loss that might have been incurred if insolvency had been postponed. Such systems should also have both manager-displacing and manager-preserving codes, but should be even more protective of managers in the manager-preserving code.

We can now ask: when is VAP appropriate? Of the benefits of VAP described above, it would appear that the argument that VAP encourage firm-specific investment is vindicated by empirical data (in the Acharya, Sundaram and John (2004)

study). Also, debtors do not appear to be expropriated by Chapter 11, bond prices reflect VAP at issuance. If we accept that debtholders simply adjust their interest rates to reflect the value they assume would be lost in a Chapter 11 process, then we could describe the situation under Chapter 11 as a case where shareholders are paying debtholders in order to be able to maintain control of the firm in bankruptcy, which seems reasonable enough. The situation is similar to the arguments for weakening secured credit above- if the debtholders can adjust, then there is no harm to any party. However, this ignores the role of debt as a provider of financial discipline. Leaving the power to instill financial discipline to the courts weakens the power of the market. In a debtor-controlled insolvency process, firms would control their risk of insolvency through carefully managing their capital structure. In a court-controlled, manager-friendly insolvency process, however, the risk the managers face of being displaced is up to the courts. This then becomes a Coaseian question: should we leave financial discipline to the courts or to the markets? (A Coaseian answer would be that we should leave decisions to the courts when markets fail, which they may be considered to, if a firm's debt-holders are so dispersed they cannot be relied on to make a coordinated, efficient debt restructuring.)

Another question that should be asked is: should other countries adopt a Chapter 11 style system? Should the UK? Three factors are relevant: company ownership (Hahn 2004), debt concentration (ACS 2002), and debtor-creditor information flows (BI 1999). As ACS point out, as debt in the UK becomes more dispersed, the "London Approach" will become more difficult to implement, and a formal court-based procedure may become necessary. ACS also mention that the UK is moving towards a "debtor-in-possession" system for small companies in the

Insolvency Act 2002. I presume this is a reference to the moratorium for small companies in Schedule A1, where directors are allowed to continue to manage the company while proposing a Company Voluntary Arrangement (CVA). However, as Hahn points out, small companies, which are likely to be family-run or at least closely-owned, are the worst candidates for manager-preserving approaches. Small company owner-managers have the strongest incentives to keep the firm running for as long as possible at any cost and to take the highest risks in an attempt to save the firm, because they have a fair amount of their own personal wealth invested in the firm. As for under-developed countries, while BI argue, quite rightly, that creditor-debtor information flows are poor, it is not clear if court systems in these countries are sophisticated enough to deal with issues pertaining to the financial well-being of companies. Also, most of these countries (LLSV 1997, 1998) have concentrated corporate ownership, which, as Hahn suggests, is inappropriate for manager-preserving insolvency.

Valuations and Voting: the Balance of Power

At the centre of insolvency law lies the assumption of debtholder conflict. If debtholders are not in conflict, then there is no reason for a firm to enter a formal insolvency process; the firm can simply restructure. All that would be required, in a worst case scenario, would be a mechanism for passing control of firm over from shareholders to debtholders. Bankruptcy would be nearly costless as debtholders would coordinate in order to eliminate bankruptcy costs (Haugen and Senbet 1978). Unfortunately, debtholder conflict is inevitable in insolvency: senior (perhaps secured) debtholders only require the firm to be sold for a sufficient amount to repay them and

therefore would usually be more concerned with prompt repayment rather than maximizing value and junior debtholders would want the firm to continue operations and perhaps assume increasing risk in order for there to be a possibility the firm will be worth enough to cover their repayment.

Recall our earlier discussion of risk/return; an investment can have the same value while varying on the risk/return scale. In the case of an insolvent company, even if different classes of debtholders can agree on the value of the company, they can still diverge greatly on the manner in which it is to be managed. Take, for example, an insolvent company which is worth $110, with secured debt of $100 and unsecured debt of $50. The company can be liquidated immediately, paying $110, or it can be allowed to continue, where its value can appreciate to $160 or decline to $60, with equal probability. Both contingencies provide the same payoff: $110. However, the payoff to debtholders is different. The liquidation scenario will pay $100 to the secured creditors and $10 to the unsecureds; the reorganization scenario, on the other hand, has a payoff of $80 (50% of 100+60) to the secured creditors and $30 to the unsecureds (60/2).[68] Therefore, even when the creditors are agreed on firm value, their choices in regard to the firm's future will be different.

However, debtholders have a strong incentive to disagree about how much the firm is worth. Senior debtholders will attempt to value the firm as low as possible, in order to deny junior debtholders any share, and junior debtholders will attempt to

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68 Note that a reason for using $110 as firm value in the example is because if firm value is set at $100, that is, the amount owed to secured creditors, then the unsecured creditors would have no say in the future of the firm, as the firm would effectively belong to the secured creditors. If the secured creditors should then pursue a risky reorganization, whatever benefit they accrue would then belong to them alone. The unsecured creditors would have lost their claim completely.

value the firm as highly as possible, in order to receive any returns the firm might have.

There are three elements to every insolvency: 1) the valuation of the insolvent firm, 2) the control of the future of the insolvent firm and 3) the determination of the ownership of the insolvent firm. These three elements are connected (one could say they are circular). The valuation of the insolvent firm could determine the ownership of the firm and the owners of the firm could then decide its future. Or, if the insolvency process is controlled by an administrator, the administrator could value the firm, which would determine the ownership of the firm. Or, if the insolvency process of that country is auction-based, the firm would be auctioned, and the shareholders and creditors would be paid from the proceeds of that auction. The valuation-control-ownership loop, then, can be cut at any link. However, determining which link to instigate the insolvency process is not trivial.

A) Market Valuations of the Bankrupt Firm

Arguments for market valuations start from the observation that the Chapter 11 bargaining process is flawed. 1) The integrity of the bankruptcy process is ultimately maintained by the judge's valuation of the dissenting creditors' claims (because, as mentioned above, a plan may not a) distribute to a class less than the class would get in a liquidation without unanimous consent, or b) be "crammed down" unless it is "fair and equitable"). This can lead to deviations from the absolute priority, often inadvertent. 2) The process of bargaining can lead to inefficient capital structure (often involving deviation from absolute priority) as bargaining power given by

Chapter 11 can lead to strategic negotiations. 3) The process itself is costly, both in direct litigation cost and delays, which can arise from a genuine inability to reach agreement or from strategic concerns. (Bebchuk 1988) On an empirical basis, it has been alleged that Chapter 11 (compared to the previous 1978 act) lends itself to inefficient behavior from managers, which has lead to: 1) an increase in the frequency of bankruptcy filing, 2) shareholders losing greater wealth and 3) bondholders losing greater wealth (Bradley and Rosenzweig 1992, but see counter-arguments in LoPucki 1992).

To avoid reliance on judges and strategic bargaining, it is argued that a market-based valuation system can be used. Once a market valuation has been established, a debt-to-equity can be done to distribute the reorganized firm's assets. There are many versions of market based valuation.

Auctions. The most obvious approach would be to auction off the firm's assets. If the purpose of the auction is merely to value the firm, Roe (1983) has suggested that it might be enough to auction off a portion of the company's assets (Roe suggests 10%). Baird (1986) and Jackson (1986) argue that there is no reason to limit the sale of the firm to 10% and advocate the sale of the entire firm by auction.

The advantage of the auction approach is that the problem of control is, if not solved, then sidestepped. The auction process itself can be controlled by a third party, since the auction should maximize the value of the firm without the auctioneer requiring specialized information or incentives. However, it may be questioned whether auctions in general are efficient mechanisms for determining value. At least

three problems remain: A) In an English auction (that is, bidders raise prices until there is a winner), it is a well-established result that the winning bid will be closer to the second-highest valuation rather the highest. This is because the winning bid merely has to beat the second-highest bid, which might not be as high as the price the winner is willing to pay. In a closed-bid auction, on the other hand, a bidder that knows his valuation is high may be wary of overbidding and therefore wait to see a winner first, and then if his valuation is higher, buy the firm from the winning bidder. That is, there is an incentive not to reveal information. B) there is persistent risk for bidding firms to suffer from the winner's curse, where it is the bidder with the most optimistic valuation of the firm, rather than necessarily the bidder who can most efficiently use the assets of the firm, who wins the auction. C) potential bidders, who are most likely to be firms in the same industry, may tend to be liquidity constrained at the same time the auctioned firm goes bankrupt. Therefore, insolvency auctions may well be underpriced as bidders simply do not have the capacity to pay full price. (Shleifer and Vishny 1992).

Options-based Valuation. The Bebchuck (1988) options proposal works by a) giving the most senior class all of the shares in the bankrupt firm then b) junior claimants are then given options (based on their pro-rated share of their classes' claim) to buy the shares of the senior class by paying the total amount the senior class is owed. If the junior claimants believe the firm is worth more than the debt owed to the senior class, the junior claimants can buy the shares from them at the face value of the debt.

This scheme has the significant advantage that it does not require a "correct" valuation. Each class will simply be accorded rights; it is up to the classes to apply these rights for efficient gains. Once the company has been valued, Bebchuk (1988) notes that "the choice of capital structure cannot be used to divert value from one class of participants to another". Thus, the task of actually reorganizing the firm can entrusted to a variety of parties. Because company value has already been divided, it is even possible to simply have the reorganized company vote for a scheme under normal corporate law (Aghion, Hart and Moore 1992). Another advantage of the options scheme is that it can alleviate the liquidity problem of the auctions approach. As the options accorded the junior claimants are tradable, the junior claimants can simply sell them or use them as security to obtain external funding.

Dilution Mechanism. Adler and Ayres (2000) have proposed a mechanism whereby the court issues shares to the senior claimants and then solicits schedules from all classes of claimants to buy or sell shares at a fixed price ($1), conditioned on a particular number of new shares issued to junior claimants. This process aims to force both senior and junior claimants to reveal their true valuation of the company. Senior claimants would sell the shares they hold once the level of dilution diminishes the value of the firm to the value the senior claimants think the firm is worth and junior claimants would buy shares up to the level they think the firm is worth.

The dilution proposal aims to reduce the liquidity problem of the options proposal. In the Bebchuk (1988) proposal, even if the value of firm is above the claims of the senior claimant, if the junior claimants lack liquidity and are unable to pay off the senior claimants entirely, any senior claimants not bought out will be

making a gain, violating absolute priority. From this perspective, the Bebchuk (1988) options proposal is a special case of the dilution proposal, where the senior claimants tender their entire share without dilution.

Consider a paradigm case: both parties agree that the firm is worth $160. The senior class gets 100 shares, priced at $1. Dilution shares are then continuously supplied to the junior class until a) the senior class desires to sell its shares and b) the junior class stops wanting to buy shares. This should occur at the same time, that is, when 60 dilution shares have been issued, because that is the point at which each share is now worth $1. This is essentially a fixed-price sealed-bid auction for the value of firm in excess of what the senior class had been given. The amount given to the senior class, however, has to be the amount the senior class is owed. Consider again the case above: the senior class is owed $80 and both parties agree that the firm is worth $160. At the equilibrium dilution point, the senior class has 100 shares and the junior class has 60 shares, each share is worth $1; the senior class makes a profit; conversely, if the senior class is given less than it owed, the senior class will make a loss (if the senior class is owed $110 and the firm is worth $160, the same scheme would result in a $10 loss to the senior class). To maintain absolute priority, the amount given to senior class has to be exactly equal to what it is owed.

Therefore, we can view the dilution mechanism as a reverse auction, where the winner of the auction has to pay the senior class whatever it is owed. From this perspective, it is possible to execute the mechanism with an external auctioneer. The advantage of handing the process over to one of the parties is that it can make the process cashless. It works as a reverse auction because the price is initially set high

and is then bid down until there is a buyer. (In the basic Adler/Ayres framework, this would be junior class.) The usual drawback of a reverse auction is that the price cannot go higher than the initial offering price, however, in this case, that is not significant, because if the price is so high that the auctioneer does not allow it to be bid down (in the dilution framework, the senior class does not sell even at no dilution), then the whole firm simply falls to the senior class (implying that the firm is worth less than what the senior class is owed).

The advantage the Adler and Ayres offers over the Bebchuk options proposal is that, if the Adler/ Ayres proposal works perfectly, it should not require either class to have liquidity at all, since the dilution mechanism should distribute shares to the equilibrium price without either class having to buy anything. (Once a valuation has been established, the shares can then be distributed in order to pay off the senior class.) In the worst case scenario, where the senior class (or the auctioneer) attempts to test the junior class's liquidity by "daring" them to buy the shares at low or, for that matter, no dilution, the amount the junior class requires is at worst equal to what is required under the Bebchuk scheme. The Adler/Ayres proposal, in other words, works as a cashless auction (for the junior and senior classes; third-party bidders will still have to pay cash). To put it another way, the winner of the auction has to pay the senior class what they are owed and the junior class any value in excess of that (in accordance with absolute priority), however, whichever class wins the auction gets the entire company and can then pay off the losing class in shares, which means that no cash changes hands.

In summary, the dilution mechanism works as an auction where the senior class are protected against junior class over-valuation by a put option, where they can force the junior class to buy them out at the face value of their debt, while the junior class is protected against senior class undervaluation by a call option, where the junior class can buy senior class shares at undervalue. To reformulate the dilution mechanism in starker terms, the junior class is given three options: a) it can propose a distribution of shares acceptable to the senior class or b) it can pay off the senior class at face value and get the entire firm. If the junior class is unable or unwilling to do a) or b), then c) the senior class gets the entire firm. Stated in this way, we can see that where the dilution mechanism adds to the options proposal is in the added alternative of proposing a distribution of shares acceptable to both junior and senior classes.

To restate the logic of the procedure: the senior class will only agree to take shares in the reorganized firm if it is equal to or above the value of their debt and the junior class will only give shares to the senior class if the shares are equal to or lower than the value of the debt. If the senior and junior classes agree on valuation, this procedure will reveal that value (for example, if the company is worth $160 and the senior class are owed $100, the equilibrium distribution would be to give the senior class 85% of shares, which would reveal the $160 valuation). If an equilibrium valuation is reached, no cash needs to change hands. We can note further that even in cases of divergent valuations, absolute priority will be maintained to the perceived valuation of each party. If the senior class values the firm higher than the junior class, it will accept a lower number of shares rather than be paid the face value of debt, and if the senior class value the firm lower than the junior class, it will simply be paid the face value of debt.

Problems with Market Valuations. It is generally recognized that markets cannot be relied on to solve every problem automatically. There are widely discussed problems that lead to market failure. The market valuation methods cited above do not escape these problems. There are three problems in particular that have not been satisfactorily resolved:

1) Liquidity. The authors of all the methods above acknowledge that liquidity can be an impediment to the implementation of their procedures. In the auction method, whether in 10% version or full auction version, if the likely buyers of the business are affected by the same market forces that lead to the bankruptcy of the auctioned company, then the price the bankrupt company fetches in the auction is likely to be lower than its true value. In the options proposal, if the junior creditors cannot obtain funding to buy out the senior creditors, then the return will accrue to the senior creditors, violating absolute priority. Similarly, in the dilution mechanism, if the senior creditors choose to sell their stake, the juniors must be able to obtain funding to make the mechanism respect absolute priority.

Generally, in a reasonably efficient market, firms should be able to obtain funding for a profitable project, even if they do not possess the fund themselves, by borrowing or issuing shares. In the options proposal, the options themselves can be sold, which would mean the creditworthiness of the junior class would not be an issue. Adler and Ayres (2000) cite four reasons why liquidity issues would be mitigated in their proposal: 1) Third party bids could be allowed, which would, in effect, work like an auction. However this would still be affected by the above observation that likely

third party bidders themselves may be liquidity constrained. 2) Dilution leverage. That is, the junior class could use the dilution shares they are issued as collateral for a loan. However, if the senior class is acting strategically, it would, rationally, choose to "put" their shares at the lowest possible dilution, precisely to deny the use of dilution shares as leverage. 3) Free-riding. Adler and Ayres (2000) argue that individual senior class members would be reluctant to "put" their shares because they would choose to hold out for the possibility of gaining from the reorganized company's shares. However, if the senior class believe the junior class to have a similar valuation of the company, the senior class knows it will offered shares in the reorganized company equal to the value of the debt they are owed. Therefore, it would make sense strategically for the senior class to either a) challenge the junior class's liquidity or b) only accept a share offer if it is sufficiently generous (thus violating absolute priority). 4) Acquiescence. If the shares of the company may be worth more if sufficient share ownership is given to junior claimants, the senior class may allow the junior class to hold shares even if the senior class can win a liquidity challenge. Note, however, that this applies to all of the above forms of market valuation. While such situations could occur in practice, it would be remiss to allow a contingency to be one of the primary solutions to such a central problem.

2) Transaction and Informational Costs. The above discussion raises the general question: what impedes the functioning of markets? Situations in which institutions could function better than markets are when there are high transactions costs (including information asymmetries). In addition to the discussion above, acquiring external funding can involve significant transaction costs, both directly, such as the costs in obtaining and documenting the funding and compensating the

lender for various risks (i.e. paying interest) and indirect costs, such as, having to post collateral and tying up capital for other projects.

We can also discuss informational problems. Creditors are unlikely to be sufficiently informed to manage (or, for that matter, sell) the business they finance. External financiers are likely to have even less information about the business, and as such, would not be in position to finance (without significant costs), much less manage, the reorganization of the bankrupt firm. (See the discussion in Bufford 1994.)

3) The Problem of Control. The valuation approach aims to set the value of the firm, which would then decide the ownership and control of the firm. However, control is an intrinsic element of the value of the firm in two ways: a) the value of the firm may depend on who controls the firm (that is, what direction the firm is heading, or even a reflection of the competence of the managers of the firm) and b) controlling blocks of the firm command a premium (as discussed in the second chapter). The valuation approach effectively ignores these elements.

A. In all but one of the approaches mentioned above, the valuation of the reorganized firm will be uncertain because the prospective buyers of the firm do not know who will control the firm (or even which management team will lead the firm). (The exception is the whole company auction, which will be discussed later.) In analogous cases, such as an IPO or an M&A, the management team or prospective buyer will have to set out a prospectus for the status and future of the firm. In the 10% auction, options or dilution proposal, the identity of the management of the reorganized firm is potentially until the valuation process is complete. This leads to

uncertainty in the value of the firm. The exception to this is a whole company auction, where the buyer will, of course, control the firm.

The problem also occurs in the options and dilution proposals, but in different forms. In the dilution mechanism, in some cases this will not be a problem. For example, if we assume that 50% gives control of a firm, the senior class is owed $100, the firm will be worth $120 if the senior class controls it and worth $160 if the junior class controls it, then in this case, it is clear that whichever valuation we use the senior class will end up controlling the firm. (Note that the senior class may well subsequently hire the junior class to manage the firm. However, this will only affect the valuation of the firm *subsequent* to the valuation.) Situations where there will be problem are when, for example, if we again assume 50% as the control threshold and the senior class is owed $100, the firm will be worth $190 if the firm controlled by the senior class and worth $210 if it is controlled by the junior class. In this case, the valuation and control of the firm are inextricably linked. The junior class will not be able to offer the higher valuation unless they are absolutely certain they will gain control. In the options proposal, the problem occurs at the other end of the spectrum. Recall that under the options proposal, the junior class has to buy out the senior class at the face value of their debt. If the senior class is owed $100, and the firm is worth $90 if controlled by the senior class and $110 if controlled by the junior class, the junior class will only be willing to exercise any of their options if they are confident they can exercise enough of their options to gain control.

B. Controlling shareholders of firm command a premium. They control the future of the firm, they have more information and they may even derive private

benefits from the control. The fact that such controlling blocks may exist is a serious flaw of the Roe 10% auction proposal, as a 10% block will not reflect the value of the controlling block. (Roe 1983) Similar complications arise in the options and dilution proposals. If the exercising of the options or the dilution mechanism leaves any single shareholder in possession of a controlling block, that resulting shareholder in effect has profited from the distribution. Roe (1983) has suggested (and Bebchuck (1988) has endorsed) a provision whereby any party that is provided with a controlling block is required to dispose of his controlling position, by selling his shares until they fall below a certain threshold, within a specified period of time. However, this would ensure that the resulting reorganized company has a dispersed shareholding structure, which, particularly since the reorganized company does not yet have a management team in place, could lead to serious problems in corporate governance (as discussed in Chapter 2).

B) Structured Bargaining

It is the contention of many opponents of market valuation methods that the best (though, admittedly flawed) way to avoid the distortions of market valuations is have the court guide the restructuring process (Bufford 1994, LoPucki 2003a). The court will both limit the range of options available (preserving absolute priority) and facilitate the passing of desirable restructuring plans (e.g. cramdown in Chapter 11). These are sometimes irreconcilable goals. It has to be recognized as well that any type of structured bargaining apportions negotiating leverage to the parties and that it is difficult (perhaps even impossible) to impose negotiating rules without distorting the balance of power.

We will now examine the bargaining process under the UK administration procedure. The administration restructuring process can be divided into two general steps: 1) The administrator has to propose a plan that, unless the company's value is low enough such that unsecured creditors will receive no distribution, will be voted on by unsecured creditors.[69] 2) In this proposal, the administrator may propose to restructure the debt using one of the two tools for court-assisted restructuring: a) a company voluntary arrangement (CVA) under Part I of the Insolvency Act or b) a scheme of arrangement under section 425 of the Companies Act.[70]

1. The Administrator's Proposal. At the outset of the administration, the administrator will set out a proposal for the purpose of the administration.[71] If the administrator thinks that the company has sufficient property for a distribution to made to unsecured creditors, then the administrator must hold an initial creditors' meeting where the unsecured creditors will vote on the proposal. Resolutions are passed by a simple majority of members present.[72] Secured creditors are not allowed to vote the secured part of their debt (unless the administrator thinks unsecured creditors will get nothing).[73] However, secured creditors' rights are protected by section 73 (1)(a) and 73 (2)(a) of Schedule B1, Insolvency Act 1986, which prevents the administrator setting out a proposal that affects the rights of a secured creditor of the company to enforce his security, unless the relevant creditor consents. The secured

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69 Rule 2.40 (1) and (2), the Insolvency (Amendment) Rules 2003.

70 Section 49 (3) (a) and (b) Schedule B1, Insolvency Act 1986

71 Section 49 (1) Schedule B1, Insolvency Act 1986

72 Rule 2.60 (1) Insolvency (Amendment) Rules 2003.

creditor states his estimation of the value of his security in the proof of debt,[74] but, if the administrator is dissatisfied with the valuation, the administrator may require any property comprised in the security to be offered for sale.[75] (The terms of the sale may be agreed or as the court may direct.[76])

Presumably, only unsecured creditors are given the right to vote because they are the residual risk bearers and secured creditors' rights are adequately protected. However, this is problematic both in regard to shareholders and secured creditors:

1) Shareholders. With regard to shareholders, recall that a company may enter administration when "the company is or is likely to become unable to pay its debts".[77] That is, the company may enter administration from pure cashflow reason, even though the assets of the company are valuable enough for distribution to shareholders. Even in cases where shareholders may be entitled to distribution from the company, they are not entitled to vote, nor are their rights protected by the statutory purposes of administration, which means they cannot even defend their rights by an application to the courts. (The purposes only protect "the interests of the creditors of the company as a whole".[78]) If the company is indeed worth more than is owed to creditors, the administrator, working for the interests of the creditors, may pursue a course of action

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73 Section 52 (1) (b) Schedule B1 Insolvency Act 1986 read in conjunction with Rule 2.40 (1) and (2) of the Insolvency (Amendment) Rules 2003.

74 Rule 2.72 (vii) Insolvency (Amendment) Rules 2003.

75 Rule 2.93 (1) Insolvency (Amendment) Rules 2003.

76 Rule 2.93 (2) Insolvency (Amendment) Rules 2003.

77 Section 11(a) Schedule B1 Insolvency Act 1986.

78 Section 3(2) and (4)(b), Schedule B1 Insolvency Act 1986.

that does not maximize the value of the company, but rather a lower risk policy that guarantees the unsecured creditors the highest return.

2) Secured Creditors. A rationale for denying secured creditors the right to vote (at least for the secured portion of their claim) is that secured creditors are not the residual riskbearer of the company. The reason why residual owners are considered to be the optimal decision-makers for the company is because they capture the marginal risk and return of the company. However, in cases where firm value is highly variable, this is no longer true. Decisions regarding firm policy can affect more than just the value of the lowest priority class. Recall our discussion earlier that senior and junior classes have differing strategies in regard to risk-bearing for the firm. Senior classes have incentives to keep the risk of the firm low because they do not capture any benefit if firm values goes beyond what they are owed, but are affected if firm value falls below that threshold. Conversely, junior classes have incentives to pursue a high-risk strategy because their downside risk is limited. Allowing only unsecured creditors to vote would mean that unsecured creditors would be likely to pursue a high-risk strategy. Secured creditor rights are protected, however, to the extent that they can enforce their security. This can still, nevertheless, lead to violations of absolute priority if the firm is worth more restructured than liquidated. The situation is similar to the forces behind "strategic NPLs" (Non-Performing Loans).

The Asian Crisis was marked by the phenomenon of strategic NPLs. This was a situation where distressed debtors would elect not to repay their loans and, in effect, challenge creditors to take them into bankruptcy proceedings. At the time, most countries affected by the Asian Crisis had auction-based (i.e. liquidation) bankruptcy

systems. One counter-intuitive result was that very few firms were actually liquidated and most firms were restructured in ways that violated absolute priority. This is because these firms had much higher going-concern values than liquidation values. What happens then is, because all debt restructuring had to done with the consent of both parties (debtor and creditor), the system gave debtors the negotiating leverage to offer the following deal to creditors: either a) the firm is liquidated and the creditor gets minimal returns or b) the firm can be restructured, however, the excess value from the restructuring had to shared with the debtor. (See a discussion along similar lines in Kordana and Posner 1999.) To use a numerical example: the firm is worth $50 if liquidated and $120 if restructured. The creditor is owed $100. The creditor can choose to liquidate the firm and get $50 or he can negotiate with the debtor to restructure the firm, however, in a restructuring, the creditor must offer part of the excess returns to the debtor. That is, out of the $70 ($120-$50), since the leverage for the negotiation is split evenly (both the creditor and the debtor have the power to collapse the deal), each party would probably get half. Therefore, the creditor would receive $85 and the debtor would receive $35, which violates absolute priority.

In the case of UK administration, it may be argued that the administrator is statutorily bound not to offer a deal that violates absolute priority,[79] and therefore such a situation cannot arise without the secured creditors alleging "unfair harm" against the administrator.[80] However, in the realities of deal-making, it is possible that the unsecured creditors could make it known that they will not accept any deal that does not split the excess value equally. Arguably, the risk is mitigated under the UK regime

79 As previously mentioned, the administrator must act "in the interests of the creditors of the company as a whole".

as the administrator has the option of proposing a going-concern sale before the issue comes to a vote by the creditors' meetings (see the discussion in Armour and Mokal 2005: 21-22). The situation under the present UK regime would then be as follows:

1) The administrator could effect a going-concern sale, on the grounds that delaying the decision to sell the company would be detrimental to its value (note: not for the reason that such a decision would be blocked if put to a creditors' vote). The Court has indicated that it is willing to countenance such a sale, but the sale may be contest later as an abuse of the administrator's powers (Armour and Mokal 2005: 22)

2) The issue of a going-concern sale may be put to a creditors' meeting vote, where the same concerns as above would apply. Presuming the going-concern sale does not completely pay back the unsecured creditors (thus giving them the right to vote), they could still vote to block the sale, with the aim of procuring a better (priority-violating) deal.

3) If the administrator's proposals and its subsequent revisions are rejected, then the issue falls to the courts. In that case. s. 55 (2) of Schedule B1 states that the court may:

(a) provide that the appointment of an administrator shall cease to have effect from time to time;

(b) adjourn the hearing conditionally or unconditionally;

(c) make an interim order;

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[80] Section 74(1)(a) and (b).

(d) make an order on a petition for winding up suspended by virtue of paragraph 40(1)(b);

(e) make any other order (including an order making consequential provision) that the court thinks appropriate.

It would seem that in any case where the unsecured creditors fail to coerce the secured creditors and the administrator into getting a preferential deal, the issue will ultimately reach the courts, either as a challenge to the administrator's use of powers, as in 1), or as a court decision if the administrator's proposals are rejected by the creditors' meeting. It is therefore crucial that the court present a line of decisions that will dissuade unsecured creditors from taking unfair advantage of the voting power given them by the insolvency regime. In *Re T & D Industries*,[81] Neuberger J advised that administrators seeking to avoid challenge should seek the consent of as many creditors as possible. This would indicate that the court believes that the going-concern sale should be a reflection, as far as possible, of what creditors would desire (if given the time to decide). However, in this case, the court would have to clearly indicate that the unsecured creditors are not to use their rights in the creditors' meeting to the detriment of the secured creditors (perhaps by arguing that by effecting a going-concern sale, the administrator is fulfilling its duty of serving the interests of all creditors, whereas allowing it to come to vote would benefit only the unsecured creditors.)

2. Debt Restructuring. An administrator is allowed to propose a plan that affects the right of a secured creditor to enforce his security or disturb the priority of a preferential creditor only in three ways: a) he obtains the consent of the creditor, b) a

CVA or c) a scheme of arrangement.[82] Effectively, in an insolvency where there are many creditors with conflicting interests, there are only two ways to apply to the court for assistance in reaching a reorganization agreement: a CVA or a scheme.

CVAs. In a CVA, both a shareholders' and creditors' meeting have to held.[83] Approval at the meetings requires a 75% majority of the value of the members present or voting by proxy.[84] Once passed, the arrangement binds all parties, both those entitled to vote and those that would have been so entitled had he had had notice of it.[85] However, the meetings may not approve of any proposal that affects the right of a secured creditor to enforce his security, except with the concurrence of the creditor concerned.[86]

As Finch (2002: 352-253) points out, there are two main issues regarding the CVA: 1) whether the approval majority of the CVA is too high and 2) whether shareholders should given the right to participate in the CVA at all.

1) There are valid reasons for maintaining a high threshold for any resolution that will affect the return of those dissenting. As Finch (2002: 352) relates, the DTI argued that the 75% rule "was designed to encourage companies only to enter a moratorium if a successful rescue is likely and to provide an effective bar to unsound proposals being accepted". The Insolvency Service, after consultation, "was moved by

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81 [2000] 1 BCLC 471

82 Section 73(1) and (2) Schedule B1 Insolvency Act 1986.

83 Section 3(2) of Part 1 of the Insolvency Act 1986.

84 Rule 1.19 Insolvency Rules 1986.

85 Section 5(2)(b) Part 1 Insolvency Act 1986.

the argument that lowering the threshold would not necessarily have any significant effect on acceptance levels; and that concerns would be aroused by binding creditors against their will by a simple majority". However, given the fact that the voting provisions do not bind secured creditors (who must concur individually) and the high majority bar, it is doubtful whether the CVA voting provisions will be of much assistance in cases where agreement between creditors is caused by the presence of many creditors and conflicting interests (the paradigm case for bankruptcy law).

2) As argued above, there is no reason to exclude shareholders from a reorganization if the value of the firm leaves them a stake. What is worrying about the CVA provisions is that it has no minimum value requirement. Even more worrying is Section 4A (3) of Part 1 of the Insolvency Act 1986 which states:

> If the decision taken by the creditors' meeting differs from that taken by the company meeting, a member of the company may apply to the court.
>
> This has to read in conjunction with Section 4A (6), which states:
>
> On an application under subsection (3), the court may-
> (a) order the decision of the company meeting to have effect instead of the decision of the creditor meeting, or
> (b) make such other order as it thinks fit.

What is most distressing is that there are no statutory guidelines (and at the moment, minimal judicial precedents) regarding the application of these sections. Section 4A(6)(a) would appear to imply that there is a presumption that in the case of shareholder and creditor conflict, the shareholders' resolution is to prevail. Section 4A(6)(b), if read literally, would appear to give the court the authority to allow the

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86 Section 4(3) Part 1 Insolvency Act 1986.

creditors' resolution to prevail. (How far does that authority extend? May the court amend the resolutions? Can the court affect the rights of secured creditors? Surely not.) What is required here is some variant of the "fair and equitable" rules of Chapter 11 that guides the court's decisions on whether and how to prefer one meeting's resolutions over another. For example, if the value of company extends to the shareholders and the creditors are adequately protected, the court may prefer the resolution of the company meeting. As such, section 4A leaves too much room for confusion[87].

Schemes of Arrangements. Section 425 of the Companies Act 1985 allows for a company to come to an arrangement with its creditors. Resolutions may be passed by a majority in number representing three-fourths in value of the creditors or class of creditors.[88] The major difference between a CVA and a scheme is that "the supervision of a voluntary arrangement is left mainly to the nominee of the scheme rather than the court, as under a section 425 scheme."[89] Schemes of arrangement have many requirements, many of which are only vaguely defined, which may be challenged in court. As such, schemes under section 425 have not proven popular. As Finch (2002: 326) states: "A major constraint on use has been that such schemes have been so rigorously protective of minority interests that, in practice, schemes have not

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87 There are some precedents from winding-up cases. In *In Re Tea Corporation* [1904] 1 Ch. 12, the court disregarded dissent from shareholders when it regarded the shareholders as having "no interest whatever in the assets" and in *In Re St. Thomas' Dock Company* (1875-76) LR 2 Ch. D. 116, the court chose to dismiss a petition for winding up from unsecured creditors when it believed the assets from a winding up to be insufficient to cover the secured debt. Aside from the burden upon the court to value the company (which the court might not be best placed to do), these judgments appear to be conceptually sound.

88 Section 425 (2) Companies Act 1985.

89 Palmer's Company Law. 12.003, April 2002.

been approved unless they have happened to satisfy the interests of all parties affected by them."

One major difference between s. 425 schemes is that creditors are to be divided into classes. The commonly used definition of a class was given by Bowen L.J. in *Sovereign Life Assurance Co. v. Dodd*[90]: "those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest". Although it could argued that any party voting against the scheme could be considered evidence of a dissimilarity of common interest, this view has been corrected in several decisions. In *Re BTR Plc.*, Jonathan Parker J. argued that the rights which arise from class should be considered distinct from the personal interests of the members of the class.[91] Chadwick L.J. warned in *Re Hawk Insurance Ltd.*[92], that "the courts should be wary of giving the minority a veto by the overzealous application of court distinctions. The minority are still protected by the need to obtain the court's sanction even if the meetings have approved the scheme."[93] One advantage that a scheme may have over a CVA for debtors is that, in a scheme, it may be possible for secured creditors to come to an arrangement without individual consents. That is, if a majority comprising 75% of value of a class of secured creditors consent to a scheme, that may be sufficient to confirm the scheme even if it impedes on the right of the secured creditors to enforce their security. However, while "those who have a common security, e.g. holders of debentures ranking pari passu, will comprise

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90 [1892] 2 Q.B. 573

91 [1999] 2 B.C.L.C. 675, at p. 682

92 [2001] 2 B.C.L.C. 480 at 519

93 Palmer's Company Law, 12.017.4, July 2002.

a class", creditors who have "similar though not common security" will probably not comprise a class.[94]

There are many obstacles to approving a scheme in practice:

1) Constitution of Classes. If classes have been not classified correctly, the court may not subsequently sanction the scheme. However, the court will not rule on the classification of classes until the final hearing for the court's sanction of the scheme. This leaves considerable uncertainty. This practice has been strongly criticized in *Re Hawk Insurance Ltd.*[95], where Chadwick L.J. pointed out that such late decisions over this matter means that where the applicant made a wrong decision at the outset there will have been a considerable waste of time and expense.

2) Fair Representation. Each class must also be fairly represented. In addition to the rule that approval requires a majority of three-fourths in value of the class, if that majority are in a position to gain from the scheme by reason of some other capacity, then the court may reject the scheme, particularly if the minority object.[96] Note that requirement that approval requires both a majority in numbers as well as 75% of value already makes schemes more difficult to approve than CVAs. (For the simple reason that it amounts to two requirements, which may not overlap, instead of one. See Braham and Steffen 2001.)

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94 Palmer's Company Law, 12.018.2, February 2002.

95 [2001] 2 B.C.L.C. 480

96 *Alabama, New Orleans, Texas and Pacific Junction Railway Co. Re* [1891] 1 Ch. 213, 244

3) Reasonable Approval of a Man of Business. The court may not sanction a scheme if it concludes that there is "such an objection to it as that any reasonable man might say he could not approve it".[97] However, as Lloyd J. in *Re Equitable Life Assurance Society* said:

> Unless it be said that these favourable votes were obtained under some misapprehension or as a result of inadequate information, it would be a remarkable proposition that a Scheme favoured by more than 220,000 of the Society's policy-holders was one which no intelligent and honest man in their position could reasonably approve.[98]

A scheme, then, can only be passed if the court sanctions it at two levels, both at classification of classes and the fair and equitable nature of the scheme itself. A scheme requires: 1) an extensive statement sent to all creditors and members, 2) an approval vote from a majority in number representing 75% in value and 3) sanction from the court regarding classification and the fair and equitable nature of the scheme. It can be seen why schemes are regarded as an expensive, difficult and complicated processes.

Conclusion. Both CVAs and Schemes under s. 425 have problems that render them unlikely to be helpful in resolving conflicts between creditors. CVAs do not affect the rights of secured creditors, require a 75% majority and furthermore, appear to allow shareholders a say in the proceedings whether the value of the company extends to them or not. Schemes, on the other hand, would appear to allow voting within the secured creditor class, but, on the other hand, require an even more stringent majority (75% in value which must also be 50% in number), are procedurally

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97 Lindley L.J. in *Re Alabama, New Orleans, Texas and Pacific Junction Ry.* [1891] 1 Ch. 213, 239.

cumbersome, and are open to extensive intervention by the courts (towards the rejection of the scheme, not for the facilitation of the scheme). As Finch (2002: 355) notes, from the perspective that creditors are likely to be in conflict, "it may be argued that the CVA is unlikely ever to offer the most popular or effective route to rescue because in most areas of corporate trouble the creditors tend to have divergent interests and powers that rescue operations are most likely to be arrived at by degrees of imposition rather than negotiation". Therefore, whether for a CVA or a Scheme, improvements would have to "institute changes that will reduce divergences of interest (or perceived divergences of interest) between different creditor groupings". (Finch 2002: 355)

The Privatization of Bankruptcy

There is a long line of argumentation, particularly in the American bankruptcy literature, encouraging the use of private solutions to bankruptcy. The failings of Chapter 11 are well documented and therefore it is to be expected that participants should have strong incentives to avoid these problems through private negotiations. For example, Jensen (1988) argued that one benefit of concentrated debt (e.g. an LBO) would be to effectively privatize the bankruptcy process as having large, few creditors allows the process of debt restructuring without having to go through the Chapter 11 structured bargaining process. A pair of papers by Baird and Rasmussen take these arguments even further: they allege that 1) the traditional goal of bankruptcy- to preserve the going concern value of the firm- is no longer important, as the value of a unitary corporate form in a world of lowered transactions costs is now

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[98] [2002] B.C.C. 319, 344

minimal[99] and, therefore, 2) large corporations and their creditors deal with financial distress either by privately negotiating a solution (such as a prepackaged bankruptcy) or arranging a sale; companies that enter bankruptcy without a solution already in place are usually also without going-concern value. (Baird and Rasmussen 2003a and 2003b.) LoPucki (2003a) has argued against the conclusions of Baird and Rasmussen, pointing out that 1) the value of the corporate form also rests on the relationships between the people in the organization, which is not easy to reestablish when the firm is split up and 2) the Baird and Rasmussen hypothesis would imply that there is some contractual means to efficiently allocate rights in a bankruptcy outside the formal process, however, this mechanism has not been specified.

Ignoring for the moment the empirical debate between LoPucki and Baird and Rasmussen (whether the number of large bankruptcy reorganizations have increased or not), we will examine here the contention that the trend for large bankruptcies (in the US) to end up either a prepackaged bankruptcy or an asset sale (also noted in Skeel 2001) is desirable and an indication that the market is correcting towards efficiency through contracting. This is similar to the argument that UK insolvency need not be improved, as most large insolvencies in the UK are dealt with adequately by the "London Approach".[100] It is possible to note at least two alternate hypotheses:

1) Prediction. Prepackaged bankruptcies could be increasing because parties are becoming more sophisticated and now able to predict, for better or worse, how they would fare in the courts. Rationally, if any party in a prepackaged bankruptcy

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99 This follows from Coase's classic argument that the reason for the existence of the corporation (as opposed to separate contracts between individuals) is that transactions costs (e.g. negotiating costs) between individuals is high and can be lowered by uniting these individual in a corporate enterprise.

thinks it can do better in a Chapter 11 process than from the prepackaging, then they would have an incentive to push the bankrupt firm into Chapter 11. If the results are largely determinate, then there is no reason why the parties will not simply apportion the reorganization in the same proportion they predict they will receive under Chapter 11. This, however, does not indicate any approval or disapproval of the Chapter 11 process. It simply preempts it.

2) Cost Avoidance. In fact, Chapter 11 need not be entirely predictable. If all parties believe they will end up worse in Chapter 11 (through costs, both direct, e.g. legal fees and indirect, e.g. reputation loss, inadequate financing, delays), they might come to an agreement simply to avoid Chapter 11. Once again, the fact that the case did not reach Chapter 11 does not mean that the agreement reached is efficient, one would expect the party that bears the most loss from the Chapter 11 process to concede the most in order to achieve a deal that avoids Chapter 11 as much as possible.

It is possible even to say that all bankruptcy contracting takes place in the shadow of Chapter 11. In the same way, the "London Approach" takes place in the shadow of UK insolvency law. These private negotiations are presumably more efficient than the formal process itself, but this need not be because they are intrinsically efficient; these "privatized" bankruptcies could simply be avoiding the costs of formal bankruptcy. If the underlying law, ultimately the last resort in an insolvency, is improved, then the private negotiations themselves would improve.

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100 For details on the "London Approach", see Armour and Deakin (2001).

Conclusion

While the desirability of "rescue" is debatable, the amendments introduced by the Enterprise Act 2002 to the UK insolvency regime in unlikely to lead to any real rescue. If we consider that a court-assisted rescue is most required in cases where there are conflicts of interests between creditors (and even maybe shareholders), we can see that the present regime poses many impediments in efficiently resolving those cases:

1) The administrator has no statutory duty to look after shareholder interests (even if shareholders still carry residual value in the company) and the statutory duty to "rescue" the company only applies to very restricted situations.

2) The two debt restructuring regimes offered (CVAs and s. 425 schemes) require high creditor approval. The CVA does not affect secured creditor rights and the s.425 scheme is very strongly protective of minority interests. These are unlikely to be successful in cases with high inter-creditor conflict.

3) We cannot simply rely on out-of-court mechanisms, such as the "London Approach" because ultimately such mechanisms will reflect the law. If any party can get a better return by using the judicial mechanism, they will. The fact it is not possible to contract out of insolvency regimes means that all negotiations take place in the shadow of insolvency law.

In sum, the new administration regime cannot really be called a "rescue" regime at all, but rather an unsecured creditor biased regime. Given that the Enterprise Act 2002 also introduced the ring-fenced fund for the benefit of the unsecured creditor (as discussed in chapter 2), it can perhaps cynically be argued that the statements on "rescue" are, in fact, nothing more than cant obscuring the real purpose of the Act, which is obviously to strengthen unsecured creditor claims against secured creditor claims.

Chapter 5:
Conclusion

My central theme in this thesis through this thesis is that markets are constantly adjusting. The absence or weakness of an institution does not mean that the market breaks down; it compensates. If equity protection is weak, investors will rely on debt; if the bankruptcy courts are inefficient, debt restructurings will take place privately. This means that the identification of any alleged weakness in a country's economic system has to be undertaken with a high degree of subtlety: you cannot stop at pointing out the deficient institution, you have to follow through to the limits of what the market can do to compensate for that deficiency. For example, critics of the American capitalism in the 1980s (when Japan was ascendant) would claim that the American background of arm's length shareholding and lending impaired its ability to fund innovation. This problem was admirably solved in the 90s by the proliferation of venture capitalism (which requires an active stock market). A notable fact is that, if we compare developed countries over a 20 year period, it is difficult to identify a system with a distinct advantage (as measured by growth rate of GDP per capita). (Turner 2001)

I have examined three cases in particular: ownership concentration, secured credit and insolvency.

Concentrated Ownership

In a recent paper, Mark Roe (2005: 246) presents two conclusions, the first strong, the second weak: a) "studies that examine corporate law worldwide tend to

overpredict the importance of corporate law in the world's richest nations" and b) "development agencies may do everything right in getting the corporate law institutions of these nations ready for ownership separation, and it is at least possible that no one comes to the party". I agree with both of these conclusions. Roe's (2005: 247) argument is that "The quality of conventional corporate law does not fully explain why and when ownership concentration persists in the wealthy West, because core *corporate law does not even try to directly prevent managerial agency costs from dissipating a firm's value*" (italics in original).

This might be overstating the matter. Part of the problem, in my opinion, is that Roe is simply using the wrong measure: he should be looking at private benefits of control, rather than separation of ownership and control. There are many forces at play in the separation of ownership and control that have nothing to do with private benefits: for example, the growth and size of corporation, the market for managers, and patterns of shareholding in a society. Private benefits are a much more direct measure of the impact of corporate law and in this, as Gilson and Gordon (2003) put it, corporate law imposes an "upper bound" of how much majority shareholders can take. Even in "wealthy" countries, Holderness and Sheehan (2000: 162) find a wide differential in how much American and New Zealander minority shareholders get paid in reorganizations which can be explained primarily by corporate law. Dyck and Zingales (2002) find that LLSV's "anti-director" rights explain 17 percent of the variation in private benefits of control across countries.

Nevertheless, it is clear that extra-legal institutions are at least as important as corporate law in both separating ownership and control and lowering private benefits

of control. Roe (2005: 243) presents evidence that greater labor protection (which could indicate that a) "the polity would tend to promote non-profit-maximizing expansion" or b) "nations in which labor or the left held significant power could be unwilling to build the institutions that facilitate distant shareholding") is a better predictor of low ownership separation than either the LLSV index or *even private benefits of control.* As for the control premium, Dyck and Zingales (2003), find that, controlling for two extra measures, diffusion of press readership (a proxy for the "shaming" effect on executives) and tax enforcement (tough tax authorities keep corporate reporting honest): "Any distinction between English-based legal systems and others disappear. If anything, common law countries have *higher* (not lower) private benefits of control once these extra legal institutions are taken into consideration, but this effect is not statistically significant." (italics in original)

Secured Credit

As chapter 2 argued, some kind of priority arrangement is necessary for firms that borrow sequentially from more than one creditor. Without priority, the forced mixing of the risks of the two loans could lead to an inefficient outcome for one of the creditors, which would, in turn, lead to reduced access to funding for the debtor. One could say that if priority in lending did not exist, it would have to be invented (or just privately contracted).

Even arguably the most egregious of secured credit arrangements, the floating charge, has a role to play. As argued above, the floating charge has a role in English distressed debt reorganizations akin to the American DIP (Debtor-In-Possession)

lending arrangements. As Skeel (2004) among others has argued, DIP has emerged in the last decade as a vital tool in post-petition Chapter 11 financing. DIP financing has at least two virtues: 1) it keeps the debtor in business, thereby avoiding business disruption costs, 2) close monitoring from the DIP creditor prevents the bankrupt firm from undertaking suboptimal risky projects. (Skeel 2004: 1923-124) One major difference between floating charges and DIP financing, however, is that DIP financing requires court-approval. This is vitally important as floating charges can also simply be used to transfer value away from unsecured creditors. On balance, given the possibility for misuse, the English floating charge system should be modified to be closer to DIP financing, perhaps with court approval or subsequent censure or even requiring some level of unsecured creditor consent.

As for the 10% ring-fencing, or carve-out, from the floating charge now available for unsecured creditors under the Enterprise Act 2002, it fulfills few of the arguments in its favor. 1) Carve-outs do not encourage further bank monitoring. Even if security makes banks "lazy" (the empirical evidence is unclear), all a carve-out accomplishes is it reduces the amount a debtor can borrow on a secured basis. The bank continues to be "lazy", it simply lends less money. 2) Carve-outs do not discourage torts. Tort claimants are the most deserving nonadjusting creditors. However, a carve-out is unlikely to inspire secured creditors to increase monitoring against the debtor committing torts: a) for a tort claim to substantially change the payoff to secured creditors, the debtor must have minimal unsecured debt, that is, it is the risk of tort that threatens to create the possibility of a carve-out at all and b) as in 1), secured creditors simply are generally not very close monitors. 3) Carve-outs are irrelevant to value-diversion in insolvency. The argument has been made that debtors

and secured creditors can collude to divert value away from unsecured creditors. However, preference and fraudulent conveyance provisions are the proper safeguards against this kind of behavior. Secured creditors do not have any more incentive, or facility, for that matter, for defrauding unsecured creditors.

Insolvency Law

Even though the stated purpose of the administration regime under the Enterprise Act 2002 is to promote "rescue", the law does little to empower shareholders or managers. Instead, more power is placed in the hands of unsecured creditors, which, insofar as unsecured creditors are closer to being *residual* claimants, is commendable. However, this state of affairs neglects the advantage of regimes that promote company continuation (i.e. Chapter 11), which is to allow managers and shareholders some return in the event of insolvency that they may not deserve by letter of their contracts, in return for their cooperation in steering the company through insolvency and the period preceding insolvency.

Instead, the new administration regime strengthens unsecured creditor claims, much like another section of the Act, which provides for a 10% ring-fenced fund for unsecured creditors. Unlike the ring-fenced fund, however, this might not be a bad thing, if we believe that aligning the interests of the administrator closer to the residual claimant is desirable. As argued in chapter 4, though, the issue of the "residual claimant" in insolvency is not quite so simple. Unsecured creditors and secured creditors could still have widely varying objectives in insolvency (unsecured creditors have an incentive to pursue high-risk projects and secured creditors have an

incentive to pursue low-risk projects). Ultimately, the administrator, assisted (or, rather, constrained) by the court, will still have to delicately balance the interests of each party.

Implications and Areas of Further Research

One of the fundamental questions of regulation is: which should we mistrust more, markets or governments? In which situations are markets or governments more likely to fail? Mainstream economists have more faith in the market. The underlying reason for this is simple: market participants have better information and more direct incentives to succeed; governmental officials, on the other hand, have indirect information and are faced with many potentially distortional evaluations before they are rewarded through the political process. Greed and ingenuity are often strong enough forces to solve most problems; the times when they are likely to fail are when it pays more to create problems than to solve them.

The many discussions and cost/benefit analyses of market vs. bank-based systems and equity vs. debt-based economies face one basic question: why is the means of financing relevant? This is not so much an application of Modigliani-Miller capital structure irrelevance, but an extension of Merton's observation: financial instruments can be replicated by other financial instruments (thus rendering regulation ineffectual). (Merton 1995) One of the key differences between debt and equity comes down to control rights. However, it is possible to construct debt arrangements that work very much like equity. The equity-like qualities of control and upside sharing can be replicated in a debt arrangement: a company with long-term ties with a main

bank could have an arrangement where loans have strong covenants, are relatively short-term (one to three years) and interest adjusted to match the operating performance of the company. It is also possible for equity structures to look similar to debt, e.g. non-voting shares with a dividend promise, possibly with a shareholders' agreement. We must keep in mind that arguments against poor corporate governance are actually warnings against the dangers of inefficient investment: either underinvestment due to undervaluation or inefficient investment due to rent-seeking.

Transactions Costs

I propose here that it is not very useful to characterize systems as debt or equity-centric. We should instead on concentrate on the important factor here: transaction costs. What separates so-called bank/market economies or debt/equity economies is the avenues the corporations in these economies have to obtain financing. This is reliant on the means investors have to recoup their investments. We can separate the types of control into three layers: 1) extra-legal control, 2) private contractual control and 3) public securities control.

It has been noted that in jurisdictions where the rule of law is weak, financing relations have to be based on extra-legal control. This includes short-term loans (so that the debtor is continuously reliant on the creditor and does not dare default), personal connections and just plain threat of force. There doesn't seem to be any reason why one form of financing would be preferred over another in this type of system; as all forms of financing require some kind of personal contact, however, financing would be relatively difficult and transaction costs would be very high.

The second type of system is where public securities markets are weak (perhaps not even because the regulators are weak, but simply because the market is too small and illiquid), but rule of law in general is functional. What this implies is that we have a situation where contracts work, but enforcement is not "automated", as it were. Financing is therefore predominantly internal, or through a reliable intermediary, in most cases banks. It would appear we are left in a situation where only big banks are able to provide financing as they have the means to engage in extensive negotiation and monitoring, however, we should also ask: why can't equity arrangements be similarly negotiated? If the impediments to an equity culture are primarily information and control, it should still be possible to use shareholders' contracts to establish both information and control. Arguably, this is what venture capitalists do in risky equity transactions in the United States. Perhaps the way to view the situation is not that privately contracting economies are bank-centric, but that the means of financing comes through two ways: banks and conglomerates. Another feature of non-US and European economies is that there is no diversification discount (in some cases there is a premium) and the economy tends to be dominated by a handful of large conglomerates. One way to view these conglomerates is that they function as financiers (especially if we consider these groups unlikely to have special expertise in operating diverse businesses). In other words, because individual investors have a hard time guaranteeing their returns, most financing would be through intermediaries, whether banks or indirect shareholding through a conglomerate. Investment through intermediaries should not be problem provided there is sufficient competition among the intermediaries to create efficiency.

Unfortunately, in small or young economies and due to economies of scale, intermediaries in these economies tend to be few.

The third type of system is where arms-length investment by individual investors is now possible. This would imply that securities regulators are sufficiently reliable to support confidence in these investments. From a political economy perspective, the pressure to institute regulators to enable public investment should come when individual savings are high enough so that investors demand different ways to invest.

Viewed from this perspective, the problem isn't one of legal protection of debt or equity, but one of transaction costs and standardization. (In other words, there is private equity and private debt and public equity and public debt.) As long as an enforcement mechanism can be found, any suitable control structure can be replicated. However, transaction costs to contract and enforce that structure can be very high. Given the benefits of having standardized institutions that lower transaction costs, though, why don't businesses create them, even without government intervention?

Impediments to Arms-Length Capital Markets

There are three reasons why companies may not be able to develop their own finance-enabling institutions: 1) asymmetric information, or credibility, problems, 2) collective action problems and 3) rent-seeking or monopoly problems. The first two are related problems, as they are both commitment problems- companies can

strengthen their credibility by committing to an standard, but this requires collective action.

1) Asymmetric information (adverse selection). External financing, whether debt (bonds) or equity, requires that the investor be able to trust the company. This applies to all steps of the investment process: the revelation of information, continued honest operation of the company, and the payment of returns (whether in the form of interest, dividends or future divestment of securities). However, if the investors have no means to verify the trustworthiness of the companies, the investors will rationally discount all companies to take account of the risk that the company may prove dishonest. Companies have to find a mechanism to commit- such as verification by a third party.

2) Collective action. One way of lowering transaction costs is by establishing standardized contracts. Having shares traded on a reputable exchange is a way of engaging in a standard contract with external investors; the investor is vouchsafed certain standards in information revelation and good conduct.

3) Rent-seeking. The most pernicious problem, however, is when certain groups in a community use its control over financing to influence industries, such as to maintain monopolies or oligopolies. At the turn of the 20th century, both JP Morgan and JD Rockefeller were rightly accused of

using their control over a significant portion of American finances to perpetuate monopolies (Chernow 1998: 390). In general, capital markets do not care which products they finance, they care only about the return, however, in cases where capital providers have a vested interest in the product market, such as cases where creditors have a quasi-equity interest in the monopolist, then the control over capital can be used to control competition (Mokyr 2002: 256).

Who Should We Trust?

As has been argued throughout this thesis, any given state of corporate governance favors one controlling group over others: if shareholders are dispersed, this gives managers de facto control over firms, if there is a controlling shareholder, the controlling shareholder can extract a control premium, in companies with a main bank, the bank can extract rents from the firm. This leads to a general question of whether regulators should choose to favor any particular group. Or, to put it another way, which group should regulators favor? The question would then become: which group, if given control, would be most given to efficiency? From an economic perspective, we should ask which group would have the best incentives to put its efforts into improving the performance of the firm and not into rent-seeking. This question is hard to answer generally. Any answer would have to rely on the divergence between ownership and control. This is because rent-seeking ultimately has to have a victim. The rents have to come from someone. Viewed from this angle, the divergence is strongest for managers of firms, as they may not be owners at all (although arguably managers have the least scope for tunneling). Another way to

approach this problem is to ask which group is easier to monitor given limited investor and government resources? This would rely a great deal on local circumstance and the state of current regulations in that jurisdiction.

It is important to emphasize that the shifting of power to managers, a controlling shareholder or banks happens "naturally", as it were. Corporate governance arrangements tend to settle into one of these forms. The problem with choosing a regulatory structure is that it limits the forms corporate governance arrangements can take. As in the discussion above, banks can be regulated such that they cannot take a strong governance stake in companies. Similarly, by lowering the control premium, it makes it less likely that a controlling shareholder will appear in firms (or as argued in chapter 2, the firm will have only one shareholder). The result of limiting corporate governance arrangements is that the result may be inefficient. We are faced with a tradeoff between abuse and flexibility.

You could say it is a choice between regulating and legislating: should firms be allowed to choose their own governance arrangements (and therefore run the risk that a group may end up controlling the firm beyond its ownership stake) or should firms be constrained in their governance arrangements (and therefore face situations where the governance structure is inefficient)? We might also note that transaction costs appear to be lower in situations where the capital market is actively regulated, rather than protected through legislation. Perhaps it is more efficient pooling costs into a single regulatory body than to rely on post-facto collective legal action (no matter how facilitated).

It is possible to mention here a rather odd phenomenon. In economies where external equity is weak, strict regulations of banks could create a financing gap. If banks are not allowed to take quasi-equity stakes in companies (e.g. shareholding and board representation limits, interest rate regulation that disallows intertemporal smoothing), the only other source of financing will be internal. The standard paradigm of banking regulation, which focuses on bank illiquidity, moral hazard and consumer protection (see Goodhart et al 1998), could therefore be inappropriate for economies that rely on bank-financing as its sole source of external financing.

Corporate Governance in the Long-Run

Rent-seeking in corporate governance arrangements assume there is a victim. The rents must be paid by a party that should be receiving more. In repeated transactions, therefore, the rent-paying parties should become reluctant to finance. This, particularly coupled with asymmetric information, means that countries with poor corporate governance are faced with expensive funding, whether because of risk-discounting or increased transaction costs. One possible phenomenon is that, in newly liberalized economies or new securities markets, investors have not obtained enough information to discount the corporate governance risk correctly. Firms would have an incentive to keep corporate governance regimes weak in order to facilitate expropriation. However, note that the expropriation should only happen once (or at least just the first few times) before investors learn.

This should mean that corporate governance standards should improve when companies in that country require more external capital. In a way, we could expect

significant expropriation when a country first liberalizes financially or has its first IPO wave; from that point on, the firms themselves, especially faced with expanding markets, should have an incentive to improve their corporate governance in order to obtain financing. Poor corporate governance, therefore, should not be a persistent problem, except in the case where financiers have an incentive to limit the level of public financing in an economy. This has the potential to be a persistent source of corporate governance weakening, as would be the case if financing limitation is used as an aid to monopoly as discussed earlier. This danger has to strongly regulated against.

We can therefore speculate that, excepting the forces that want to limit financing, corporate governance should tend to improve due to two forces. On the supply side, as companies require growth financing and can no longer expropriate investors, companies should look to create a credible system for investor confidence. On the demand side, as countries become wealthier and citizens look for methods of savings, two things should happen: the market for intermediaries should deepen (as was the case in New England banks- Lamoreaux 1996) and savers should look for more direct forms of investment, i.e. creating an environment for an active equity and bond market.

The Role of History

Sweeping comments on corporate financing structures (and implications thereof) suffer from a fundamental problem: these structures often change and the causes of these changes are various. Take the "law matters" LLSV hypothesis. The

import of legal systems is largely a legacy of colonialism, which is a contested topic in its own right, with an extensive literature. Causation then becomes troublingly tangled: a) colonies were selected by imperialist states (with naval powers, like England, presumably getting the cream of the crop) and b) different colonial masters, sometimes with widely differing agendas, implement different infrastructural changes. More recent historical events also have a huge impact. The two world wars obviously have effects felt to the present day.

Take for example Japan and France. Japan had a vibrant capital market before the Second World War. However, post-WWII, in a condition of scarce capital, the Japanese government decided that: "[r]elying on stock and equity seemed risky, [...] since the government might have different priorities from individual investors; it would be better to use the banks to push capital around the economy, since this could be *controlled*." (Tett 2004: 9, italics in original) As for France, the French government spent the decades after the wars systematically nationalizing large portions of the French economy. As late as 1982, the Mitterand government pushed through programs of nationalization that "[a]t its conclusion, the state owned 100% of 13 of the 20 largest French industrial firms and held a controlling block in many others. It was also in control of the country's largest financial enterprises as well as a large number of smaller French banks." (O'Sullivan 2005: 357) Given that such structures are likely to be path-dependant, it is difficult to argue for purely economic causes for current corporate structures. (Bebchuk and Roe 1999)

Even Rajan and Zingales's (2003: 226-246) argument that progress from relationship capitalism to arm's length capitalism has been impeded by vested

interests who use their established power to prevent new entrants is open to historical challenge. Banks in New England did not change from relationship lending to arm's length lending as a response to external forces breaking up old, cozy relationships, but rather because the amount of capital available in the system became too much for a relationship system to handle. (Lamoreaux 1996: 89-118)

We should not forget that, at the end of the day, "[w]hether we look at the comic attempts of economists to explain randomness or the tragic vulnerability of the poor, luck is a constant influence on the quest for growth". (Easterly 2001: 214)

The Pretence of Knowledge

Can we engineer a financial system? Should national policy makers attempt to nudge their financial systems in certain directions- for example, should developing countries specifically try to deepen their equity markets and develop bond markets or should the US or UK encourage institutional investor activism? These are important questions, unfortunately, the answers we currently have are not very satisfactory. Given path-dependence in financing, creating an equity-culture might require the weakening of bank ties (as has been argued is the case in Germany and Japan). Should developing countries really take steps as extreme as this? In the US and UK, institutional investors are being seen as guardians against greedy managers, but what of the institutional managers themselves? Are their incentives (timing returns for fund-termination) really the most efficient for the economy? The danger in attempting to guide an entire financial system is that the tools we have are crude and our understanding tenuous at best. As Hayek said in his Nobel lecture, regarding

economic theory: "... the effects on policy of the more ambitious constructions have not been very fortunate and I confess that I prefer true but imperfect knowledge, even if it leaves much undetermined and unpredictable, to a pretence of exact knowledge that is likely to be false... To act on the belief that we possess the knowledge and the power which enable us to shape the processes of society entirely to our liking, knowledge which in fact we do not possess, is likely to make us do much harm."

The history of financial regulations and corporate governance standards is the history of reactions to crises and scandals. The problem of legislating in the wake of manias, panics and crashes is that the reaction to irrational exuberance is often irrational paranoia. The Sarbanes-Oxley Act in the US is misguided in many of its basic principles (Romano 2005) and is proving to be costly to the point of driving many companies private (Carney 2006). Placing too much emphasis on the negative consequences of corporate governance could distract from the role of corporate governance- to ensure the proper utilization of corporate assets. Perhaps the regulation of corporate governance should be approached similarly to monetary policy: expansiveness and stringency should vary according to how much the system is at risk.

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