Labor omnia vicit improbus

Virgil, *Georgics* (Book I, 145-146)

London School of Economics and Political Science

Capital Structure and Corporate Governance: The Role of Hybrid Financial Instruments

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Abstract

This thesis consists of a study of English and US corporate finance law and, in particular, the law in relation to hybrid financial instruments. I consider hybrids any financial instrument that presents a mix of equity and debt characteristics. Therefore this thesis excludes from examination all the derivative instruments, while it focuses on two main types of hybrid security, in relation to their relevance to the situation studied: preference shares and convertible bonds.

Despite a clear distinction in law between equity and debt, the development of sophisticated hybrid financial instruments has forced regulators to look beyond the legal form of an instrument to its practical substance. As observable in practice, the increase in financial innovation reflects the necessity of the parties to allocate control and cash-flow rights in a way that diverges from the classic allocation resulting from equity and debt. Most of the empirical and theoretical research in this area has focused on the tax advantages of issuing hybrids as a way of reducing the cost of capital or on their capacity to be subordinated to all the creditors and to be unable to trigger the liquidation of the firm in case of default on its payouts. However, very little contribution has been made to the analysis of these securities with regard to their implications for corporate governance.

This thesis aims to discuss the rationale for issuing hybrids, and to evaluate the law relative to these instruments against the background of both agency costs and property rights theories. The functional approach unveils an important rationale for issuing hybrids. The UK and US have legal systems characterised by transactional flexibility. They rely heavily on *ex post* standards strategies to protect preference shareholders and on the judiciary to evaluate the fairness of a transaction. This flexibility places the UK and US legal systems among the most business-friendly countries. The vacuum left by mandatory company law in favour of a major flexibility in the market has pushed the parties to fill it contracting for their rights. In so doing they have facilitated the business relations and better protected themselves with careful drafting.

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INTRODUCTION

This thesis consists of a study of English and US corporate finance law and, in particular, the law in relation to hybrid financial instruments. Generally, all research or work on corporate finance law begins by underlining a basic distinction regarding how capital is raised. This concerns the two different channels of investment in a company: "equity" and "debt". Equity represents the totality of the claims characterised by governance entitlements, while debt is regarded as the part of the capital structure that benefits from financial entitlements. Given that equity is the last of bankruptcy priorities, it is often defined as risky capital compared to debt, which is distinguished by its contractually specified financial claims. In particular, I refer to ordinary shares as the equity stock held by the members of the company because this is the classic class of shares clearly distinguished from debentures both in law and fact. The rights of an ordinary share are considered to be essentially residual, and a shareholder only expects to benefit from the surplus, both for any given period and as accumulated over a period, i.e. retained earning. For this reason, ordinary shareholders are also called the "residual claimants" in the corporation and usually hold all or most of the voting power, the right to contribute to the organisation of the company's business and the right to control its affairs, appointing and removing its directors, through attendance at meetings or voting. Conversely, the full rights of a debt-holder contrast well with the expectations of a shareholder. I refer to "bond" as a debt security held by a creditor of a company. This contract is the legal relationship between a company and its bondholder, based on a pecuniary cause, where the investor loans a certain amount of money to the company and the latter engages itself in repaying this amount by a certain date or on a fixed date with corresponding periodical interest. The bondholder is in law not a member of the company with rights in it, but a creditor with rights against it. This can result, if the company defaults, in the bondholder petitioning the Court on behalf of its rights and asking for the repayment of its credit.[1]

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[1] See Davies P.L., *Gower and Davies' Principles of Modern Company Law* (Sweet and Maxwell, 8th ed. 2008) 1148-1150; Kershaw D., *Company Law in Context: Text and Materials* (OUP, 2009) 649; Ferran E., *Principles of corporate finance law* (Oxford University Press, 2008) 49-54 and 313; Pennington R., *Pennington's Company Law* (London, Butterworth, 2001) 234-235.

Despite a clear distinction in law between equity and debt, this has become increasingly blurred over the years, and sorting reality into clear-cut categories has become extremely difficult. Some of the financial instruments issued by companies, so-called "hybrid" instruments, fall into a grey area between debt and equity, forcing regulators to look beyond the legal form of an instrument to its practical substance. In the context of this thesis, I adopt a broad definition of the financial category "hybrid financial instruments". In particular, I consider hybrid (or of hybrid nature) any financial instrument that presents a mix of equity and debt characteristics.

Therefore, this thesis excludes from examination all the derivative instruments that are debt whose value is derived from the performance of assets, interest rates, currency exchange rates or other external indexes, but not from the issuer's own shares. Instead, there are two main types of hybrid security that will recur in my analysis, in relation to their relevance to the situation studied: preference shares and convertible bonds. Although a third type of hybrid is included in this definition, the thesis does not devote as much attention to it as the others due limitations of space. This is the debenture-holding covenant or veto rights. While it is common practice to consider preference shares and convertible bonds as hybrid, it is less intuitive to include bonds with covenants or veto rights in this group, especially considering that in the British experience these covenants or appraisal rights are not commonly used, and the few that are have become standard clauses in commercial contracts. However, these securities, which are financial obligations – being generally deeply subordinated debt – retain a power of control, typical of controlling shareholders, that limits the directors' discretion in the management of the company through the use of positive and negative covenants.

The thesis compares the UK law dealing with hybrid instruments with the corresponding law of the US in particular the laws of New York and Delaware, which are the most relevant jurisdictions in relation to company law. The comparative analysis with the US experience on this matter is extremely important to fully understand the origins and the growth of these securities over the years since they have a similar history of development. Comparing the US and UK approaches shows how different legal standards are often used in these two legal systems to reach the same results. Furthermore, although the legal jurisdiction of relevance is the UK and the issues are discussed in a UK context, many of the general principles

discussed in the thesis apply to all common law jurisdictions. Therefore in relation to hybrid instruments, the US market is too important to be disregarded.

The aim of the thesis is twofold. First, it intends to unveil the costs and benefits of issuing hybrids and the function of hybrid instruments such as preference shares or convertible bonds in the modern company. For this reason, the thesis combines the analysis of corporate theories with a legal assessment of these instruments. Most of the research conducted on hybrid instruments has taken its first steps from the Modigliani and Miller (M&M) theorem, focusing on the profile of optimal leverage, namely the optimal ratio of debt to equity capital. Economic theory shows very little justification for a strict equity/debt distinction and it became quite clear to me that the law – by applying this distinction – creates a strong incentive for regulatory capital *arbitrage.* Finance theory explains this phenomenon mainly by pointing towards the differing tax and regulatory treatment of debt and equity as well as information asymmetries between the creditors, shareholders and managers. The differences in tax, accounting and regulatory treatment give rise to distortions and this can be costly for the society. Rather than focussing on the "real advantages" a certain capital structure offers, companies mainly try to optimise their capital structure with a view to these two areas. Much of the increase in the use of hybrids throughout the past two decades can be explained by tax and regulatory factors. Therefore, most of the empirical and theoretical research in this area has focused on the tax advantages of issuing hybrids as a way of reducing the cost of capital from a company's point of view, or on their capacity to be subordinated to all the creditors and to be unable to trigger the liquidation of the firm in case of default on its payouts. However, very little contribution has been made to the analysis of these securities with regard to their implications for corporate governance. A large part of this thesis is dedicated to this original approach.

In particular, I propose a functional approach for understanding hybrid financial instruments. Currently, our approach is based on the traditional understanding of *debt* and *equity* as fundamentally different, opposing methods for financing a corporation's business. Starting from there, tax and accounting regulation try to define every hybrid financial instrument as merely a mix of the two opposing ends of the "capital spectrum" – pure debt or pure equity. I argue that this simplified view of hybrid financial instruments fails to properly grasp the complexity of modern corporate finance. In my view, more emphasis should be put on the *agency*

relations and the *property law claims* embedded in such "unconventional" financial instruments.

Economic theories on the nature of the firm have generally explored two areas that are essential to reduce managerial opportunism and the related conflicts of interest. These are the *ex ante* incentives alignment and the contractual design to avoid *ex post* hold-up problems. Agency costs and property rights theories are targeted at preparing the right incentives for concentrating the relevant bargaining action at the *ex ante* contracting stage. While property rights theory emphasises the importance of ownership when it comes to allocating control powers and residual claims, the literature on agency deals with the principal-agent relationships and discusses how to align managers' and shareholders' incentives in order to maximise the company's wealth. Transaction cost economics maintains that bargaining is pervasive during a business life. In addition, companies deal with uncertainty and risk in their businesses. Thus, governance mechanisms for *ex post* regulation or measurement are needed to avoid expensive disputes and hold-up problems during the life of the firm. These problems are a direct consequence of contracts being incomplete by nature. However, a more flexible contract going beyond pure equity or debt can effectively work as a very efficient compensation contract, aligning the ex ante incentives of managers and investors and thus, reducing the agency costs. Moreover, the special features of hybrid contracts allow a perfect economic integration between the investors in the firm. This thesis aims to discuss the rationale for issuing hybrids, and to evaluate the law relative to these instruments against the background of both agency costs and property rights theories.

A functional approach also means putting more emphasis on the corporate governance implications of hybrid financial instruments. While some scholars question the case for mandatory company law, as a matter of fact there are no jurisdictions leaving all questions of corporate law and governance to the incorporators' freedom. Assuming that there *is* a case for mandatory corporate law, we also need to ask whether holders of financial instruments who are not shareholders in the traditional sense, but whose contribution fulfil much of the same function as traditional equity financing, should also be offered the same level of (mandatory) protection we deem necessary for the typical member of a company. Therefore the second aim of this research is to evaluate the legal standards and strategies available for the protection of different categories of hybrid-holders

repaying this amount from a corporate governance perspective. Hybrid financial instruments as preference shares and convertible bonds are primarily an instrument of corporate finance and, as such, ought to offer shareholders the certainty of entitlements and protection of their rights while at the same time satisfying business needs as a security with specific functions and usefulness in modern corporate capital structures. As emerges from the historical analysis of these financial contracts, the status of preference shares has often given rise to a number of grounds for dissatisfaction. Historically, companies in need of finance have often raised funds in the form of preference shares, promising investors a higher return and priority for capital repayment at liquidation to compensate for their lack of voting rights. However, once these companies became profitable again, they often excluded preference shareholders from sharing in the profits beyond a certain fixed percentage stipulated in the terms of the contract. Preference shareholders support a risk similar to ordinary shareholders when they contribute funds in a time of financial difficulty for a company because they are, like ordinary shareholders, subordinate to all the creditors in liquidation. However, they do not enjoy the same rewards if the company is successful. It seems therefore that preference shares have become more similar in nature to debentures than to shares, without having the same advantages. The assessment of the value of these shares, compared to ordinary bonds, while the company is a going concern, is difficult because it must take into account the contingency of whether or not the ordinary shareholders will act to appropriate the company's profits for themselves before a winding-up. With regard to the nature of the preference share, it is arguable that many of its inconsistencies could be eliminated if it were fully equated, with respect to capital entitlements, with debenture or other fixed-income securities. However, the essential nature of the preference share has never been clarified by the courts or in law, apart from their rights, which are stated to be contractual in nature. This poses the main problem for hybrid instruments.

This thesis aims to identify and assess the interrelationship between legal and contracting solutions to governance and finance problems through the use of hybrid instruments such as preference shares and convertibles in several critical situations. It is often debatable how far their protection is a matter of contract and how far it is a mandatory matter of company law. Although nowadays the UK courts seem to have reached some definitive canons of construction, some recent US cases take a

different direction, opening up again the discussion of directors' fiduciary duties towards shareholders as a whole, including preferred shareholders. The analysis shows that a lot of scope is left to the parties involved to bargain for their financial rights and rights of *voice.* Mandatory rules for public companies, which are few, are generally optional for private companies. This provides the investors with a strong incentive to contract for their rights.

In Chapter 1, I initially define the hybrid instruments under examination, giving the reader an understanding of the peculiarities of these securities and of their evolution over the years. Chapter 2 discusses the economic and legal rationale for distinguishing between various claimants in the firm. The law is dedicated to a classification approach. In particular, this chapter examines some regulatory issues in relation to hybrids following classic legal analysis, which includes the legal classification of these securities according to different legal disciplines. The study highlights the limits and the inconsistencies of this approach and provides the basis for a new taxonomy: a functional approach. This approach is applied in the remaining chapters of the thesis. Chapter 3 concludes Part I by setting out the theoretical framework with a reassessment of the main theories of corporate finance and governance. In Part II, the hybrid instruments as referred above are observed in several critical situations depending on their relevancy to the situation. Therefore the governance regulation of hybrid instruments is analysed in significant corporate decisions such as firm's constitution, variation of class rights, assets disposal and distribution of dividends (Chapter 5), in corporate financing decisions under uncertainty when the risks of opportunism of the parties is very high (Chapter 6) and in corporate control transactions (Chapter 7). Statutory law, legal standards and strategies for protection are discussed, compared and evaluated. Chapter 8 concludes with some considerations.

The legal distinction between equity and debt can be meaningless and the results of that categorisation misleading. As observable in practice, the increase in financial innovation reflects the necessity of the parties to allocate control and cash-flow rights in a way that diverges from the classic allocation resulting from equity and debt. Companies and capital structures evolve continuously in conditions of uncertainty and the incentives of the parties may diverge during the years. Thus, the parties may disagree on something they agreed on before. In such situations, the law is intended to protect the weak party from any possible abuse, while at the same time

facilitating the business in the best interest of the firm. The functional approach unveils an important rationale for issuing hybrids. Both the US and UK have legal systems characterised by transactional flexibility that places these two countries among the most business-friendly legal systems. Both the US and UK legal systems rely on *ex post* standards strategies to protect preference shareholders and on the judiciary to evaluate the fairness of a transaction. The choice of the regulator not to burden the market with excessive mandatory company law has left a lot of scope and given a strong incentive to the parties to contract for their rights. This has favoured the business and allowed the parties to better protect themselves with careful drafting.

PART I – REGULATORY ISSUES OF HYBRID FINANCIAL INSTRUMENTS: THE CLASSIFICATION APPROACH

Chapter 1. A Historical Perspective

The purpose of this chapter is to describe these hybrid financial instruments and to examine their origins in order to inform later analysis of the character of those securities. In particular, the examination focuses on the evolution of these instruments showing how certain forms of contract, as preference shares, have moved away from standard equity peculiarities and certain others, as subordinated irredeemable debentures, convertible bonds and bonds with covenants, have moved away from standard debt characteristics. Moreover, it assesses the financial issues that such hybrid contracts raise and how the law and the courts have coped with their use since their first appearance in the history of corporate law.

1.1. The birth and evolution of preference shares in the British legal system

Atypical security issues, which were different from ordinary shares, can be found in the records of British companies as long ago as the seventeenth and eighteenth centuries[2]. In 1702, the stock of the East India Company was divided into two

[2] Since they appeared as an alternative to equity and evolved over the years such that preference shareholders' rights became "somewhat more approximated to the role … of debenture-holders" as Lord Evershed MR stated in 1949, *Re Isle of Thanet Electricity Supply Co.* [1950] Ch. 161 at 175. See also Gower L.C.B., *Principles of Modern Company Law* (3rd ed. London: Stevens & sons, 1969) 22-28 and 357-368; Pennington R., *Partnerships and Company Law* (London, Butterworth, 1962) 97-103; Farrar J.H., *Farrar's Company Law* (London: Butterworths, 1988) 226-235 at Ch. 18; Michie R.C., *The London Stock Exchange: a history* (OUP 1999) 31 ff.; Burgess R., *Corporate Finance Law* (London, 1992) 319-323; Stiebel A., *Company law and precedents* (London, 1929) 62-71; Scott W. R., *The Constitution and Finance of English, Scottish and Irish Joint-stock Companies to 1720*, I, (Cambridge, 1912) 364-365; Stiles C.R., Alphabet of Investment, *Fin. Rev. of Rev.*, May 1918, 24-26. In this treatise, the author refers to the bonds issued in , see also Dewing A. S., *The Financial Policy of Corporations* (New York: Ronald Press Co. 3rd ed., 1921) 113–136; Idem, *A Study of Corporation Securities: Their Nature and Uses in Finance* (New York: Ronald Press Co., 1934) 134, n. (b); Idem, *Corporate Promotions and Reorganizations* (New York: Ronald Press Co., 1914) Ch. 2 at 19; Berle A., *Case and Materials on Corporation Finance* (St. Paul, 1930) 438, 441, 459; Burtchett F.F., *Corporation Finance* (New York, 1934) 79 ff.; Cook W., *A Treatise on the Law of the Corporations having a Capital Stock* (New York, 1923) I, 884-935; Masson R.L., *New Shares for Old* (Boston, 1958) 22-46; Evans G.H., Early Industrial Preferred Stocks in the United States, 40 *J. Pol. Econ.*,

classes, one of which, since it was entitled to a dividend of eight per cent to be paid by the government, can be considered analogous to preference shares.[3] Among an increasing number of British companies in the later eighteenth and the early nineteenth centuries, there was also a rise in the number of companies issuing securities which are best described as preference shares.[4] Although these companies were the first to use these privileged securities in Great Britain, it was with the railroad corporations that this new instrument of finance developed and became popular.[5]

The financial distress of the early transportation companies was one of the main reasons for the growth of the preference shares. The projects carried on by these companies were almost habitually started without an adequate understanding of the engineering difficulties to be overcome and in many cases, the initial capital was exhausted before the work was completed. Proprietors often faced with the prospects of a bankruptcy with the consequent loss of their enterprise, or the choice to entice new funds into their business in the hope that the project could eventually be made to pay a reasonable return. At that time, many barriers created difficulties for a company intending to raise money. First of all, the small size of markets and limitations on the circulation of a currency (along with related risks) meant that the resources required for each project had to be obtained mainly in the region in which

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1932, 227-243; Schultz W.J. and M.R. Caine, *Financial Development of the United States* (New York: Prentice-Hall, 1937) 52-56 and 96-103; Baskin J.B. and P.J. Miranti, Jr., *A History of Corporate Finance* (New York: Cambridge University Press, 1997) 152; Lawson J.D., 'Preferred Stock', *The American Law Register,* New Series, XX, 1881, 633-649; Buxbaum R.M., 'Preferred Stock—Law and Draftsmanship', 42 *Cal. L. Rev.,* 1954, 243; Stevens W.H., 'Stockholders' Voting Rights and the Centralisation of Voting Control', 40(3) *The Quarterly Journal of Economics*, 1926, 357, 367 ff.

[3] Scott W. R., *The Constitution and Finance of English, Scottish and Irish Joint-stock Companies to 1720*, I, (Cambridge, 1912) 186.

[4] For example, this is the case of Aberdeenshire Canal in 1801, the Commercial Docks Company in 1811 and again in 1817, the Edinburgh Joint Stock Water Company in 1819, the Gloucester and Berkeley Canal Company in 1822, the Southwark Bridge Company in 1823 and 1824, the Edinburgh and Glasgow Union Canal and the Leominster Canal companies in 1826 and the Portsmouth and Arundel Canal and the Thames Tunnel companies in 1828. For more details of these cnal companies in 1826 and the Portsmouth and Arundel Canal and the Thames Tunnel companies in 1828. For more details of these cases and an accurate bibliography of the publication written at that time see Evans G.H., *British Corporation Finance 1775-1850* (Baltimore: Johns Hopkins Press, 1936) 74-81; Bishop H.C., The Joint-Stock Company in England, 1800-1825, *The Journal of Political Economy*, XLIII, 1935, at 1-33; Bishop H.C., The Joint-Stock Company in England, 1830-1844, *The Journal of Political Economy*, XLIII, 1935, at 331-364.

[5] Kostal R.W., *Law and English Railway Capitalism 1825-1875* (Oxford: Clarendon Press, 1994) 28-48; Evans G.H., *British Corporation Finance 1775-1850* (Baltimore: Johns Hopkins Press, 1936) 82-106 and Michie R.C., *The London Stock Exchange: a history* (OUP 1999) 31 ff.

the project was located. Secondly, the raised money could not be immediately productive because the time required for construction was at least several years. Furthermore, the parliament introduced a limitation on corporate borrowing powers to one-third of the paid-up share capital.[6]

In such a situation, since mortgages, annuities and promissory notes were not always well accepted because offering higher interest rates could often mean to face a high risk of bankruptcy, the sale of shares was the only device left.[7] However, in order to finalise a sale of shares in such a desperate condition, they had to make the shares more attractive to the existing propriety or the public. Two methods for doing this were developed: the first was to sell shares at a discount and the second was to attach a preferential dividend to the new shares. The former had a number of drawbacks mainly due to the fact that the capital raised did not equal the par value of the shares issued. Given that a company, in order to increase its debt, had to comply with the limitation imposed by law on the equity-debt ratio, there were two clear disadvantages in issuing shares issued at a discount. These were not only that they lowered the proceeds of the sale but also that they reduced the possibility of the company to raise new funds in the future. Moreover, registered companies were prohibited from issuing shares at a discount.[8] If the new share and loan capital actually raised were not sufficient to enable the company to complete its works, Parliament had to be petitioned for the privilege of issuing more shares and the procurement of a supplementary act was costly. The preference share, which could be sold at par or at a smaller discount than an ordinary share, minimized this disadvantage. It is in such a confused context, in which the need for financing new businesses was strong and the regulation for corporate finance was in continuous change that, the new instrument - preference share - was born and during its life, it

[6] Dickson P.G., *The Financial Revolution in England: A Study in the Development of Public Credit, 1688-1756,* Modern Revivals in History, (Gregg Revivals; 1967 ed.) Ch. 14.

[7] Evans G.H., *British Corporation Finance 1775-1850* (Baltimore: Johns Hopkins Press, 1936) 76-77 and 85; Morgan V.E. and Thomas W. A., *The Stock Exchange, Its History and Functions* (Elek Books, London, 1962) 44; Michie R.C., *The London Stock Exchange: a history* (OUP 1999) 26-28.

[8] *Ooregum Gold Mining Co. of India v. Roper* [1892] A.C. 125.

acquired an important economic status before its clear legal definition was developed.[9]

Another important consideration that has to be taken into account, concerns the significant role of the statutory companies in the evolution of the preference shares. As it emerges from the empirical data of that time, most of the companies adopting these new kinds of securities were utility companies such as railway, gas, water and electricity undertakings. In the past, when these public utilities were left to private enterprise, statutory incorporations by private Acts were comparatively common since the undertakings would require power and monopolistic rights which needed a special legislative grant. Subsequently, as a result of the post war nationalisation measures, most of these statutory companies have been taken over by public boards and corporations set up by public Acts. An evidence of the changing conditions of those years is the history of the Oxford Canal. Under its act of incorporation, passed in 1769, the company was supposed to pay five per cent interest on all sums paid in upon its shares but given that this payment was proved to be "disadvantageous and inconvenient" to the company, its rate was reduced to four per cent by a second parliamentary act in 1775. Later, when the proprietors, to assure the payment of the dividends that were in arrears, decided to transform these accrued amounts into capital stock, Parliament sanctioned this agreement and removed the obligation to pay four per cent interest on the shares. Dividends were henceforth to be determined by the company, although certain limits were placed upon the rate until the borrowed money had been repaid. However, the inconvenience and humiliation, which beset companies which were financially unable to comply with the terms of their agreements requiring the payment of a fixed dividend on all shares, led to the introduction of more cautious provisions into parliamentary acts.[10]

Forty years later, as the railway industry developed, some important newspapers of that time strongly supported the payment of about four per cent fixed dividend on the deposits and calls paid upon shares, arguing that this would create the right conditions for raising new money, inject new funds to finance future

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[9] Evans G.H., *British Corporation Finance 1775-1850* (Baltimore: Johns Hopkins Press, 1936) 96; Mitchie, 1999, note 75 above, at 31-36; Morgan and Thomas, 1962, note 75 above, 68-69; Baskin and Miranti, 1997, note 70 above, 122.

[10] Gower L.C.B., *Principles of Modern Company Law* (3rd ed. London: Stevens & sons, 1969) 6 and 438-439.

projects as well as lend stability to the stock market.[11] The idea of a fixed return for the investor did not involve any preferential treatment for a particular class of shares, but the idea might have strengthened the inclination to offer a preference whenever the condition of a company made impossible the payment of dividends to all shareholders. Furthermore, some differentiation in shareholders that had gradually been introduced also made the use of preference shares a logical step for a company in dire financial straits. On June 4, 1829, the Edinburgh and Dalkeith Railway was authorized by Parliament to issue shares with a "Right to Preference or Priority" over the existing shares to the extent of a five per cent non cumulative dividend but with a further participation in profits. Following this example, between 1829 and 1850 more than one hundred railway preferred stock issues were either authorized by Parliament or made by companies.[12]

Since their first appearance, preference shares were characterized by a hybrid nature. Being a privileged class of shares with the right to receive a fixed dividend, preference shares were sometimes made to rank with or ahead of the debt in the payment of their financial entitlements,[13] the only exception being the payment of the annual interest and principal due on the government loans.[14] Moreover, the preference shares were issued with a guarantee of either property or revenue from a particular source and allowed the conversion into ordinary shares when all calls were paid.[15] In addition to the promise of a preferred dividend, sometimes reinforced by

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[11] Kostal, 1994, note 73 above, 28-48; see also Herapath's Railway Magazine, May 1839, at 209-215.

[12] Gower L.C.B., *Principles of Modern Company Law* (3rd ed. London: Stevens & sons, 1969) 351-353; Mitchie, 1999, note 75 above, 58-59; Baskin and Miranti, 1997, note 70 above, 152. For an historical empirical data on preference shares issued in those years, see Evans G.H., *British Corporation Finance 1775-1850* (Baltimore: Johns Hopkins Press, 1936) 163 (Appendix).

[13] As in 1822 when the Gloucester and Berkeley Canal was authorised to issue preference shares which were entitled to pay dividends in preference to any existing ordinary shareholder but also in preference to any interest or payment in respect of any mortgage, bond, note, debenture, annuity or other security due to any creditor.

[14] In the Whitby and Pickering Railway Act of 1837, the statute fixed that the preferred dividend was payable after the interest on the existing debts, but in preference to the interest on debts incurred subsequent to the issue of the new shares. The Edinburgh and Glasgow Union Canal Act of 1826 not only ranked the preferred shareholders *pari passu* with the creditors, but it made the dividends cumulative; in other words, the part of the dividend outstanding was deferred and accrued to the future dividend payable. Finally, the London and South western Railway Act, dated 1839, contained a provision which allowed the payment of a dividend to a preferred shareholder "subject and without prejudice to all mortgages and bonds made and issued and to be made and issued".

[15] See the cases of the Sunderland and Durham Railway in 1840 and of the Preston and Wyre Railway Harbour and Dock Company in 1843 in *Herapath's Railway Magazine*, November 7, 1840 at 858 and *Ibid.*, January 21, 1843, at 71.

provisions designed to assure the fulfilment of the company's obligations, the preference shareholder often possessed many of the rights of the ordinary shareholder. These included unlimited participation in profits, the privilege of voting and the right to subscribe to new issues. Sometimes when profits were negligible or nonexistent, the dividend promised on preferential shares was to be paid out of capital. Although Parliament did not pursue a uniform course at first, when the speculation in shares increased and it was thought desirable to take adequate measures, Parliament decreed in the Companies Clauses Consolidation Act that no company should declare a dividend which would hinder its capital maintenance unless the mortgagees and bond holders gave their consent.[16] This concept was strengthened few years later when the House of Commons took an even stronger attitude stating that it would not grant any railway the right to pay interest on calls out of capital. The Courts did not consider the Companies Clauses Consolidation Act a document legitimating the preference shares and narrowly interpreted this statute so that preference share issues not specifically authorised by Parliament were illegal even as late as 1863, the date in which the fist general act dealing with preference shares was created.[17]

Preference shares became very popular and the proceeds of their sale were used to retire loans. However, their peculiarities were about to change with their growing success. Preference shares were introduced in the market as a temporary device, their privileges being guaranteed for only a short period at the end of which the financial distress of the issuing company would presumably have disappeared. Parliamentary provisions usually protected the rights of the preference shareholder as long as he retained his preferential position, but gradually, the preference shares became a perfect replacement for debt while being shares. As a consequence, they started to lose the right to rank ahead of or on a par with debt and their preferential dividend became payable, only out of distributable profits and if approved by the general meeting. They only maintained the priority to be paid before the ordinary shares received anything and otherwise accumulated in a subsequent year. However, even this protection was disappearing since some issues were being made non cumulative.

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[16] "... the interest of the money borrowed upon any such mortgage or bond shall be paid in preference to any dividends payable to the shareholders of the Company", Companies Clauses Consolidation Act, 1845.

[17] The Companies Clauses Act, 1863, 26 & 27 Vict. c. 118, sections 13-15.

Furthermore, voting rights and participation in new issues of securities were increasingly reserved for the ordinary shareholder and the right to convert preference into ordinary shares was restricted.[18] While until 1847, preference shares were assumed to have voting rights unless they had been issued specifically as non-voting shares, in the second half of the nineteenth century, the participation privilege was relatively less frequently given and the non-participation feature was often linked with the right of conversion and sometimes a prohibition on voting.[19] Another group of express provisions, which were attached to preference shares, included those, which provided for the termination of the dividend priority through conversion and redemption. Whenever the dividend was not promised in perpetuity, preference shares automatically became ordinary shares upon the expiration of the preferential dividend period.[20]

Between the end of the nineteenth and the first half of the twentieth century, the use of preference shares decreased and many outstanding preferred issues were redeemed by companies and replaced with other sources of financing.[21] Despite the scepticism showed by some commentators of that time,[22] interest in preference shares revived in the UK and US markets between the 1950s and 1980s.[23] The phenomenon, which allowed the reintroduction of the preference shares in the market, was the rather substantial growth of the companies' receivables during the 1950s. This was financed mainly with short-term debt and by the end of the 1958,

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[18] Evans G.H., *British Corporation Finance 1775-1850* (Baltimore: John Hopkins Press) 92.

[19] As in the cases of the Monklands Railway in 1848 and London, Brighton and South Coast Railway in 1847, see Herapath's Railway Magazine, February 1847 and September 1848 at 282 and at 665 respectively.

[20] Few doubts rose regarding the advisability of creating shares, which would permanently bear a high dividend rate. Fixed income bearing security could be dangerous in view of the possibility of periods of price inflation or unfair and unsuitable. See this point in Evans G.H., *British Corporation Finance 1775-1850* (Baltimore: Johns Hopkins Press, 1936) 135-148.

[21] Ashworth W., *An Economic History of England, 1870-1939* (Cambridge University Press, 1961) 271-272.

[22] Dewing A., *The Financial Policy of Corporations* (New York: Ronald Press Co. 5th ed.., 1953) 166; Santow L.J., 'Ultimate Demise of Preferred Stock as a Source of Corporate Capital', XVIII(3) *Financial Analyst Journal*, May-June 1962, 47-54.

[23] For some cases compare among others Fergusson D.A., 'Recent Development in Preferred Stock Financing', 7(3) *The Journal of Finance*, 1952, 461-462; Donaldson G., 'In Defense of Preferred Stock', 44 *Harvard Business Review*, 1962, 136; Fisher D.E. and G.A. Wilt Jr., Non-Convertible Preferred Stock as a Financing Instrument, 1950-1965, 23(4) *The Journal of Finance,* September 1968, 624; Elsaid H.H., 'The Function of Preferred Stock In the Corporate Financial Plan', *Financial Analyst Journal,* 1969, 112-116.

the ratio debt to equity had reached a critical point and new form of equity finance was necessary.[24]

The main obstacle they had to overcome was the introduction of a UK corporation tax in 1965. Since preferential dividends were paid out of taxed profits, it was argued that preferred stock financing did not compare favourably with debt financing which benefited from the tax deductibility of interest. However, it was also argued that the comparison between debt and preference shares tended to mislead and confuse the issue. If preference shares had to be compared, a more significant comparison would have been with common stock, such as ordinary shares.[25]

Many advantages characterised preference shares over the common ordinary shares. Firstly, preference shares, being equity, could improve the capacity of the firm to take on additional debt financing and create a better ratio equity/debt. This fact could represent a possibility to pay a lower interest on new bond issues. Secondly, the liquidation preferences and the preferential dividend paid to preference shareholders were limited. Therefore, they were a cheaper source of funding, assuming that the cost of ordinary shares is measured by the expected return on the finance supplied. Thirdly, in a situation of financial distress within a company, it was possible to suspend the payment of the preferred dividends, whereas it was not possible to default on the payment of interest without causing the winding up of the company. Thus, in case of temporary insolvency, preference shares and their peculiarities became very crucial for the company as they could signify continuation or cessation of the business.

Empirical research also showed that companies issued convertible and non-convertible preferred shares simply to exploit the market conditions and meet the various demands of different types of investors.[26] At that time many investors were particularly inflation-conscious but still desired the protection of a fixed income security. The prevailing sentiment was that if the earnings of a corporation rose along with inflation (which is by no means certain), common shares would rise in

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[24] See Lindsay J.R. and Sametz A.W., *Financial Management: An Analytical Approach* (Homewood, Ill.: Richard D. Irwin, Inc., 1963) 400.

[25] Gower L.C.B., *Principles of Modern Company Law* (3rd ed. London: Stevens & sons, 1969) 353; Donaldson, 1962, note 91 above, at 125.

[26] Houston A.L. and C.O., 'Houston, Financing with Preferred Stock', 3 *Financial Management,* 1990, 52 ff.

price and therefore the preference shares, especially the convertible ones, would have also risen in market value.[27]

From the 1960s to the 1980s, preference shares have significantly financed the increasing merger and acquisition activities in the UK and US markets.[28] Empirical studies reported a large use of convertible preference shares. Many were the reasons behind the use of these securities. Convertible preference shares offered common shareholders of the target company a double opportunity: equity in potential higher earnings as well as in assets. If the firm's cash flow proved to be successful, they could convert and reap the benefit of higher earnings, whereas if the expected increase in earnings did not materialise, they could enjoy whatever protection the bonds might provide.[29]

During the 1980s, significant changes occurred in the market for preference stock in terms of large number of new types of preference shares issued. Moreover, in sharp contrast to previous periods,[30] the results showed that industrial firms rather than utilities issued the majority of preference shares.[31] This phenomenon was facilitated by the downturn in capital expenditures by the utility industry and changes in the tax laws that made preference shares a tax-advantaged investment for corporate investors.[32] The advantage was conferred by a tax exemption accorded to the recipient for eighty-five per cent of the amount of dividend paid.[33]

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[27] Elsaid, 1969, note 91 above, 112-114.

[28] Phillips H.E. and J.C. Ritchie, 'Investment Analysis and Portfolio Selection', (South Western Publishing Co, 2nd ed. 1983) 32; Huckins N.W., 'An Examination of Mandatorily Convertible Preferred Stock', 34 *The Financial Review*, 1999, 89-108.

[29] Elsaid, 1969, note 91 above, 112-115. However, convertible preference shares were not used primarily to finance mergers, see Houston and Houston, 1990, note 94, at 53-54.

[30] See Phillips and Ritchie, 1983, note 96 above, 32-35 and 597-598; for US situation see Evans G.H., The Early History of Preferred Stock in the United States, *The American Economic Review*, 1929, 43-58.

[31] See Laurent S., *Securities that do the deal: The decision to issue preference shares by UK firms,* working paper, Bristol Business School, 2001, 23; Houston A.L. and C.O., 'Houston, Preferred Stock Financing: A Survey of Trends in the 1980s', 7(4) *Journal of Applied Business Research*, 1991, 1-8.

[32] Fooladi I. and G. Roberts, 'On Preferred Stock', *Journal of Financial Research*, Winter 1986, 319-324. They integrated preferred shares into Miller's "Debt and Taxes" framework.

[33] In the US market, the rise of preference shares was due to some important regulatory changes in the financial service industry that produced significant implications for capital structure choice. For example, a change made to Federal Home Loan Bank Board regulations in 1984 permitted thrifts to transfer up to thirty per cent of their assets to wholly owned financial subsidiaries for the purpose of obtaining a separation from the assets of the parent firm and collateralising the issuance of securities, typically preferred stock. See, Cooper S.K. and Fraser D.R., The Boom in Bank Preferred. Stock Issues, The Bankers Magazine (November/December 1983), 73-77.

In the UK market, the introduction of the Companies Act (CA) in 1985 has left a lot of scope for shareholders to regulate the terms of preference shares, the only constraint imposed on the companies being the existence of at least one class of shares with unlimited voting rights and one class of shares entitled to receive the net assets of the corporation upon dissolution.[34] An enormous variety of different rights, related to dividends, return of capital, voting, conversion into ordinary shares, redemption and other matters, might be attached to classes of shares described as preference shares[35]. Furthermore, different series of preference shares can be created, namely categories of preferred shares within the same class that differ according to the financial entitlements attached. Their only commonality is the privilege of a higher dividend to be paid in preference to all the other ordinary shareholders.[36]

A class of preference shares may have mandatory and fully cumulative dividends included in its rights or may not, reflecting a payment stream of highly contingent and speculative quality. Moreover, after creditors have been paid in full upon liquidation, preference shareholders may have a priority pay-out over the common capped at the amount paid in per share at original issue. The preference shares may have the feature of being convertible and redeemable at a certain time and at the option of the issuer or of the investor. As such, depending on a company's requirements, it is very easy to let such securities take on the characteristics of debt or equity, or virtually transform preference shareholders into creditors or residual claimants. In the event they are made redeemable at the option of the company, carrying a fixed cumulative dividend without any voting rights and with priority in repayment of capital in liquidation, they represent the extreme borderline in the equity-debt continuum of the corporate financial structure.[37]

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[34] In UK, ss. 638 and 556 of the CA 2006 (before s. 128 of the CA 1985 and originally s. 33 of the 1980 Act) allows the registration of particulars of special rights, normally included in the company's memorandum or articles, see among the many handbooks Davies P.L., *Gower and Davies' Principles of Modern Company Law* (London: Sweet and Maxwell, 7th ed. 2003) 624; Stedman G. and Jones J., *Shareholders' Agreement* (Sweet & Maxwell, 1990) 7 ff.

[35] Whether shares are ordinary or preference shares may be a question of construction: *Alliance Perpetual Building Society v. Clifton* [1962] 1 W.L.R. 1270; [1962] All E.R. 828.

[36] In UK under s. 128-129 Companies Act 1985; in USA, the Model Business Corporation Act at section 6, paragraph 2, refers to "one or more series within a class" of preferred shares. In Canada, s. 229 of the Business Corporation Act.

[37] See sec. 159 and so on of the Company Act 1985 and for a quick *excursus* Stocks T.E., *Corporate Finance: Law and Practice* (London, 1992) 17; McCormick R. and Creamer H., *Hybrid Corporate Securities: International Legal Aspects,* (London, Sweet & Maxwell, 1987), 16.

1.2. Particular features of the preference shares

1.2.1. The preferential dividend

One of the main features of preference shares is represented by the qualified right to receive a preferential dividend on the distribution of profits, before any dividend is paid on the company's ordinary shares for a financial year or any shorter period prescribed by its memorandum or articles.[38] As preference shares are part of the company's share capital, any distribution of dividends has to be done only out of existing and sufficient profits according to s. 830 (1) and (2) of the CA (CA) 2006,[39] because otherwise the payment of the dividend would be an illegal return of capital to the preference shareholders.[40] In addition to the General Meeting's approval of the final accounts, in which a positive result or distributable funds must emerge, preferential dividends (like ordinary dividends) are payable only if declared.[41] Therefore the resulting resolution that decides the amount of dividends directors propose to distribute is the source of the company's obligation to pay.[42] Once that dividend is declared, it becomes a credit for the shareholders and no ordinary shareholder can be paid unless all the preference shareholders are satisfied according to their privileges.[43] In truth, the directors' discretion may be limited and the

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[38] Davies P.L., *Gower and Davies' Principles of Modern Company Law* (London: Sweet and Maxwell, 7th ed. 2003) 620-623; Pennington R., *Partnerships and Company Law* (London, Butterworth, 1962) 97-99; Farrar J.H. and Hanningan B.M., *Farrar's Company Law* (Butterwords, fourth ed., London, 1998) 230; Morse G., *Palmer's Company Law* (London, vol. 1, 1959) 6039-6052; Bratton W., *Corporate Finance, Cases and Materials* (5th ed., New York, 2003) 353-385; Hill J., 'Preference Shares' in Austin and Vann (eds), *The Law of Public Company Finance* (Law Book Company, Sydney 1986), ch.6 139-168.

[39] s. 263 (1) and (2) of the CA 1985.

[40] *Trevor v Whitworth* (1887) 12 App Cas 409.

[41] Arrears even of cumulative dividend are prima facie not payable in a winding-up unless previously declared. See *Crichton's Oil Co, Re* [1902] 2 Ch. 86 CA; *Roberts & Cooper, Re* [1929] 2 Ch. 383; *Wood, Skinner & Co Ltd, Re* [1944] Ch. 323.

[42] *Bond v Barrow Haematite Steel Co* [1902] 1 Ch 353; *Re Accrington Corporation Steam Tramways Co* 2 Ch 40 [1909] 2 Ch 40. It makes no difference if the articles provide that the preference dividend shall become payable without any declaration; this merely dispenses with a declaration by the shareholders in general meeting and it is still necessary for the dividend to be declared by the directors see *Re Buenos Ayres Great Southern Railway Co Ltd* [1947] Ch 384, [1947] 1 All ER 729. See also *Burland v Earle* [1902] A.C. 83, PC; *Godfrey Phillips Ltd v Investment Trust Ltd* [1953] 1 W.L.R. 41.

[43] *Wood v Odessa Waterworks Co* [1889] 42 Ch D 636.

preferential dividend may become a credit of the preference shareholder even after the first resolution that approves the annual financial statements, assuming profits are available. It is sufficient to expressly include in the memorandum of the company the profits in each year to be applicable first in payment of a preferential dividend on the preference shares[44] or to be due on certain defined dates.[45]

The dividend attached to a preference share may be cumulative or non-cumulative. It may also be fixed or limited to a percentage of the nominal amount of the shares per year. It is a cumulative preferential dividend when is payable out of the profits in priority to the subordinate class or classes of shares so that if the profits of one year are not sufficient to pay the dividend for that period, the deficiency accumulates against subsequent profits[46]. Thus, no dividend can be paid in respect on ordinary shares or junior classes of preference shares until the preference dividends for all past financial years have been paid in full. The accumulation of unpaid preference dividends may continue over any number of years, because it is not a debt, which becomes statute-barred after the expiration of a limitation period. The accumulation will cease only once every preference shareholder has been paid for all the past complete financial years. If preference shares of the same class have been issued at different times and the dividend is unpaid in respect of some shares for more years than it is in respect of others, the total arrears have to be satisfied rateably when a dividend is paid in order to comply with the entitlements of each preferred category.[47]

It is generally presumed by courts that, when one class of shares carries a fixed dividend in preference to another class, the dividend is cumulative, even though the

[44] Like in *Evling v. Israel & Oppenheimer Ltd*, [1918] 1 Ch. 101, where clause 6 of the memorandum of association provided that “the profits of the company” in each year should be applied in an order of priorities, in which the placing of sums to reserve was expressed to be subsequent to the payment of preference dividend. Here, the dividends paid out reduces the total profit distributable to the ordinary shareholders.

[45] See *Bradford Investments* (No. 1), Re [1991] B.C.L.C. 224.

[46] *Re Wakley, Wakley v Vachell* [1920] 2 Ch 505; *Godfrey Phillips Ltd v Investment Trust Corporation Ltd* [1953] Ch 449, [1953] 1 All ER 7.

[47] *Webb v. Earle* (1875) L.R. 20 Eq. 556; *First Garden City Ltd v Bonham-Carter* [1928] Ch 53, where Tomlin J. held that payment should be proportionate to the total arrears of each class. See also before *Weymouth Waterworks v. Coode & Hasell* [1911] 2 Ch. 520, where Parker J. held that payment should be proportionate to the rate of dividend.

terms of issue do not in any way indicate that they ought to be,[48] unless the construction of the regulations can be applied to deny it.[49] Earlier, the doctrine has argued whether a preferential dividend had to be paid out of undistributed profits carried forward from prior financial years, or only out of profits realised in the current year. The problem is now definitively resolved by the law: profits available for distribution are defined under s. 831 of the CA 2006 (s. 263(3) of the CA 1985) as the company's accumulated realised profits from the time of its incorporation less the company's accumulated realised losses from the time of its incorporation.[50] It then seems unnecessary for the terms of issue to contain any formulas explaining how it has to be defined the distributable profit for preference shares, because in the absence of a contrary provision,[51] the dividends are payable out of profits and revenue reserves already in hand.[52] Of course, this can only be done if profits or reserves still exist when the payment is proposed. Otherwise if this surplus has been eroded or eliminated by previous losses suffered by the company since they were earned or created, or if it has been capitalised and bonus shares has been issued and paid up by the capitalisation, a preference dividend cannot afterwards be paid out of them, given that no longer exist.[53]

When a preferential dividend is stated to be non-cumulative, if dividends for that year are insufficient or inexistent, a preferential dividend does not cumulate upon omission of payment and the deficiency is extinguished instead of being carried

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[48] See *Webb v Earle* [1875] LR 20 Eq. 556; *Henry v. Great Northern Railway Co* [1857] 1 de G & J 606; *Stevens v South Devon Railway Co* [1851] 9 Hare 313; *Sturge v Eastern Union Railway Co* [1855] 7 de GM & G 158; *Crawford v North Eastern Railway Co* [1856] 3 K & J 723; *Corry v Londonderry and Enniskillen Railway Co* [1860] 29 Beav. 263; Foster v. Coles and N.B. Foster & Sons Ltd. [1906] W.N. 107.

[49] *Staples v. Eastman Photographic Materials Co.* [1896] 2 Ch. 303, CA.

[50] On this matter before the introduction of the s. 263 see *Long Acre Press Ltd v Odhams Press Ltd* [1930] 2 Ch 196, [1930] All ER Rep 237.

[51] *Re Bridgewater Navigation Co* [1891] 1 Ch 155 at 169 where the company's articles direct the payment of the whole of the residual profits to the ordinary shareholders. In US, *see* the American case *Gallagher v New York Dock Co* 19 NYS (2d) 789 [1940]; affd 32 NYS (2d) 348 [1941] where it was expressed in the terms of issue that the preference dividend for each financial year was payable out of profits of that year alone.

[52] *Crawford v North Eastern Railway Co* [1856] 3 K & J 723.

[53] *Re John Fulton & Co Ltd* [1932] NI 35. See also the American case *Lich v United States Rubber Co* 123 F 2d 145 [1941].

forward against subsequent profits.[54] Thus, the difference between cumulative and non-cumulative preference shares is very substantial. While the preferential dividend accumulates over the years in the former case, it expires in the latter if it cannot be paid out of the yearly distributable profits available for the company. It appears that the interests of the ordinary and preferred shareholders may not always be aligned, as in the case of the non-cumulative preference shareholders, and opportunistic behaviour of ordinary shareholders may concretize at the expenses of the preferred shareholders.[55] In fact, in case of corporate retention of annual earnings, the market share value appreciates correspondingly and the ordinary shareholders theoretically may always realize their capital appreciation by selling some of their shares at enhanced market prices. Different is the case of the cumulative and non-cumulative preferred shareholders. The cumulative preferred shareholders are entitled to an annual fixed percentage of return on investment regardless of corporate earnings and at least exert some pressure toward distribution of dividends to common shareholders, since arrearages block any other payment of dividends, even if accruals are often threatened with elimination by corporate action and thus might not bloat market quotations.[56]

However, the situation is even worse for the non-cumulative preference shareholders who do not receive accrual rights when annual earnings are retained. Sometimes, when it is expressly stated in the terms of issue that a preference shareholders' class right to receive a non-cumulative preferential dividend is confined to the annual profits, it would appear to be possible for directors to utilise the reserves and retained earnings, if available, to pay dividends on the ordinary shares through a buyback of these shares, in an year in which the company reported a loss, while paying no dividends on the non cumulative preference shares. Furthermore, another source of conflict is represented by the directors' discretion to propose a dividend at the annual general meeting. Theoretically, the board of directors is at liberty to recommend carrying as much profit as they see fit to

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[54] Recently in Australia, see *Trojan Equity Limited v CMI Limited* [2009] QSC 114; in UK *Coulson v Austin Motor Company Limited* (1927) 43 TLR 493.

[55] See Stevens W.H., The Discretion of Directors in the Distribution of Non-Cumulative Preferred Dividends, 24 *Geo. L. J.,* 1936, 371. For an analysis of some of these problems see the discussion paper of the UK Law Commission, *Shareholders' Remedies* (Cm 3769, London, 1997).

[56] Meck J. F., 'Accrued Dividends on Cumulative Preferred Stocks: The Legal Doctrine', 55 *Harvard L. Rev.,* 1941, 81 ff.; Stiebel A., *Company law and precedents* (London, 1929) 147-148.

reserves. Therefore, they could carry the totality of the profits and extinguish the entire preferential dividend for that year if they are aware a payment of dividends could jeopardise the company's going concern.[57]

The key problems which have arisen with particular reference to dividends on preference shares have been those concerned with the precise amount of which is entitled normally, and upon winding up. Since a dividend cannot be distributed if not declared, it has been uncertain whether preference shareholders are entitled to their dividends after winding-up procedures have already commenced, if these dividends have not been declared and no express provision for their payment has been made in the company's regulations. The courts have shown a substantial evolution on this matter. An early decision of the Court of Appeal laid down the basic principle that, *prima facie*, arrears of a cumulative preferential dividend were not payable on liquidation.[58] The only exceptions to this were when the articles entitled the shareholders to their dividend once profits had been earned irrespective of a declaration, in which event they would be entitled to payment if the company had accumulated profits in its hands,[59] or when the dividends had actually been declared, though not paid, before the liquidation. Subsequently, the courts in several instances have avoided the application of this principle and reached the opposite conclusion instead.[60]

Generally, in order to satisfy its cumulative preference shareholders, a company will have to provide in its articles of association or the memorandum with the entitlement to receive a dividend in a winding up, even if not declared while the

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[57] Theoretically, the holders of preference shares cannot prevent the company setting aside profits earned in any year to make good the losses sustained in previous years or to build up reserve if good faith is observed, even if their preferential dividend is cumulative. See *Bond v. Barrow Haematite Steel Co.* [1902] 1 Ch 353; *Fisher v Black and White Publishing Co* [1901] 1 Ch 174; *Re Buenos Ayres Great Southern Railway Co Ltd* [1947] Ch 384, [1974] 1 All ER 729. This seems to be the approach in US as well where non cumulative preferred dividends could be reasonably retained as long as the directors could show an appropriate corporate purpose for doing it, *see Lich v. U.S. Rubber Co.,* 39 F. Supp. 675 (D. N.J. 1941) in contrast with the previous approach called the Wabash rule see *Wabash Railway v. Barclay*, 280 U.S. 197 (1930). This rule was expanded later by the judgment in *Guttmann v. Illinois Central R.R. Co.,* 189 F. 2d 927 (2d Cir. 1951), cert. denied, 342 U.S. 867 (1951).

[58] *Re Crichton's Oil Co.* [1902] 2 Ch. 86, C.A.. This presumption was applied in *Re Roberts and Cooper, Ltd.* [1929] 2 Ch. 383 and *Re Wood, Skinner & Co., Ltd.* [1944] Ch. 323.

[59] *Re Bridgewater Navigation Co.* [1891] 2 Ch. 317 C.A.

[60] *Re Walter Symons, Ltd.* [1934] Ch. 308; *Re F. de Jong & Co.* [1946] Ch. 211, C.A.; *Re E.W. Savory, Ltd.* [1951] 2 All E. R. 1036; *Re Wharfedale Brewery Co.* [1952] Ch. 913.

company was a going concern.[61] If the preference shareholders are merely entitled to "unpaid preference dividends" or "arrears of dividends", the dividends are calculated only up to the commencing of the winding up.[62]

1.2.2. Priority to the repayment of capital in event of liquidation

Preference shares usually have priority to the return of capital in event of liquidation of a company, if funds are still available after that all the creditors have been paid. However, while preference shares are *prima facie* assumed to have a cumulative dividend, it cannot be presumed that just because a class of shares carries a preference with respect to dividends, it likewise carries a right to preferential treatment for capital in a winding up.[63] However, any capital priority is conditioned on express clauses stated in the articles, in the memorandum or in the terms of issue of the company. The preference shareholder's priority to the repayment of capital generates a further discussion regarding the entitlement of a preference shareholder to participate in the surplus assets of the company after that all the creditors have been satisfied. The interest of this debate is due to the fact that capital assets, to which the preference shareholders may or may not have a claim, include accumulated profits of previous years which could have been distributed by way of dividend to the ordinary shareholders prior to the commencement of the winding-up.[64] However after winding-up has been commenced and company's debts and liabilities have been satisfied, the same accumulated reserves become part of the company's residual capital assets in which the preference shareholders are entitled to share equally with the ordinary shareholders. Therefore the question that was presented was whether or not the preference shareholders were entitled to participate

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[61] *Re New Chinese Antimony Co Ltd* [1916] 2 Ch 115; *Re Springbok Agricultural Estate Ltd* [1920] 1 Ch 563; *Re Wharfedale Brewery Co* [1952] Ch 913, [1952] 2 All ER 635..

[62] *Griffith v Paget* [1877] 6 ChD 511; *Re E W Savory Ltd* [1951] 2 All ER 1036.

[63] *Re London India Rubber Co.* (1868) L.R. 5 Eq. 519; *Re Accrington Corp. Steam Tramways* [1909] 2 Ch. 40. Nor will an exclusion of participation in dividends beyond a fixed preferential rate necessary imply an exclusion of participation in capital although it will apparently be some indication of it, see *Scottish Insurance Corporation v Wilsons and Clyde Coal Co* [1949] AC 462, [1949] 1 All ER 1068; *Dimbula Valley (Ceylon) Tea Co., Ltd.* [1961] Ch. 353.

[64] *Re Bridgewater Navigation Co* [1891] 2 Ch 317, where the Court of Appeal decided that the surplus had to be regarded as belonging to the ordinary shareholders and therefore distributable to them alone.

rateably with the other shareholders in the surplus assets of the company on winding-up.[65]

The courts' reasoning on this matter has substantially changed over the years. Earlier, it was held at first instance that, in the absence of an express exclusion of participation in surplus assets, preference shareholders were entitled to participate - *pari passu* - with the other ordinary shareholders in addition to any preferential rights.[66] In 1914, the House of Lords decided that where the preference shareholders were given a preferential dividend, that was all they were entitled to by way of dividend.[67] For the purpose of defining preference shareholders' rights on return of assets in liquidation, the courts were uncertain as to what was meant by surplus assets. It was held in the Court of Appeal that reserves of undistributed profits which could have been distributed by the way of dividend, before the commencement of a winding up to the ordinary shareholders, were not included in the surplus assets.[68] In fact, the company cannot declare a dividend after it commences winding up,[69] and the preference shareholders cannot acquire a title to the assets by anything done in the winding up proceeding, unless the dividend was not declared.[70] Thus, a preference as regards both dividends and return of capital were presumed to be non-participating in dividends but participating as regards a return of capital.[71] After a period of considerable fluctuations of judicial opinion,[72] in 1949, this distinction was removed by the House of Lords; preference shareholders with preferential or express rights to dividends or to a repayment of capital were presumed not to be participating

[65] See *Dimbula Valley (Ceylon) Tea Co., Ltd. v. Laurie* [1961] Ch. 353.

[66] *Re Espuela Land and Cattle Co.* [1909] 2 Ch. 187.

[67] *Will v United Lankat Plantations Co* [1914] AC 11, H.L.

[68] *Re William Metcalfe Ltd* [1933] Ch. 142, C.A.

[69] *Re Catalinas Warehouses and Mole Co Ltd* [1947] 1 All ER 51; *Re Artisans' Land and Mortgage Corpn* [1904] 1 Ch 796. *Re W Foster & Son Ltd* [1942] 1 All ER 314; *Re Severn and Wye and Severn Bridge Railway Co* [1896] 1 Ch 559.

[70] *Re Odessa Waterworks Co* [1901] 2 Ch 190n; *Re Crichton's Oil Co* [1902] 2 Ch 86; *Re Madame Tussaud & Sons Ltd* [1927] 1 Ch 657; *Bishop v Smyrna and Cassaba Railway Co* [1895] 2 Ch 265; *Re Bridgewater Navigation Co* [1891] 2 Ch 317; *Scottish Insurance Corporation v Wilsons and Clyde Coal Co* [1949] AC 462, [1949] 1 All ER 1068.

[71] In *Re William Metcalfe Ltd* [1933] Ch. 142, C.A.

[72] *Cf. Re Fraser & Chalmers Ltd.* [1919] 2 Ch. 114; *Anglo-French Music Co. v. Nicoll* [1921] 1 Ch. 386; *Re John Dry Steam Tugs* [1932] 1 Ch. 594 (in favour of preference shareholders) *contra: Re National Telephone Co.* [1914] 1 Ch. 755; *Collaroy Co. Ltd. V. Giffard* [1928] Ch. 144.

as regards further dividends or capital repayments.[73] It was said that a preferential right, if expressly specified in the memorandum, is presumed to be exhaustive[74] and the burden of proving the contrary is upon the preference shareholders if they claim further or better entitlements.[75]

Subsequently, it was reasonably said that to analyse nature and origin of surplus assets would have led to insuperable difficulties and seemed to be quite illogical,[76] since under our dividend rules any part of the surplus could have been distributed to the shareholders by way of dividend. Therefore, the preference shareholders were granted with the right to participate to the surplus profits in liquidation but only when the articles provided that undistributed profits should be divisible among such shareholders.[77] Nowadays, it is common to see preference shares carrying a priority to return of capital, whereas the liquidation preference is often fixed at a specified price per share and no rights to surplus assets in winding up are allowed.

Similarly, some uncertainty, arising from the case of a company distributing a dividend to its shareholders through a reduction of capital, pushed the court to take

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[73] *Scottish Insurance Corporation v Wilsons and Clyde Coal Co* [1949] AC 462, [1949] 1 All ER 1068; later confirmed by the case *Re Isle of Thanet Electricity Supply* Co. [1950] Ch. 161.

[74] *Will v United Lankat Plantations Co* [1914] AC 11, H.L. In USA, see, *Waggoner v. Laster,* 581 A.2d 1127 (Del. 1990). In Canada *International Power Co. v. McMaster University & Montreal Trust,* [1946] S.C.R. 178 followed the *Will v United Lankat Plantations Co,* making that the law; also recently *Re Canadian Pacific Ltd.* (1990), 68 D.L.R. (4th) 48 (Alta. C.A.).

[75] *Scottish Insurance Corporation v. Wilsons & Clyde Coal Co.* [1949] A.C. 462; *Re Isle of Thanet Electricity Supply* Co. [1950] Ch. 161. Previously in *Re William Metcalfe & Sons, Ltd.* [1933] Ch. 142, as in some earlier cases, the view had prevailed that a preferential right in this category was not exhaustive but operated to confer an additional privilege over those otherwise enjoyed by the preference shareholders as a member of the company. For a discussion of these points, see Morse G., *Palmer's Company Law* (London, vol. 1, 1959) 303; Pennington R., 'Preference Shares Again', 105 *S. J.,* 1961, 451 where the Author explains when the provision precluding participation in surplus assets is absent, the court construes the right of preference shareholders in respect of capital to be the same as if the provision were expressed, but this is because the court treats the priority given for repayment of preference capital as exhaustively defining the preference shareholders' rights and not because the court implies a provision precluding participation in surplus assets in the terms of issue. See also Pickering M.A., 'The problem of preference shares', *MLR*, Sep. 1963, 503-505.

[76] It is also inconsistent with the well established principle that on a winding up all assets are distributed as a fund of capital see *Staffordshire Coal & Iron Co. v. Brogan* [1963] 1 W.L.R. 905, H.L. and with the line of cases culminating in *Re Wharfedale Brewery Co.* [1952] Ch. 913 see these cases in Gower L.C.B., *Principles of Modern Company Law* (3rd ed. London: Stevens & sons, 1969) 362-363.

[77] *Dimbula Valley (Ceylon) Tea Co., Ltd.* [1961] Ch. 353. See also *Re Bridgewater Navigation Co* [1891] 2 Ch 317, where actually under the original articles there was only one class of shareholder.

an opinion.[78] The court held that their position was the same it would apply in a winding up and that accordingly the first class of capital to be repaid was the class comprising the preference shares.[79] Therefore, as long as the statutory requirements are complied with and the preference shareholders receive their rights on a winding up,[80] the reduction has to be approved.[81] This decision was later approved by the House of Lords, although in that situation, the articles expressly provided that the rights attached to the preference shares on a return of capital other than on winding up were the same as the rights which they enjoyed on a winding up.[82]

When preference shares are drafted to receive a share of surplus profits in the company, all combinations accepted by the parties are possible. They can rank *pari passu* with the subordinate shares after those shares have received a specified dividend, receive an aliquot portion of the surplus profits, or their dividend can rise automatically in proportion to the dividend on the ordinary shares rises beyond the specified figure. For example, the market of preference shares has known a standard of preference shares commonly called *preferred ordinary shares*.[83] These securities have the rights to participate in surplus profits but they are not entitled to priority for repayment of the capital in respect of their shares in the company's winding up. Their participation dividend cannot be cumulative because it is related to and bound up with a dividend on common stock. Therefore, both classes of ordinary shares participating or not, share the fortune or the misfortune. Directors likewise have discretion to propose at the general meeting, or refuse to propose, even though earned, participation dividends on preferred or ordinary dividends on common stock. For this reason, preference ordinary shareholders have a position with respect to

[78] For an interesting and doctrinal opinion see Gower L.C.B., 'Company's reduction of capital: Note, 14(3) *MLR,* 1951, 330-333.

[79] This arrangement seems nonsensical, because the preferred shares participating as regards income but non participating as regards capital, on a reduction of capital they are paid off on the latter basis, thus losing any share in the accumulated reserves, for Gower L.C.B., *Principles of Modern Company Law* (3rd ed. London: Stevens & sons, 1969) 362 footnote 93a.

[80] *Re Saltdean Estate Co Ltd* [1968] 3 All ER 829.

[81] This approach has been confirmed in more recent judgments, see *Re Ransomes plc* [1999] 2 BCLC 591; *Re Ratners Group plc* [1988] BCLC 685; *Re Holders Investment Trust Ltd* [1971] 2 All ER 289.

[82] See *House of Fraser plc v ACGE Investments Ltd* [1987] AC 387, HL.

[83] See Birds J. and Boyle A.J., *Boyle and Birds' Company Law* (6th eds, Jordan, 2007) 213.

participation dividends analogous to that of a holder of non-cumulative preferred stock.[84]

Other variations can consist of issuing different series or categories of preference shares. Normally, if a class of preference shares is issued with an attached right to a fixed preferential dividend, it means a preferential dividend in priority to all other shares. However, where the preferential rights are defined only in the articles of association or by resolution, the company could, as a rule, create preference shares ranking *pari passu* with the original preference shares simply by inserting an article that states whether a new class of preference share shall modify the rights of already existing preference shareholders. In addition, preference shares may hold the right, in a winding up or on a reduction of capital, to a premium. The terms on which an issued share may provide for the payment of this premium is known as a "Spens Formula" and is commonly attached to preference shares. This formula is used in cases in which the value of the shares of a company is represented in a stock market. According to the Spens Formula, holders of the share capital concerned are expressly entitled to a premium, if during a defined period prior to the repayment, the shares have been standing in the market at a figure in excess of par. The premium is usually calculated with reference to the average stock exchange price for the relevant period before the payment subject to adjustments to take account of any accrued arrears of dividend, which is reflected in the market price of shares.[85]

Unfortunately, because of the variety in the drafting of these documents throughout history, the courts have had to evolve different canons of construction of the documents, thus overruling earlier decisions and defeating the legitimate expectations of the investors who purchased preference shares relying the construction adopted earlier. At the moment, reasonable and uniform canons of construction as well as a *modus operandi* to determine their entitlements appear to have been adopted. Thus, the nature and the extent of a class rights is, first,

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[84] See Berle A. and G. Means, *The Modern Corporation and Private Property* (New York: Harcourt Brace and World, 1926) revised edn, 1968, 307-312 where he wrote that the doctrine of the non cumulative stock cases, that merely deferring dividends does not alter rights, should be applied also in the cases of participating preferred or ordinary dividends paid on common stock, otherwise the participation right of the preferred stock ceases to be a right in contract and becomes a mere gamble on the manner in which a board of directors will exercise its discretion.

[85] It could be argued whether the inclusion of the Spens Formula makes preference shares relevant shares for the statutory pre-emptive rights contained in Companies Act 2006, s. 560.

determined primarily as a question of the construction of the relevant regulations of the company.[86] Secondly, where specific provision in the nature of preferential rights is made, such provision will normally be construed as definitive of the whole of the rights of the class in respect of that provision.[87] Thirdly, in the absence of specific provisions the rights of all shareholders are deemed to be the same.[88]

The fundamental legal concept of the inclusion of these securities to equity capital has never been qualified by the courts or by the statute. Better still, some past judgements have shown a reversal in trend on the nature of preference shares, recognising that the position of a preference shareholder has again become more approximated to that of a debenture holder than was the case some 80 years ago.[89] For instance at law, unless it is explicitly conferred by the company's regulations, preference shareholders do not have any right to participate in surplus profits.[90] The package of rights of the preference shares usually vary greatly depending on the result a company want to achieve issuing these securities.[91]

1.2.3. Conversion and redemption of preference shares

There are two common features that are generally included in the terms of a preference share: the conversion and the redemption clauses. I will discuss the conversion first. Preference shares may be made convertible at the option of the holder into common shares or at a fixed ratio specified in the memorandum of association. Where the conversion option is exercised, the company must notify the Registrar of Companies within one month of the alteration in the rights attached to the converted shares and their redefinition as ordinary shares.[92]

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[86] See *Scottish Insurance Corp v. Wilson & Clyde Coal Co.* [1949] A.C. 462; 1949 S.C. (H.L.) 90; 1949 S.L.T. 230

[87] This proposition was stated in *Re Isle of Thanet Electricity Supply Co.* [1950] Ch 161, CA.

[88] *Birch v Copper* [1889] 14 App Cas 525.

[89] See Lord Simonds in *Scottish Insurance Corp v. Wilson & Clyde Coal Co.* [1949] A.C. 462; 1949 S.C. (H.L.) 90; 1949 S.L.T. 230; and Sir Raymond Evershed in *Re Isle of Thanet Electricity Supply Co.* [1950] Ch 161, CA.

[90] See the case *Will v. United Lankat Plantations Co.,* Ltd [1914] A.C. 11.

[91] Pickering M.A., 'The problem of preference shares', *MLR*, Sep. 1963, 499-519.

[92] Companies Act 2006, s. 636.

The apparently simple matter of converting preference shares into ordinary shares can become one of considerable complexity, at least where the nominal value and the number of the ordinary shares into which the preference shares are to be converted differ from those of the preference shares to be converted, so that there is a danger that the transaction will involve an unauthorised return of capital, on the one hand, or the issue of shares at a discount, on the other. If the nominal or paid up value of the preference shares is changed on their conversion into ordinary shares, whether on the exercise of preference shareholders' conversion options or as a result of agreement at the time of conversion, the conversion may be effected in five alternative ways: by the company consolidating or subdividing the original shares into ordinary shares with a higher or lower nominal value each, the paid up capital in respect of the original shares being allocated proportionately to the new shares;[93] by the preference shareholders surrendering their original shares in exchange for new ordinary shares with a total paid up value not exceeding that of the surrendered shares and the amount remaining to be paid up on the new shares, being not less than the amount unpaid (if any) on the original ones;[94] by the company reducing its issued share capital by a special resolution approved by the court so as to repay the capital paid up on the preference shares, issuing new ordinary shares to the former preference shareholders in their place and appropriating the amount of the reduction of capital to pay up the nominal value of the new shares;[95] by the company purchasing the preference shares for cash under its statutory power to effect off market purchases and the preference shareholders subscribing for new ordinary shares and paying for them with the purchase price;[96] or by a scheme of arrangement approved by meetings of all interested classes of shareholders and by the court.[97]

If the paid up capital in respect of the ordinary shares resulting from the exercise of conversion is to be greater than the capital paid up on their original shares, the difference may be provided by capitalising the company's undistributed profits or revenue reserves, but this may be done only if the company's articles

[93] Companies Act 2006, s. 617.

[94] *Re County Palatine Loan and Discount Co, Teasdale's Case* [1873] 9 Ch App 54.

[95] Companies Act 2006, s. 641 (3)(4)(5), Re St James' Court Estate Ltd [1944] Ch 6.

[96] Companies Act 2006, s. 690 and s. 694.

[97] Companies Act 2006, s. 895 (2).

expressly so provide. This option for the preference shares can be attractive when common shares are publicly traded, so that an active market exists for the conversion securities.

The company can also make the preference shares redeemable at a future date. This type of shares appeared in England granted to companies under s. 46 of the CA 1929, a provision introduced following the recommendations of the Greene Committee.[98] The use of redeemable preference shares increased due to their advantages. First, they allow a company to raise short-term capital while enjoying the benefits of a relational contract. Second, they ensure that any loss of control resulting from an issue of shares to outsiders is only temporary. However, since their existence these peculiar shares have sparked many doctrinal debates on the nature of the obligation to redeem them at a fixed time and on the coordination of these securities with the set of guidelines of maintenance of capital and with the prohibition against a company to purchase its own shares.[99] Despite of the distrust at that time on the utility of this tool, in 1948, the power to issue redeemable preference shares was given to companies by s. 58 of the CA, which reproduced with certain amendments the section of the previous Act.[100] Later, s. 159 in the 1981 Act extended this possibility for both private and public companies to all the categories of shares.[101] Thus, all the shares are now potentially redeemable either by initial agreement on issue or by subsequent agreement to purchase. This new authority has to be seen in the context of ss. 658-676 (ss. 162-169 before in CA 1985) which allow companies, subject to certain procedures, to purchase their own shares and sometimes to hold those shares as treasury shares. Generally, the preference shares are issued as redeemable shares either at a set date or event, or at the option either of the company or the shareholder. The date or dates for redemption of the shares will commonly equate with the investors usual requirements for the payment of a

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[98] 1926 Cmnd 2657, para. 28 where the Greene Committee commented redeemable preference shares "would prove useful in certain cases" and should be given, "provided that proper safeguards are adopted".

[99] *Trevor v. Whitworth* (1887) 12 App. Cas. 409. For a discussion see Gower L.C.B., *Principles of Modern Company Law* (4th ed. London: Stevens & sons, 1979), 413.

[100] 1945 Cmnd 6659 where the Cohen Committee that concluded proper safeguards were particularly necessary to protect creditors from the potential harm arising from the erosion of the doctrine of capital maintenance.

[101] For a quick comparative *excursus* see Stocks T.E., *Corporate Finance: Law and Practice* (London, 1992) 17 ff.

commercial loan.[102] The redeemed shares must be fully paid and the terms in the articles must provide for payment on redemption. These requirements apply equally for companies purchasing their own shares.[103]

The power of a company to issue redeemable shares, provided it is authorised to do so by its articles, is now contained in s. 684 of the CA 2006. No redeemable shares may be issued at a time when there are no issued share of the company which are not redeemable,[104] obviously in order to avoid the result of a company being left with no share capital following the redemption of the shares. The modalities of redemption have been, since their introduction, a matter of some dispute among the doctrine because it was unclear whether the company's articles could give a measure of discretion to the directors with regards to the detailed aspects of the redemption, such as the redemption price and the date of redemption or whether it requires those details to be set out specifically in the articles.[105]

The debate seemed to subside when the British Parliament introduced s. 133 in CA 1989, delegating to the directors the power to fix the redemption date and allowing the redemption price to be determined in accordance with a formula specified in the company's articles as an alternative to specifying a firm redemption price in the articles. However, the requirements of including a redemption date or a period in the articles created some difficulties and critics, because it precluded shares being issued on terms that they were redeemable at the option of the company and / or the holder as contemplated by the CA 1985 or as being redeemable as a result of specified events. Furthermore, these requirements had adverse capital adequacy implications for banks and for private companies whose shares were not actively traded because it could be difficult to devise a viable formula that did not require a measure of discretionary judgement from its auditors or other valuers as to the value

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[102] Stedman G. and Jones J., *Shareholders' Agreement* (Sweet & Maxwell, 1990) 18.

[103] As modified by the Companies (Acquisition of Own shares) (Treasury Shares) Regulation 2003, SI 2003/1116, reg. 2(1), (3) as from December 2003.

[104] s. 684 (4) of the CA 2006.

[105] This idea was also strengthened by some analogy in Australian law, where a provision similar to the English one has been interpreted as permitting the articles to provide for delegation to the directors: *TNT Australia Pty v Normandy Resources NL* [1990] 1 ACSR 1, SA SC; see this and other cases in Hill J., 'Preference Shares' in Austin and Vann (eds), *The Law of Public Company Finance* (Law Book Company, Sydney 1986), 143-153. In the U.S.A., in order to avoid expensive amendments to the articles of incorporation, a number of states authorised the creation of "blank shares" namely shares containing no financial terms at all but delegating the board of directors to designate them. See recently *Siegman v. Palomar Medical Technologies,* [1998] WL 118201 Del. Ch.

of the shares. The Company Act 2006 clarifies the position in favour of a flexible approach.[106] Therefore, s. 685 permits the directors to "determine the terms, conditions and manner of redemption of shares if they are authorised to do so by the company's articles or by a resolution of a company".[107] The current approach can then be summarised as the requirement to provide the terms and manner of redemption in the articles with a cautious approach for what concerns the level of details to include according to Article 39 of the Second Directive.[108] However, such provision can also be inserted at a later date from the time when the shares are issued. It is not essential to specify a redemption date or period, and it seems possible to include in the articles the possibility to redeem the shares at any time at the option of the company and / or the holder or after the occurrence of specified events.[109]

Detailed rules apply to the financing of redemption. Apart for private companies for which an exception applies,[110] redeemable shares can be redeemed only out of distributable profits or out of the proceeds of a fresh issue of shares made for the purpose.[111] It is also usual to expect the company to pay a premium on redemption and this premium sometimes varies with the date of redemption, decreasing in value with the passing of time. The financial terms of redeemable shares may include a provision for the payment of a redemption premium, that is, an amount greater than the par value of the shares. Redemption premiums must be paid out of distributable profits[112], except that in respect of redeemable shares which were issued at a premium, where any premium payable on redemption may be paid out of the proceeds of a fresh issue of shares, but in this case a redemption premium may not exceed the lesser of the aggregate amount of share premiums received by the

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[106] In 1993, the Company Law Review (CLR) proposed to remove the requirement and instead to require companies, after the event to include this information in the return which companies are required to make to the Registrar. See, *Company Law Review: Terms and Manner of Redemption of Redeemable Shares. Sections 159A and 160 (3) of the Companies Act 1985,* DTI Consultative Document.

[107] Company Act 2006, s 685(1).

[108] Second Council Directive 77/91/EEC of 13 December 1976.

[109] Ferran E., *Principles of corporate finance law* (Oxford University Press, 2008) 157-58 and 227; Burgess R., *Corporate Finance Law* (London, 1992) 323.

[110] Companies Act 2006 s. 709 ch 5

[111] Ibid, s. 687 (2). See *Quayle Munro Ltd, Petitioners*, [1991] S.L.T. 723, I.H.

[112] Ibid, s. 687 (3).

company on the issue of the redeemable shares and the amount credited to the company's share premium account at the date of the redemption (including share premiums paid as part of the proceeds of the fresh issue of shares).[113]

Normally, on redemption the preference shares are cancelled and the issued share capital reduced by their nominal amount, or when redeemed out of the proceeds of a fresh issue the capital yardstick will be maintained as a result of the issue.[114] In any case, they cannot be held as treasury shares.[115] Sometimes, where no fresh issue of shares for the purposes of redemption is contemplated, the requirement that capital be repaid from profits may be inhibiting for an issuing company. It may be difficult for the company to find sufficient profits for both payment of dividends and redemption. Issuing preference shares at a premium can solve this problem. However, in order to avoid unlawful repayments of the company's assets to the shareholders[116] and to protect creditors, a provision in s. 733 of the CA 2006 provides that when redeemable shares are redeemed out of assets representing a company's distributable profits, the amount by which the company's issued share capital is thereby diminished must be transferred from profits or revenue reserves to a special capital reserve called "the capital redemption reserve".[117] This reserve can be reduced only in the same way as paid up share capital.[118] The amount credited in this special reserve replaces the aggregate nominal values of the redeemed shares and the transfer from profits or revenue reserves makes the amount transferred unavailable for distribution of dividends.[119] However, it is possible for this amount credited to capital redemption reserve to be converted into share capital by the company using it to pay up the nominal value of the new fully paid shares to be issued as bonus share.[120]

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[113] Ibid, s. 687 (4).

[114] Ibid, s. 687 (5).

[115] Ibid, s. 688 CA 2006.

[116] See, for instance, *Dimbula Valley (Ceylon) Tea Co. v Laurie* [1961] Ch. 353; *Re New Zealand Flock & Textile Ltd* [1976] 1 N.Z.L.R. 192; *Blackburn v Industrial Equity* [1977] 2 A.C.L.R. 421; [1977] 3 A.C.L.R. 89.

[117] CA 2006, s. 733 ss 1-4.

[118] CA 2006, s. 733 ss 5-6.

[119] CA 2006, s. 734.

[120] At general law the prohibition not to allot shares at a discount s. 580 and the exceptions at ss. 586, 587, 593 of the CA 2006 see *Ooregum Gold Mining Co. of India v Roper* [1892] A.C. 125. For an analysis of the main debate regarding the so called "nimble dividends" see for all, Hill J., 'Preference

1.2.3.1. Failure to redeem

It is s. 735 of the CA 2006 that deals with the consequences of failure to redeem preference shares by the due date. However, prior to the 1981 Act, which introduced that provision, the question of failing to redeem had been surprisingly uncertain. There were basically two main perspectives. On the one hand, the agreement to redeem between the parties was considered as not being compulsory because it is not a contractual obligation arising from a debtor-creditor relationship but is simply a shareholders' expectation as others. Therefore, the shareholder could not sue the company for the redemption moneys as a debt owing. At an extreme point, what has sometimes even been put forward is that upon the passing of the date for redemption the shares cease to be redeemable and the shareholder has no right whatever to insist on redemption. On the other hand, it was said that shareholders had a contractual right to redemption and although redeemable preference shareholders could not enforce it by a mandatory injunction, the failure to redeem might surely justify winding up of the company or the granting of an injunction to prevent payment of dividends to ordinary shareholders until redemption of preference shares had taken place.[121] That argument had to be viewed in light of the rules governing the method of redemption in the CA.[122] Thus, if no funds specified under this section were available to redeem the shares there would be no default by the company in failing to redeem and no contractual rights which the shareholder could enforce. Moreover, although a winding up order in favour of the preference shareholders might in certain circumstances be appropriate, it could not be based on any breach of contract, but simply on the general principles under the "just and equitable" ground. In this direction a further possible source of relief for the shareholder, whether or not the nature of the redemption clause was contractual, would have been an action under s. 994 on the basis that the failure to redeem was "unfairly prejudicial to the interests"

Shares' in Austin and Vann (eds), *The Law of Public Company Finance* (Law Book Company, Sydney 1986), 155.

[121] Morse G., *Palmer's Company Law* (London, vol. 1, 2004) para. 6.027.

[122] Now s. 684 CA 2006 (before s. 159 CA 1985).

of the preference shareholders. The court would have had sufficiently broad powers to make an order requiring the company to redeem the shares.[123]

The uncertainty regarding what the remedies of a shareholder are if the company fail to redeem or purchase his shares and what happens if the company goes into liquidation before the shares have been redeemed or purchased was clarified by s. 735. Accordingly, the company is not liable for damages in respect of any failure on its part to redeem or purchase.[124] However, the shareholder shall retain any other right to sue the company but the court shall not grant an order for specific performance "if the company shows that it is unable to meet the costs of redeeming or purchasing the shares in question out of distributable profits".[125] In the case of liquidation of the company, when "at the commencement of the winding up any of the shares have not been redeemed or purchased, the terms of redemption or purchase may then be enforced against the company and when the shares are accordingly redeemed or purchased, they are cancelled".[126] The investor seller will change his position in the company from member to creditor. However, this does not apply if the terms of redemption or purchase provided for performance to take place at a date later than that of the commencement of the winding up or if during the period beginning with the date when redemption or purchase was to take place and ending with the commencement of the winding up, the company did not have distributable profits equal in value to the redemption or purchase price.[127] Of course, the shareholder will gain little or nothing by enforcing the contract if the winding up is an insolvent liquidation because his claim in respect of the purchase price is postponed to the claims of all the creditors and all the other shareholders whose shares carry rights to capital or dividend which are preferred to the rights as to capital of the shares to be redeemed or purchased.[128]

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[123] See *Re Holders Investment Trust,* [1971] 1 W.L.R. 583, 2 All E.R. 289.

[124] Companies Act 2006 s. 735(2).

[125] *Ibid*. s. 735(3). The provision does not protect the company against paying damages in all cases as a result of its failure to redeem, see *British & Commonwealth Holdings Plc v. Barclays Bank Plc* [1996] 1 W.L.R.J., CA.

[126] Companies Act 2006 s. 735(4).

[127] Ibid. s.735(5).

[128] Ibid. s.735(6).

The vulnerability of the redeemable preference shareholders, particularly regarding receipt of dividends and redemption of shares, has been reduced by the introduction of ancillary safeguards. A typical redeemable preference share issue includes a so-called "put option". According to it, the parent company of the issuer enters into an agreement to purchase the shares from the investor in certain specified circumstances, the most important being default by the issuer in dividend payments or in repayment upon redemption. Many other occurrences may threaten the security of the preference shareholder and thus the list of triggering events in the purchase agreement may be long, covering matters such as reduction of capital by the issuer, allotment of equal or prior ranking shares, and changes to income tax law. As the name implies, the requirement to purchase the shares does not automatically arise; it will depend on an election by the investor to enforce it. This will usually be done by requiring that the investor make a purchase request within a certain period of becoming aware of the occurrence of the triggering event.[129] The consideration for the parent company's promise to purchase is the investor's promise to take up shares in the issuing company, obviously, the put option agreement must therefore be entered into before or at the same time as the contract of allotment. Otherwise the consideration would be past consideration and the promise in the put option would not be binding.[130]

A further clause is commonly included in the terms of a redeemable preference share issue whereby, if the company fails or is unable to redeem on the redemption date, a specified percentage of the holders of the preference shares may elect to have the company apply, from time to time, any money permissible towards redemption until full repayment has occurred. Only at this time will the shares be redeemed. Moreover, in order to avoid any doubt on whether the preference shareholders, acting in this way, preclude themselves from relying on failure to redeem to bring

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[129] See Hill J., 'Preference Shares' in Austin and Vann (eds), *The Law of Public Company Finance* (Law Book Company, Sydney 1986), 144 where she says that the correct analysis of this arrangement should be seen in the decision *United Dominions Trust (Commercial) Ltd v. Eagle Aircraft Services Ltd,* [1968], 1, W.L.R. at 74, where it would appear to be that a unilateral contract exists whereby the parent makes an irrevocable offer to the investor which will become enforceable upon the fulfilment of the conditions precedent of triggering event and notification. On this analysis, the investor has no right to call on the parent to purchase the shares unless there is strict compliance with the notification requirement.

[130] Triantis A.J. and G.G. Triantis, 'Conversion rights and the design of financial contracts', 72 *Wash. U. L. Q.*, 1994, 1240 ff.

into operation the put option,[131] they may explicitly write this clause to be "without prejudice" to the company's obligation to redeem on the redemption date. This wise precaution can be very useful for a preference shareholder, because assuming that the failure to redeem were construed as a continuing default, it would therefore seem that the shareholder could activate the put option at any later time. Finally, the position of the shareholder can be further fortified by the issue of a letter of credit by a bank that secures the performance by the parent of its obligations under the purchase agreement. The bank, in granting this facility, will usually require that security be given, often in the form of charges over the property of the parent company. There are many possible permutations of this basic structure. The terms of issue of the shares can contain various indemnities protecting the shareholders from, for example, detrimental changes to income tax law and other problems arisen by the hybrid characterisation of such a transaction.[132]

1.3. Elements of convertible obligations

The history of convertible bonds goes back to the beginning of the nineteenth century. At that time transport routes with railway lines were financing their investment needs. In England, as a consequence of the South Sea Company and other fraudulent issues, a strict legislation was introduced that severely limited stock promotions. However, the need for fresh finance to build the canals and railroads in the nineteenth century eventually restored public acceptance of business corporations and trading in market securities became the primary activity. This resulted in the establishment of the London Stock Exchange in 1802 and the repeal of the legislation in 1825.[133] So important did the London market become to the railroad promoters of the Middle Atlantic and Southern states that they, following the

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[131] See Hill, 1986, note 194, at 164. It is not clear whether the preference shareholders merely waive a right to redemption on a particular date, which can be reinstated by the giving of reasonable notice or rather impose a new obligation on the issuer precluding themselves from relying on the failure to redeem to activate the put option.

[132] See Dawson K., Option agreements, 18(5) *Comp. Law.* 1997, 152; Ferran E., *Company Law and Corporate finance* (Oxford University Press, 1999) 391.

[133] Morgan V.E. and Thomas W. A., *The Stock Exchange, Its History and Functions* (Elek Books, London, 1962) 16.

example of the states governments, began to issue their bonds in sterling denominations with the interest and principal payable in London.[134]

While in densely populated England and New England, local resources were sufficient to enable the early railroads to use mostly equity financing, the railroads constructed in the western United States raising funds in the British financial market were largely debt-financed.[135] US railroads tended to raise debt finance for two main reasons. *In primis*, because the importance of American railroad finance involved huge sums and only equity was not sufficient. Second, since these projects needed to seek funds from distant regions, in which the investors were poorly informed about the project's duration and its related developments, debt securities, being the safest channel to invest in a corporation's business, were considered the best mean to obtain finance.[136]

However, at that time, the greater asymmetry of information between the investors and the companies made even debt finance problematical. Financial institutions had to be invented to make "trading on equity" feasible. Generally, as long as the payment of interests and principal are guaranteed, a corporate debt security can be priced accurately. However, the evaluation of debt finance was complicated by the uncertainty and high risk perceived by the investors. In order to reduce it, in 1836, an order of English Parliament introduced a capital ratio equity-debt of one-third for companies and conditioned borrowing to the full payment of at least one-half of share capital.[137] This policy of limiting leverage may have made corporate debt securities more marketable, but also restricted possible benefits. The most prevalent technique of reducing perceived risk was therefore through liens.[138] When the debt security was issued as a debenture, but not only, it was most likely made convertible into a share of the company. The equity option was considered an

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[134] Chandler A., 'Patterns of American Railroad Finance', 28 *Business History Review,* 1954, 248-263.

[135] Cleveland F.A. and Powell F.W., *Railroad Promotion and Capitalization in the United States* (Ayer Publishing, 1909) 50-51; Dewing A.S., *The Financial Policy of Corporations* (New York: Ronald Press Co. 2nd ed., 1919) 64 and Ripley W.Z., *Railroads: Finance & Organizations* (New York Longmans, Green and Co. 1915, reprinted 2000 by Beard Books) 105.

[136] Baskin J.B., 'The Development of Corporate. Financial Markets in Britain and the United States, 1600-1914: Overcoming Asymmetric. Information', 62 *Business History Review*, 1988, 199-237.

[137] Ripley, 2000, note 200, at 116.

[138] As of 1913, 90 per cent of the funded railroad debt in the US ($11.2 billion) was backed by some type of mortgage and only 10 per cent consisted of debentures, see Ripley, 2000, note above, at 139.

acceptable compensation for the increased risk due to the absence of liens.[139] Two of the three largest privately financed roads, the Reading and the Camden and Amboy, shortly after they began construction, floated twenty-year and thirty-year sterling bond issues secured by mortgages on the road's property and convertible to stock at the holder's option. The long-term convertible mortgage bond initiated here was to remain throughout the nineteenth century the standard type of American railroad bond.[140]

A convertible obligation may be defined as a corporate obligation to pay money that includes a stipulation granting to the holder at his election the privilege of requiring the debtor corporation to deliver shares of stock in place of payment of the debt. The privilege granted to the holder of a convertible obligation is an option separate from the corporate obligation to pay the money and its invalidity will not affect it.[141] For investors, this future claim gives convertible bonds the advantage of combining desirable features of straight bonds, such as fixed income payments and principal repayment, with the upside potential of common stock.[142]

In consideration of the conversion privilege, which gives bondholder the right to convert the bond into the issuer's (or guarantor's) equity, an investor is prepared to accept a lower interest rate. Thus, a convertible bond is usually issued with a lower coupon than that payable on a comparable straight bond of the same issuer in the same currency. The coupon or interest rate payable on the bond is, however, fixed at a premium over the current dividend yield of the underlying shares so as to make the convertible an attractive investment when compared with purchasing the underlying equity. In exchange for the future equity claim, bondholders customarily also accept a subordinated status in the priority list of claims of the firm and not to

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[139] See also Cleveland and Powell, 1909, note 200 above, at 156-64.

[140] Chandler, 1954, note 199 above, at 248-263.

[141] Dewing A. S., *A Study of Corporation Securities: Their Nature and Uses in Finance* (New York: Ronald Press Co., 1934) 621 where the Author speaking of convertible bonds states "[…] But these partake largely of the nature of stocks, since they are issued with the hope that the holder will become a partner and not a creditor, if the enterprise can in the future be made to appear sufficiently attractive. They stand for an indirect method of increasing the stock or of creating an artificial market for the bonds by attaching to them a speculative element which is foreign to the fundamental conception of funded debt". Johnson C.J. and Mc Laughling J., *Corporate Finance and the Securities Laws* (New York, 1997) 697 ff.; Gower L.C.B., *Principles of Modern Company Law* (4th ed. London: Stevens & sons, 1979), 413; Magnus S.W. and Estrin M., *Companies Law and Practice* (London, 1978) 101; Berle A., *Studies in the Law of Corporate Finance* (Chicago: Callaghan & Co. 1928) 130.

[142] Bratton W.W., 'The Economics and Jurisprudence of Convertible Bonds', 1984 *Wis. L. Rev.*, 673.

impose restrictive covenants to the firm. To issuers, these concessions give convertibles advantages over straight debt, such as cost savings, increased future capacity to incur senior debt and greater flexibility to advance the interests of the common stockholders.[143]

In order to measure the conversion privilege included in a convertible bond, it becomes essential to break it down into its elements: its debt value, its conversion value and its conversion premium. Its "debt value" is the value of an equivalent straight bond with the same coupon rate. This value is sensitive to the variables dominant in straight bond valuation, such as interest rate levels and the issuer's equity cushion. The price at which the convertible bondholder may subscribe to shares in the issuer or guarantor is its "conversion price". This price is usually higher than the prevailing market price for the shares at the date of the bond issue. If the conversion price is a constant, conversion value, which the amount is resulting by multiplying the conversion price by the number of shares the bondholder receives upon conversion (conversion ratio), varies with any change in price of the underlying common stock. The terms and conditions of the bonds will prescribe the mechanics of conversion and provide that the number of shares into which the bond converts will be equal to the denomination of the bond divided by the conversion price. For example, if a bond of £1,000 denomination is convertible into shares with a conversion price of £2 per share, 500 shares will be issued to the bondholder on conversion. Effectively, the debt represented by the bond will be released through the issue of such shares.[144]

The bondholder's investment in a fixed rate convertible bond is also protected against an upward movement in interest rates, which would usually depress bond value, due to the equity cushion in the form of the conversion privilege. Even if interest rates rise well above the rate payable on the convertible, the value of a convertible may not fall or fall as much as ordinary bonds, because investors would regard the convertible feature as adequate compensation for lower interest rates. In such events, arbitrage possibilities would prevent the bond from selling below the lower of debt or conversion value. The investor stands to lose only where interest

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[143] Klein W.A., The Convertible Bond: A Peculiar Package, 123 *U. Pa. L. Rev.,* 1975, 547-573.

[144] Bratton W., *Corporate Finance, Cases and Materials* (5th ed., New York, 2003) 420; Ferran E., *Principles of corporate finance law* (Oxford University Press, 2008) 520-522.

rates rise well above the convertible coupon and at the same time the stock price of the issuer does not rise above the conversion price. Of course, the optimal gain to an investor would occur if the issuer's stock price rises well above the conversion price specified in the bond at a time prior to final redemption. The amount by which market value exceeds debt or conversion value is called "conversion premium". In convertible bonds issuer the "conversion premium" is usually around 5 to 25 per cent above current share value.[145]

The period during which a bondholder may exercise his conversion privilege usually commences at the end of the 40-day period after completion of distribution and continues until a date just prior to any date fixed for redemption of the bonds.[146] In practice, however, a bondholder would not wish to convert his bond into equity until the shares market price has exceeded the conversion price specified in the bond instrument, otherwise he would be subscribing shares at a price higher than their market price. On the other hand, a call option may be conferred on the issuer in convertible bonds, giving the company a right to redeem the bonds prior to the final maturity date. An issuer would usually wish to redeem the convertible bonds outstanding if interest rates moved significantly below the rate payable on the convertible. Such a right of redemption is also a mechanism whereby an issuer can force the bondholder to convert and exercise the conversion privilege, since the redemption of the bonds results in the extinction of the conversion privilege. Ideally, the issuer would wish bondholders to convert soon after the market price for the issuer's ordinary shares or conversion stock is at a level above the conversion price specified in the bond instrument.

1.4. Debt holding restrictive covenants and veto rights

It is already known the dependence of the corporate sector on debt. Since debt characteristics assign the creditor defined contractual rights against the

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[145] *See* Katzin J.S., 'Financial and Legal Problems in the use of Convertible Securities', *Business Lawyer*, January 1969, 359-361 says that in the US domestic market the premium was around 10% to 20%; McCormick R. and Creamer H., *Hybrid Corporate Securities: International Legal Aspects,* (London, Sweet & Maxwell, 1987), 4 place the premium between 5% and 25% in the international markets in London.

[146] See Wood P., 'International Convertible Bond Issues', 12 *JIBL*, 1986, 69.

company, providers of debt are in a position to play a significant role in corporate governance by monitoring managers and pressurising them to fulfil their obligations. Generally, the larger is the part financed by debt, the more control and pressure on the management the debt-holders will exert and this will be useful for the shareholders too.[147] The extent to which bondholders can perform or would choose to perform the function of monitoring or controlling management will depend on the size of the loan, its intended duration, whether or not it is secured and above all which kind of covenants are included in the terms of issue of their securities. The practice of financial contract design has a long tradition in UK. Loan covenants were commonly used by early UK and US commercial banks, which were usually structured as joint-stock companies. At that time, banks operated in markets characterised by a high information asymmetry. In order to reduce the risk of default, lenders must create information about the borrowers. Early banks created information by probing the applicant's credit history and current financial condition, by evaluating the flow of funds through the borrower's checking account and by negotiating restrictive covenants specifying the users to which a particular loan would be put. Therefore, covenants allow financial institutions and financiers a say in the way that borrowing companies conduct their affairs and provide them with the leverage to renegotiate for yet more stringent control of borrowers in financial difficulties. The spirit of covenants is to prevent the managers from taking actions that benefit stockholders at the expense of bondholders. This aim is pursued by dealing with three main areas of concern for banks and investors: liquidity, the long-term risk of a borrower getting into financial difficulty and management.[148]

These obligations are usually more frequent and stringent when the lender is taking a large exposure. A lender, which is advancing a relatively small amount, may attach less importance to covenants.[149] When the counterpart is composed of a pool of creditors, a large syndicate generally reduces the incentive for each investor to

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[147] In general, see Triantis G.G. and R.J. Daniels, 'The Role of Debt in Interactive Corporate Governance', 83 *California Law Review*, 1995, 1073; Cheffins B., *Company Law: Theory, Structure and Operation* (Oxford: Clarendon Press, 1997) 75-79; Ferran E., *Company Law and Corporate finance* (Oxford University Press, 1999) 480 ff.

[148] Wood P., *International Loans, Bonds and Securities Regulation* (Sweet & Maxwell, 1995) 32.

[149] Day J. and P. Taylor, 'Evidence on the Practice of UK Bankers in Contracting for Medium-Term Debt', 9 *JIBL*, 1995, 394; Day J. and P. Taylor, 'Bankers' perspectives on the Role of Covenants in Debt Contracts', 5 *Journal of International Banking Law*, 1996, 201 ff.

monitor decisions and increases haggling and coordination costs.[150] The negotiating strength of the borrowing company and the nature of its business are also relevant considerations. A small company, which has limited access to other sources of finance, may have no commercial alternative but to accept short-term finance or funds which are subject to detailed restrictive covenants, while a large and well-established company with a good credit rating and many available borrowing options may contract better and more flexible conditions in their loans.[151]

However, even if a borrower would be willing to accept severe restrictions or, perhaps more accurately, lack the negotiating strength to resist them, a lender might hesitate to impose them. In fact, if a covenant is unduly onerous so that management is required to retain more of the company's profits than it can prudently invest, this could result in investments being made in risky ventures with potentially adverse consequences for both lenders and shareholders.[152] This issue has generated concern between both academics and practitioners, especially in relation to the drafting of terms attached to publicly issued debt securities.[153] The potential difficulties arise most sharply in that context because, if the terms originally drafted prove to be too restrictive, the process of obtaining a relaxation may be particularly cumbersome, time-consuming and expensive as it may require the convening of a special meeting of the holders of the securities for that purpose.[154] Furthermore,

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[150] Rajan R.G.. and A. Winton., 'Covenants and Collateral as Incentives to. Monitor', 50 *The Journal of Finance*, 1995, 1113-1146.

[151] Normally, "bank power tends to be inversely related to borrower size, because the latter is closely correlated with credit rating and available borrowing options" see Herman E.S., *Corporate Control, Corporate Power* (New York, Cambridge University Press, 1981) 122; see also Lomax D., 'The Role of Banks', in N. Dimsdale and M. Prevezer eds., *Capital Markets and Corporate Governance,* 1994, at 161, 173-177 outlining differences in a clearing bank's relationships with small and larger businesses.

[152] Lister R., Debenture Covenants and Corporate value, 6 *Co Law*, 1985, 209 and 213; Sappideen R., 'Fiduciary Obligations to Corporate Creditors', *JBL*, 1991, at 365 and 378.

[153] In the United States the work of the American Bar Foundation in sponsoring the development of standardised forms of debenture indentures (an indenture being the contract entered into between the issuing company and the holders of securities) has provided a focus for this debate: see Brudney V., and Bratton W.W., *Brudney and Chirelstein's Corporate Finance* (4th ed. Foundation Press 1993) 187-193. For an economic analysis of covenants see Smith C.W. and J.B. Warner, 'On Financial Contracting: An Analysis of Bond Covenants', 7 *Journal of Financial Economics*, 1979, 117.

[154] Accordingly, covenants in bank loans are traditionally more restrictive than in bond issue, see Wood P., *International Loans, Bonds, Guarantees, Legal Opinions*, (Sweet & Maxwell, 2007) 137 where he says that the relaxation process, either by way of the banks consenting to occasional transactions or by way of a formal variation to the contractual terms, may be relatively straightforward. However, it has to be remembered, in order not to oversimplify, that a

managers are especially likely to resist restriction of discretion to make investments. Accordingly, these covenants are likely to appear only in private placements and institutional investors' venture capital and private equity transactions in which the lender has substantial contracting power as, for instance, in venture capital.[155]

In the common practice of business covenants, a formal distinction can be made between affirmative and negative promises or between borrower's promises to do and borrower's promises to refrain from doing. Positive covenants concern the promise of the borrower to make periodic informational reports, to comply with law, maintain its franchises, insure and maintain its properties, and pay all properly assessed taxes. These covenants are useful because allow bondholders to monitor their investment. However, they do not change the debt nature of the security, because none of them materially constrains management's discretion to operate the business, which is still prerogative of the controlling shareholders. In contrast, negative covenants oblige the borrower not to do certain operations, in order not to put its financial position at risk and in this way, they can significantly drive the business decisions-making by managers. In other words, whereas positive covenants are about information, negative covenants are about control. The longer is the list of prohibited outcomes, the stronger the control. At some point, the magnitude of control may become as great as to give the lender effective control of the firm.[156]

Negative covenants can further be divided into occurrence-based versus maintenance-based covenants. Covenants for high yield loans will typically be occurrence-based that means the issuer can only undertake certain actions, such as raising additional debt or selling assets, if the action contemplated will not result in it breaching certain financial ratio tests at that time. These may include leverage ratio

syndicated loan involving a number of lending banks could give rise to administrative difficulties similar to, if not as severe as, those which could be encountered in the context of debt securities.

[155] Bratton W.W., 'Bond Covenants and Creditor Protection: Economics and Law, Theory and Practice, Substance and Process', 7 *EBOR*, 2006, 48. For empirical data, see Kaplan S.N. and P. Strömberg, 'Financial contracting meets the real world: an empirical analysis of venture capital contracts', 70 *Review of Economic Studies*, 2003, 281-316.

[156] Bratton W.W., 'Bond Covenants and Creditor Protection: Economics and Law, Theory and Practice, Substance and Process', 7 *EBOR*, 2006, 49; Amihud Y., K. Garbade and M. Kahan, 'A New Corporate Structure for Corporate Bonds', 51 *Stan. L. Rev.*, 1998, 462 ff.; Bratton W.W., 2006, note above, 51 ff.; Smith C.W. and J.B. Warner, 'On Financial Contracting: An Analysis of Bond Covenants', 7 *Journal of Financial Economics*, 1979, 124; McDaniel M., 'Bondholders and Corporate Governance', 41 *Business Lawyer*, 1986, 423; Day J. and P. Taylor, 'Bankers' perspectives on the Role of Covenants in Debt Contracts', 5 *Journal of International Banking Law*, 1996, 201 ff.

tests as, for instance, the debt/total capitalisation ratio or the debt/EBITDA ratio and coverage tests as, for instance, the EBITDA/interest ratio. Conversely, bank credit and private placement note purchase agreements usually contain restrictive maintenance-based covenants that are tested quarterly or semi-annually. Non-compliance with such tests would typically constitute an event of default even if the issuer had not borrowed another penny since the original debt issuance.[157]

An extreme application of negative restrictive covenants comes from the use of veto rights as a protective provision often attached to preference shares in venture capital financing. These clauses give the investors a right to oppose unfair company's actions carried on against their interests. However, the scope of these provisions differs from company to company. Veto rights are generally employed by venture capital investors in order to avoid claim dilution in situations in which the risk supported by them is disproportionate vis-à-vis their return. Accordingly, they allow the investors to oppose the completion of a firm's recapitalization through the issuance of new securities involving the entry of a new investor, if the subscription price is considered to be too low compared to the real share price or the presumed share price.[158] These covenants are also frequently used in the context of an exit event, a sale of all or substantially all of the company's assets, a merger or other important corporate transactions. For instance, in IPOs, if the financier considers unacceptably low the price per share proposed for the listing, he or she may benefit from a right to veto and block the transaction by refusing to convert the preference shares into common shares.[159]

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[157] These covenants can also be used as early warning signs of a financial deterioration of the business.

[158] *See* Mann R.A. et al., Starting From Scratch: A Lawyer's Guide to Representing a Start-up Company*,* 56 *ARK. L. REV.*, 2004, 861-2.

[159] The preferred stock purchased by financiers will generally have a provision requiring the automatic conversion of preferred stock upon either an IPO at a pre-specified price per share or the requisite vote of preferred stockholders.

Chapter 2. Distinguishing between Equity and Debt

The starting point for any research in capital structure is the Modigliani-Miller theorem. It suggests that – under very strict and unrealistic assumptions – a company's capital structure does not matter. However, without doubt, a lot of energy is invested in finding the optimal capital structure for a given company in the real world. Theory explains this mainly by pointing towards the differing tax and regulatory treatment of debt and equity, respectively, as well as information asymmetries between creditors, shareholders and managers. However, once the conditions that underpin the M&M study on the optimal capital structure are relaxed,[160] the choice between financing assets with debt or equity becomes material, and *mutatis mutandis*, the classification of a financial instrument as either debt or equity. As far as classifications are concerned, accounting rules play an important role in the framework of corporate law. They are targeted to measure and classify the financial instruments issued by a company in order to reflect the desire for transparency between company and investors. Furthermore, regulatory bodies heavily rely on accounting numbers as control over regulations.

Accountants and tax authorities are dedicated to a dichotomous classification that has been considered the most suitable way to identify and then interpret certain results as the annual income and taxable results. Although in principle, a twofold distinction between equity and debt can appear quite straight forward because of their contrasting characteristics, it is in reality blurred by the existence of hybrid financial instruments, which consist in securities with a mix of both equity and debt features. Therefore, hybrids complicate the task of the regulators because they provide the users with an optimal tool of regulatory *arbitrage*.

2.1. Does capital structure matter?

During the years, the equity-debt trade off has animated many doctrinal discussions in relation to dividend policies, the optimal financial structure on investment choices, conflicts of interests arising between different claimants of future streams of returns

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[160] It means that markets are not perfect and efficient so taxes and bankruptcy costs exist as well as asymmetric information and borrowing costs.

and the management of the company, as well problems associated with the separation between ownership and control in a company.[161]

One strong argument against writing a thesis on the *Debt-Equity* distinction is the Modigliani & Miller theorem (M&M theorem), which demonstrates how the division between the two is irrelevant to the value of the firm and the doctrine on corporate finance should not concern itself with figuring out the perfect debt-equity ratio to maximize the shareholders' value. The theorem was published in 1958 and since then has been considered by many as the foundation of the modern corporate finance.[162]

In the study, Modigliani and Miller assumed several strict conditions. First, in their fictitious economy they assumed the absence of any costs of insolvency (bankruptcy costs) as well as the absence of any taxation imposed either at the firm level or at the individual level. Second, markets are efficient and perfect. The efficient markets assumption means that there is no asymmetric information between the managers and all market participants. Therefore, the prices on traded stocks, bonds or property already reflect all known information, and instantly change to reflect new information. The perfect markets assumption means that transaction costs do not exist and there are no barriers to exit or enter in the markets. Thus, all investors share homogeneous expectations about the future prices of securities and individuals can borrow at the same interest rate as corporations. Third, in this fictitious world there is no division of the stream between cash dividends and retained earnings in any period, because the management is presumed to be acting in the best interests of the stockholders. The issued shares are divided into "equivalent

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[161] See Davies P.L., *Gower and Davies' Principles of Modern Company Law* (Sweet and Maxwell, 8th ed. 2008) 815-820 and 1135-1148; Kershaw D., *Company Law in Context: Text and Materials* (OUP, 2009) 163 ff.; Farrar J.H. and Hanningan B.M., *Farrar's Company Law* (Butterwords, fourth ed., London, 1998) 158-160; Burgess R., *Corporate Finance Law* (London, 1992) 5-6; Stocks T.E., *Corporate Finance: Law and Practice* (London, 1992) 6; Hamilton R. W., *Corporations, Including Partnership and Limited Liability Companies, Cases and Materials* (St. Paul, Minn., 1998) 299; Klein W.A. and Coffee J.C. Jr., *Business Organization and Finance: Legal and Economic Principles* (New York, ninth ed. 2004) 7-11; McCormick R. and Creamer H., *Hybrid Corporate Securities: International Legal Aspects,* (London, Sweet & Maxwell, 1987), 2; but this opinion is supported since long time Dewing A.S., *The Financial Policy of Corporations* (New York: Ronald Press Co. 2nd ed., 1919) 34 and 78.

[162] See Modigliani F. and M. Miller, 'The Cost of Capital, Corporate Finance and Theory of Investment', 48 *The American Economic Review*, 1958, 261-275. The essay was modified in part later Modigliani F. and M. Miller, 'Corporate Income Taxes and The Cost of Capital: a Correction', *The American Economic Review*, 1963, 433-443, and reconsidered more recently by Miller M.H., 'Debt and Taxes', *The Journal of Finance,* 32(2) 1977, 261-275 and Miller M.H., 'The Modigliani Miller Propositions After Thirty Years', 4 *Journal of Economic Perspective*, 1988, 99.

return" classes that means that all the shares issued by any firm in the same class have the same return and the various shares within the same class differ, at most, by a "scale factor". In this way it is possible to classify firms into groups within which the shares of different firms are "homogeneous" or perfect substitutes for one another. At the same time, all bonds are assumed to yield a constant income per unit of time, are traded in a perfect market and are perfect substitutes for each other up to a "scale factor".[163]

Given those assumptions, the first and most famous proposition establishes a company capital structure does not matter because it is completely independent from the investment choices.[164] To support its thesis, the M&M theorem showed that as long as the relations between "market value" and "average cost of capital" did not hold between any pair of firms in a class, arbitrage could take place and restore the stated equalities simply because if an investor were to exploit an arbitrage opportunity and to acquire shares at a lower price, the value of the overpriced securities would fall and the under priced shares value would rise, eventually eliminating the discrepancy.

From the first proposition derives the second proposition that concerns the "rate of return" on ordinary shares in companies capitalized by debt. The second proposition establishes that gearing the firm does not increase the shareholder' return or reduce the cost of capital, because the cost of equity capital is a linear function of the debt-equity ratio.[165] Obviously, M&M theorem does not deny that a different composition of the financial structure could affect the expected rate of return of a company, but it shows that increasing the rate of return of the ordinary shares increases the amount of debt and consequently the financial risk, generating in a long-term investment a zero-sum game.

A conclusion for an optimal investment policy of the firm that summarises the M&M theorem is reported in their third proposition where they state that the

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[163] However, Stiglitz demonstrated that this third assumption is not essential, see Stiglitz J.E., 'A Re-Examination of the Modigliani-Miller Theorem', 59 *American Economic Review*, 1969, 784-793.

[164] See Modigliani F. and M. Miller, 'The Cost of Capital, Corporate Finance and Theory of Investment', 48 *The American Economic Review*, 1958, 268.

[165] See Modigliani F. and M. Miller, 1958, note above, 271 where the authors say *"the expected yield of a share of stock is equal to the appropriate capitalization rate p(k) for a pure equity stream in the class, plus a premium related to financial risk equal to the debt-to-equity ratio times the spread between p(k) and r".*

optimum ratio equity/debt is *completely unaffected by the type of security used to finance the investment*.[166] For the authors, firm value is determined by the size and riskiness of the cash-flows arising from the investments in risky projects. The underlying investment and operating decisions that determine corporate cash-flows are independent of financing decisions i.e. are unaffected, and therefore capital structure decisions will merely result in changing the distribution of these cash-flows between the different claimants. Capital structure decisions will, of course, alter shareholder's anticipated risk and returns but this will not have any impact on total firm value because in a perfect and complete capital market, investors can profit without cost from any market mispricing via the application of "home-made leverage", namely the arbitrage effect.

Subsequently in a following study, Miller and Modigliani first and Miller then observed the same scenario relaxing the no taxation assumption. Due to the preferential treatment of debt relative to equity in tax law, the optimal capital structure can be complete debt finance. However, although a firm could generate higher after-tax income by increasing the debt-equity ratio and thus higher pay-out to stockholders and bondholders, the value of the firm need not increase. The explanation for it is that while debt lowers the firm's cost of capital because passive interests are tax deductible, it rises the level of taxation to individual investors, because for an investor taxes are higher on interest payments than on equity returns. The disproportion in taxation resulting from a cheaper tax rate on dividends and capital gains than on interest at the investor level, eliminates or partly offset the tax advantage of debt finance to the firm.[167] Company will persuade the market investors to hold debt instead of shares as long as the corporate tax saving is greater than their personal tax loss.[168]

The fundamental contribution of the M&M Theory is that it structures the

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[166] See Modigliani F. and M. Miller, 'The Cost of Capital, Corporate Finance and Theory of Investment', 48 *The American Economic Review*, 1958, 288.

[167] Miller M.H., 'Debt and Taxes', *The Journal of Finance,* 32(2) 1977, 269 and 270, where the author says the value of the firm in equilibrium will be independent of its capital structure but "there would be no optimum debt-equity ratio for any individual firm".

[168] Farrar D. and L. Selwyn, Taxes, Corporate Financial Policy and Return to Investors. 20(4) *National Tax Journal*, 444-454; Myers S.C., 'Taxes, Corporate Policy and Returns to investors: Comment', 20(4) *National Tax Journal*, 1967, 455-462; Myers S.C., 'Capital Structure', 15(2) *The Journal of Economic Perspectives,* 2001, 87-88; Stapleton R.C., 'Taxes, the Cost of Capital and the Theory of Investment', 82 *The Economic Journal,* 1972, 1273-92; Stiglitz J.E., 'Taxation, Corporate Financial Policy and the Cost of Capital', 2(1) *Journal of Public Economics*, 1973, 1-34.

debate on why irrelevance of the financial structure fails around the theorem's assumptions, i.e. neutral taxes, no transaction costs, asset trade restrictions or bankruptcy costs; symmetric access to credit markets, symmetric information and firm financial policy. So doing, the theorem identifies exactly where to look for determinants of optimal capital structure and how those factors might affect capital structure.[169] With regards to firm capital structure, the Theorem opened a host of literature on the fundamental nature of debt versus equity. The doctrine has been debating whether and in which ways the distinctions between debt and equity, as two distinct forms of capital, are really substantial in economic terms.[170] Therefore the main questions driving this chapter are does a clear distinction between equity and debt, as two different opposing methods to contribute finance in a corporation's business exist in law and how hybrid financial instruments fit in this dichotomy? And if yes, since economic theory finds no justification for it, why the law needs to classify investors' claims and why companies issue hybrid instruments?

2.2. Definition of equity and share capital

The Company Act 2006 defines equity share capital as *"its issued share capital excluding any part of that capital which, neither as respects dividends nor as respects capital, carries any right to participate beyond a specific amount in a distribution"*.[171] Preference shares are normally, although not always, entitled only to a fixed return by way of both dividends and capital. They do not therefore constitute equity share capital although they may do so if the return on dividend or capital is not fixed or deferrable. In accountancy, a broader notion is the generally accepted definition as reflected in the international accounting standards documents where equity is defined as the residual interest in the assets of an enterprise after deducting its liabilities.[172] The European accounting rules makers have chosen not to make the definition of equity conceptually based, but simply based on an arithmetic

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[169] Huang P.H. and M.S. Knoll, 'Articles and Essays: Corporate Finance, Corporate Law and Finance Theory', 74 *Southern California Law Review*, November 2000, 179.

[170] Villamil, Anne P., 'Modigliani–Miller theorem', *The New Palgrave Dictionary of Economics*, in Steven N. Durlauf and Lawrence E. Blume (eds.) (Palgrave Macmillan, 2008, 2nd eds.).

[171] s. 548 (ex s. 744 of the CA 1985).

[172] IASB, F. 49(c).

calculation: that is, knowing assets and liabilities, equity can be inferred. The purpose of this choice is the desire to include the totality of classes of shares without entering in difficult legal definitions. In fact, some items included in the equity of the balance sheet are merely "accounting figures" given that they are not based on contracts as the other capital instruments. Instead, these are items sometimes based on statutory requirements, such as retained earnings and sometimes neither based on contracts nor statute such as currency translation adjustments or gains and losses that have been recognised directly "in equity". Under current International Financial Reporting Standards (IFRS), these items are not recognised in the income statement (revaluation reserve, cash flow hedging reserve). They are simply figures that exist as a result of certain accounting conventions. Nevertheless, since shareholders may claim them, at least upon liquidation, they still do form capital *interests* that are attached to a capital instrument. Therefore, it can be argued that the capital side of the balance sheet comprises "claims" that only differ on their intensity. The claims to the company's assets generally feature a combination of certain criteria such as term, type of return and existence of voting rights and their corresponding attributes: fixed term vs. perpetual life, fixed vs. variable return, existence of positive or negative covenants etc.[173] Shares and bonds strongly differ in the intensity of their claims. However, in between these two distinct categories, there is a myriad of hybrid financial instruments that mix characteristics, which are generally associated with straight equity and straight debt, making their classification into a dichotomous structure of capital very difficult.[174] Difficulties in distinguishing between equity and liabilities arise especially when the single characteristics of a security point into different directions. For example, a security may assign to its subscribers a right to participate in the company's gains and losses, which is a characteristic generally associated with ordinary shares, but at the same time be repayable at a fixed date, as a plain vanilla bond. As Table 1 below shows, it is possible to replicate any typical characteristic of equity or debt with hybrid financial instruments while obtaining a different classification. Therefore, if ambiguity in the accounting constructs is to be accepted as an important conceptual and practical issue, it is necessary to understand

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[173] Pro-active accounting activities in Europe (PAAinE), Discussion Paper "Distinguishing between liability and equity", January 2008, available at http://www.iasplus.com/efrag/0801liabequitydp.pdf (accessed March 2012).

[174] Connors P.J. and G.H.J. Woll, Hybrid Instruments – Current Issues, 553 *PLI/TAX,* 2002, 175, 181.

how these constructs are utilised by financial statement users and how they potentially influence real decisions made by companies and individuals and perhaps, potentially, affect wider interests.

Table 1

Characteristic features	**Classification as:**		
	EQUITY	HYBRID SECURITIES	DEBT
Participation in ongoing profit or losses	X	Participating preference shares	
Subordination to all the creditors in liquidation	X	Subordinated/perpetual debentures	
Fixed payment on the instrument		Cumulative preference shares	X
Variable claim in repayment / redemption	X	Profit participating loans / redeemable preference shares	
Possibility to agree on no redemption	X	Redeemable shares	
Fixed term / maturity		Cumulative redeemable preference shares / convertibles	X
Control / voting rights	X	Veto rights preference shares / voting bonds	

2.3. Why distinguish between equity and debt: the role of accounting as control over regulations

The importance of distinguishing equity from liabilities or equity instruments from debt instruments respectively has to be considered in relation to the fundamental role that accounting numbers have acquired within the framework of company law. Nowadays, accounting numbers are perceived to have sufficient credibility to act as a basis for economic contracting between corporate entities and related interest groups. Disclosure and transparency rules, which are mandatory for public companies, strongly rely on accounting numbers. Public companies generally need to publish their accounts according to certain defined international standards and have them certified by an authorized audit company. Financial accounting provides investors with the primary source of independently verified information about the

company's economic situation and the performance of managers.[175] For instance, widespread use is made of accounting-based performance measures in managerial compensation contracts[176] and in collective wage negotiations or of accounting-based covenants in public debt contracts.[177]

The level of gearing that measures the proportion of debt financing in the financial structure in comparison to equity financing is a strong instant indicator of the potential financial risk associated with a company. The rationale for this measure is based on the fact that debt is issued under contractual terms requiring the repayment of principal and interest on specified dates, whereas equity capital carries no such contractual obligations. As a matter of fact, the risk of default on debt repayments will increase as the proportion of debt finance in the capital structure increases. Decisions, which are based on risk assessments such as bankers' lending decisions and investors' decisions to buy or sell securities in the secondary markets, will depend on such analysis. Furthermore, the fundamental approach to define income implicit in conventional accounting procedures is to measure the change in equity between two points in time, adjusting for any new subscriptions of equity capital or withdrawals of capital in the period. Although profit or loss is calculated from flow variables such as revenues and expenses, the accounting model on which financial statements are based, linked by the process of double entry bookkeeping, ensures that revenues or other recognised gains are also reflected as increases in assets or decreases in liabilities, whereas expenses will coincide with decreases in assets or increases in liabilities. In both cases, changes in the values of assets and liabilities arising from investments by or distributions to the owners of an enterprise would be excluded from the definition of income. If the above definition of income

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[175] For a analysis of the role of accounting information in financial contracting see Gilson S. and J. Warner, *Private versus public debt: evidence from firms that replace bank loans with junk bonds,* Working paper, Harvard Business School, 1998, *passim*; Kaplan S.N. and P. Strömberg, 'Financial contracting meets the real world: an empirical analysis of venture capital contracts', 70 *Review of Economic Studies*, 2003, 286-295.

[176] Bushman R.M. and A.J. Smith, 'Financial Accounting Information and Corporate Governance', *Journal of Accounting and Economics,* December 2001, 237-333.

[177] Press E.G. and J.B. Weintrop, 'Accounting-Based Constraints in Public and Private Debt Agreements: Their Association with Leverage and Impact on Accounting Choice', 12 *Journal of Accounting and Economics,* 1990, 65-95; Sweeney A.P., 'Debt-covenant violations and managers' accounting responses', 17(3) *Journal of Accounting and Economics*, 1994, 281-308; Peel D. A., Pope, P., 'Corporate accounting data, capital market information and wage increases of the firm', *Journal of Business Finance and Accounting*, 1984, 177-188.

is accepted, then it is clear that the ability to distinguish between equity and liabilities is crucial to the income measurement process. In fact, the determination of the final result of the period together with the retained profits or other distributable reserves is usually the primary test for determining the maximum distribution to shareholders, whether the EU Second Directive[178] applies or whether a solvency test is taken into account, as for instance, in the case of "whitewash procedure". [179] Moreover, as a matter of fact, extensive evidence shows that equity prices for public companies listed in the secondary market are associated with reported income.[180]

Regulatory bodies heavily rely on accounting numbers as controls over regulations, for example, in the case of banks and insurances' compliance with capital adequacy requirements, in the assessment of a company's obligation to file its annual tax returns or when preparing the list of priorities in a company's winding up. Other special authorities or market controllers rely on accounting numbers. The UK Stock Exchange, for example, imposes various constraints on listed companies, such as requiring the disclosure of contracts of significance (Class 3 transactions) in the directors' report, defined as contracts which represent one per cent or more in value of a company's net assets for a capital transaction. Again accounting numbers, in this case the total assets minus total liabilities or net worth (the equity of the firm), assume a pivotal role. The reclassification for banks and insurers solvency requirements as well as the financial analysis for credit rating is strictly based on the accounting statements. Furthermore, the income measurement process is essential in the calculation of corporate tax liabilities. Finally, the law of insolvency hinges crucially on accounting numbers to define the insolvency event and hence, the situations under which directors face penal sanctions or are imposed creditor-regarding duties.[181] It is clear that the measurement of the magnitude of liabilities in relation to the total assets is crucial in the first instance in defining insolvency. Formally, one of the criteria the court will take into account when determining whether a company is unable to pay its debts is whether the value of the company's

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[178] Second Council Directive 77/91/EEC of 13 December 1976

[179] Pope P.F. and Puxty A.G., 'What is Equity - New Financial Instruments in the Interstices between the Law, Accounting and Economics', 54 *MLR* 889 (1991) at 895.

[180] Lev B., 'On the Usefulness of Earnings and Earnings Research: Lessons and Directions from Two Decades of Empirical Research', *Journal of Accounting Research: Supplement*, 1989, 153-192.

[181] Davies P.L., 'Directors' Creditor-Regarding Duties in the Vicinity of Insolvency', 7 *EBOR*, 2006, 336-337.

assets is less than the value of its liabilities, taking into account its contingent and prospective liabilities.[182]

2.4. Classification of financial instruments in different regulatory areas

Most concepts of accounting for hybrid financial instruments, for instance, in tax and accounting law, share a preliminary principle for keeping the binary structure on the balance sheet. The rationale for keeping a simple structure lies in the regulatory need to provide investors with clear and easily accessible balance sheets. Therefore, accounting and tax law attempts to fit hybrid financial instruments into the two traditional baskets – equity and debt. While this leads to a binary classification of the *entire* instrument as either debt or equity in tax law, an intermediate approach is taken in accounting. Here, using the traditional baskets, an instrument can be classified as a combination of these two ends of financing spectrum. It can easily be seen, however, that debt and equity still remain the reference points in accounting, and hence are treated as the building blocks (or ingredients) of any financial position.

Capital adequacy regulation in banking (and likewise in insurance regulation) as well as assessment of financial instruments by CRAs, on the other hand, partly abandon the traditional binary model. Banking regulation acknowledges multiple categories or different "qualities" of capital, which are represented by the various tiers and sub-tiers of capital. Unlike in accounting regulation, not all of these baskets can simply be regarded as a mix of a plain vanilla debt position with common share-like equity. Mainly because of the particular risks associated with the inherently fragile financial sector and the resulting regulatory goals, factors that do not fit in well with the traditional divide – such as remaining time until maturity, pay-out restrictions, redemption (ie pre-payment) restrictions, etc – are increasingly taken into account in bank capital regulation. This effectively goes some way towards acknowledging a multi-dimensional approach to the classification of hybrid financial instruments. Going even further, the approach of CRAs in assessing hybrids almost completely abandons the traditional divide. The aim of CRAs is to rate *the* quality of

[182] Insolvency Act 1986, s. 123.

a claim from the creditor's (or beneficiary's) perspective. This aim necessarily implies a more commercial – or functional – approach to this exercise.

It is worth noting that all of these approaches are interconnected. For instance, the approach taken by CRAs has an important impact on banking regulation. While a banking-specific regulatory framework applies to the right-hand side of a bank's balance sheet, the regulatory use of CRA-assessments[183] in relation to a bank's assets import their approach to hybrid classification into the banking regulation sphere. To a certain extent, such links also exist between accounting and tax law.

None of the aforementioned approaches is able to consistently deliver the "correct" results, even within the narrow boundaries of the respective discipline or regulatory aim. Hence, they often create incentives for regulatory arbitrage. In fact, hybrids show a capacity to evolve and change their characteristics during their life in order to exploit the differences of different tax systems or simply the inconsistencies in the same regulation. For this reason, they are widely used as tools for intra-group financing, driven by both tax and accounting regulation. Research has shown that with a simple equity-debt split the reporting companies are almost encouraged to take advantage of this somewhat limited view by structuring their instruments' terms and conditions in order to achieve a desired accounting classification.[184]

Moreover, issuers can raise funds without fully having reflected their true financial positions in head-line financial metrics such as the debt-to-equity ratio. Hence, the heavy reliance by institutional investors and analysts on key financial figures in itself creates scope and incentives for arbitrage, which is independent of the regulatory system. Just as firms sometimes buy back shares in order to "adjust" (ie manipulate) financial figures such as earnings per share (EPS), which then incidentally result in increased incentive pay,[185] managers can also use hybrid forms

[183] See Weber R., 'The regulatory use of credit ratings in bank capital requirement regulations', 10 *Journal of Banking Regulation*, 2008, 1.

[184] Engel E., M. Erickson, and E. Maydew, Debt-equity hybrid securities, 37 *Journal of Accounting Research,* Autumn 1999, 262 ff. The evidence found demonstrated how important is for managers the classification of some financial instruments and that firms often are able to pay a "premium" to achieve certain classification status.

[185] For an empirical study of this effect in the context of accelerated share repurchases see e.g. Marquardt, C.A., Tan, C.E. and Young, S.M., 'Accelerated Share Repurchases, Bonus Compensation, and CEO Horizons' (2009). Available at <http://ssrn.com/abstract=1346624> (accessed 18 January 2011).

of financing to "optimise" their firm's capital structure – or at least its perception in the market.[186]

How can the problems created by inconsistent and imperfect classification of hybrids be addressed? It has been argued that a more faithful representation of a company's financial position would require adding a third category – "mezzanine capital" – to the traditional dichotomy of equity and debt.[187] However, a threefold capital structure would not only require a costly revision of the entire accounting and tax system. It is submitted that it would also be an inadequate response to the problems identified in this chapter. If the main finding is multi-dimensionality, it is unclear how introducing a new "in-between" category would do more than complicating things even more. In fact, the proposed "mezzanine" category seems very similar in result to the already practised accounting rules applicable to certain hybrid instruments, whereby the capital raised is bifurcated (ie accounted for partially as equity and partially as debt).[188]

The analysis also shows that the different aims of classifying hybrid instruments in accounting, tax and corporate law render it impossible to find a single consistent approach for this exercise. This divergence cannot, in the opinion of this author, be bridged by introducing a third classification category. Nor will it be possible – or indeed desirable – to create a common methodology for assessing hybrid financial positions across different disciplines.[189]

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[186] Empirical evidence on this is provided by Hribar P., Jenkins N. and Johnson W., 'Stock repurchases as an earnings management device', 41 *Journal of Accounting and Economics*, 2006, 3. Hribar et al find that share buy-backs are significantly more likely to be implemented where they lead to the issuer meeting analysts' EPS forecasts which otherwise they would have fallen short of.

[187] Hopkins P., 'The effect of financial statement classification of hybrid financial instruments on financial analysts' stock price judgments', 34 *Journal of Accounting Research*, 1996, at 45-46 where the author shows how analysts examined more carefully the attributes of hybrid securities as the mandatorily redeemable preference shares when they were classified in the mezzanine instead of either debt or equity. This idea was already proposed long time ago, *see* Paton, W.A. *Accounting Theory: With Special Reference to the Corporate Enterprise* (New York, NY: Ronald Press, 1922) *passim*.

[188] See IAS 32.

[189] Creating a third category of capital or abolishing any categorization between equity and debt would necessitate addressing questions that reach beyond a stand-alone revision of the current standards. Compare the report of Ryan S.G., R.H. Herz, T.E. Iannaconi, L.A. Maines, K. Palepu, C.M. Schrand, D.J. Skinner, L. Vincent; "Evaluation of the FASB's Proposed Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both: AAA Financial Accounting Standards Committee", 15 *Accounting Horizons,* 2001, 387-400.

2.5. Hybrid financial instruments' implications for corporate law

For a long time, international regulatory bodies and courts have struggled with the classification of hybrid instruments. Over time, hybrid financial instruments and capital structures have grown to such complexity that their consistent classification across different regulatory spheres has become virtually impossible. The analysis in this Part highlights some of the most important regulatory issues raised by hybrid financial instruments and points to the influence the law has on the way companies raise their financing. We have considered several regulatory areas, all of which take different approaches to classifying hybrids.

One area that has received significantly less attention in the literature than the classical regulatory issues is corporate law. While deeply interwoven with accounting and insolvency law, corporate law also uses the distinction between debt and equity as a reference point when assigning roles within the organisational governance structure. While economic models typically regard shareholders' governance rights as a natural counterweight to their "residual claimant"-nature and their lack of fixed entitlements to the firm's assets,[190] company law typically takes a very formalistic approach towards assigning such control rights. As we have explored in other areas, hybrids can often closely resemble or even perfectly replicate an equity holder's financial position without using traditional, pre-packaged bundles of rights (ie ordinary or preference shares). Moreover, legal capital rules used in Europe likewise use a formal approach towards classifying financial instruments, thereby also leaving room for regulatory arbitrage.

Thus, hybrids can, to some extent, call into question basic propositions like "equity holders will only receive distributions out of profits (or in the course of a capital reduction)" or "debt-holders will not be allowed to vote in the shareholder's meeting". If, for instance, an issuer is able to create an equity-like financial position, which, from a corporate law perspective, does not make the holder of the instrument a shareholder, redemptions of such instruments are not formally restricted by the rules on share buy-backs. Moreover, fundamental shareholder rights like pre-emptive rights and more generally control rights in connection with share issues could potentially be diluted to the extent that shareholder-like positions disguised as debt

[190] See e.g. Williamson, O., *The Mechanisms of Governance* (OUP 1996) 185.

instruments can be issued by managers without approval of shareholders. Likewise, shares can also be structured in a way that closely resembles debt instruments, conferring control rights on parties with no (real) residual claim.

Of course, the ability of a company to assign control rights to some, but not all equity holders, is recognised by UK company law,[191] and only little restrictions apply to such structures. But even in the UK, certain shareholder rights mandatorily (also) apply to holders of non-voting preference shares.[192] By using hybrid financial instruments, parts of the mandatory corporate law can effectively be side-stepped, leading to a more flexible framework within which a company can reach a bargain with its investors than envisaged by the legislator.

A company can, for instance, issue a profit participating loan, which gives the creditor the right to share in the (pre-P&L) profits of the company, achieving a result economically similar to an issue of redeemable shares.[193] The redemption (repayment) of such a loan, however, would not be subject to strict capital maintenance rules. Moreover, as mentioned above, control of "real" (legal) shareholders is at least diluted with respect to the decision to issue such instruments.

From this reasoning it follows that in order to achieve meaningful results the assessment of hybrid financial instruments must have regard to economic realities. In other words, an inflexible classification approach will never be able to deal with all forms of hybrids and adequately address the issues they may raise.

Accordingly, the debt-equity examination needs to take a further analytical step and adopt a superior taxonomy that refers directly to the various financial and governance features embodied in any given hybrid instrument. Therefore, the analysis in the next part will consider the function of hybrids and the legal strategies

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[191] Many other countries, however, take a more restrictive approach on the issuance of non-voting shares. Restrictions as to the proportion of a company's capital issued in the form of non-voting preference shares exist, *inter alia*, in Austria, Belgium, France, Germany, Greece, Italy, Japan, Luxembourg and Spain; see Shearman & Sterling LLP, 'Proportionality Between Ownership and Control in EU Listed Companies', 2007, 13, available at <http://ec.europa.eu/internal_market/company/docs/shareholders/study/study_report_en.pdf> (accessed 10 January 2011). Restrictions generally range from 25% to 50%; ibid.

[192] See e.g. s 633 CA 2006.

[193] Certain company regulations imply a consequent accounting classification that may render the related accounting rule inapplicable in that particular case. For example, in the loss absorption approach, redeemable shares at a certain expected event are considered liability, although in Europe the Second Directive of capital maintenance expressly allows the redemption of the shares only out of distributable dividends.

available for their investors to address the opportunism that can accompany fundamental changes in the life of a firm. The list is illustrative rather than exhaustive and is written with the understanding that some suggestions may be more practical than others and some more controversial than others.

Chapter 3. Setting the theoretical framework

This chapter, which concludes Part I, aims to define the theoretical framework in which I operate and that will be useful for the following analysis in this thesis. It is centred around the economic analysis of corporate law and finance. The task of it is to found the basis of a new methodology for assessing hybrid financial instruments and the implications for the corporate governance. For this purpose, the chapter will re-examine some main corporate governance theories. In particular, transaction costs, agency costs and property rights literature is discussed at the aim of developing a functional approach. The stream of literature, which followed the M&M Theorem, has focused on the nature of capital, examining financial contracts such as debt and equity as two alternatives for the investors to respond to particular market frictions, in conditions of uncertainty and asymmetric information. Therefore, the company is not seen as a "black box" but as "simply one form of legal fiction which serves as a nexus for contracting relationships and which is also characterised by the existence of divisible residual claims on the assets and cash flows of the organisation".[194] The study on the nature of the firm, which started with Ronald Coase's seminal work,[195] has been essential in understanding the dynamics of power relations among corporate constituents.[196]

Often in the past, hybrid instruments have been analysed in relation to one or some of their characteristics but never in context. Since the economic theories have evolved with the development of the corporation, the analysis of the corporate structure and in particular of the financial instruments must also be adjusted. The originality of the methodology lies under the fact that the legal strategies concerning hybrid forms of securities will be analysed against the background of these theories.

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[194] Jensen M. and W. Meckling, 'Agency Problems and Residual Claims', 26 *J. Law & Econ.*, 1983, 327.

[195] Coase R., 'The nature of the firm', 4 *Economica*, 1937, 20 ff.; Idem, reprinted 1988, 33 and 43-47.

[196] See Triantis G.G.. 'Financial contract design in the world of venture capital', 68 *The University of Chicago Law Review*, 2001, 305-322; Armour J. and M.J. Whincop, 'The Proprietary Foundations of Corporate Law', 27 *Oxford Journal of Legal Studies*, 2007, 440-457; Kraakman R. et al., *The Anatomy of Corporate Law: A Comparative and Functional Approach* (OUP 2009, 2nd ed.) *passim*; Worthington S., 'Shares and shareholders: property, power and entitlements (Part 1 and 2)', 22(9) *The Company Lawyer*, 2001, 264 ff.; Davies P.L., *Introduction to company law* (Oxford University Press: Clarendon Law Series) 2002, *passim*; Blair M.M., 'A Contractarian Defence of Corporate Philanthropy', 28 *Stetson L. Rev.*, (1998) 26; Macey J.R., 'Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective', 84 *Cornell L. Rev.*, 1999, 1269-1273.

3.1. Transaction costs and company law

Much of finance literature has analysed the firm's choice of capital structure as separate from the firm's real decisions, for example, what to produce and how to organise production. However, for a complete analysis, capital structure should be subsumed under a more general theory of the firm. Property rights literature and agency traditions share a view of institutional design as determined by a desire to economise on agency costs. While agency literature has been the main alternative approach in the capital structure literature, this literature does not explicitly consider the allocation of control rights, which is at the base of the property rights theory. Therefore, the two theories have to be considered complementarily.[197]

The first incisive work on the study of the firm was Ronald Coase's article on the nature of the firm, dated 1937, whose implications were long overlooked.[198] This study broke with the traditional perfect competition model, adopted in the neoclassical economics theory where transaction costs were considered nil, to develop a new justification for the firm to exist. The managers of firms did intentionally what a market did spontaneously, i.e. to allocate resources to different uses. The economic reason for why the firm exists as a viable alternative to the price mechanism, of course, is because the price mechanism does not function flawlessly and costlessly. The process of internalisation of the business in the firm is explained as a means of economising on the transaction costs of using markets. However, internalisation is costly, because as firms increase in size, the managers become less efficient. Thus, in a world of positive transaction costs, governance structures matter for efficiency outcomes.[199]

The scope of Coase's paper was limited by its study of the classical firm, namely a company in which the shareholders and the managers were always coinciding. The difference between the classical firm and the modern corporation

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[197] Bratton W., 'Corporate Debt Relationships: Legal Theory in a Time of Restructuring', 1 *Duke L. J.*, 1989, 1478-1501.

[198] Coase R., 'The nature of the firm', 4 *Economica*, 1937 reprinted in 1988, at 22.

[199] The Coase's analysis of transaction costs shares strong parallels with his later study on property rights and externalities see Coase R., 'The Problem of Social Cost', 3 *Journal of Law and Economics,* 1960, 42.

were studied by Adolf Berle and Gardiner Means in their famous work.[200] The authors indicated that shareholdings in many American public corporations were so diffuse that shareholders were unable to control those who managed the firm. They argued that this separation of ownership and control caused a divergence between the maximising behaviour expected of the classical firm and that these public corporations were controlled *de facto* by managers. The problems associated with the separation of ownership and control provided an enduring basis for corporate regulation.[201]

3.2. The company as a "nexus of contracts" and the theory of agency costs

In 1976, Jensen and Meckling defined the firm in terms not dissimilar to Coase's "system of relationships" as "a nexus of contracts".[202] The "nexus of contracts" definition disregards, as far as corporations are concerned, the distinction between a corporate contract, which is of an "originating" nature and that which is merely "operational".[203] The first type, which is of special interest to lawyers, may not arise for consideration in a micro economic analysis of production theory. This explains

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[200] Berle A. and G. Means, *The Modern Corporation and Private Property* (New York, Macmillan, 1933) 244 and 312. For a recent survey on the ownership structure of the modern corporations see La Porta, R., Lopez De Silanes, A. Shleifer, R. Vishny, 'Investor protection and corporate valuation', *NBER Working Paper 7403*, National Bureau of Economic Research, Cambridge, MA., 1999, 511-513.. See also, La Porta R. et al., Legal Determinants of External Finance, 52 *Journal of Finance,* 1997, 1131-50 and La Porta R., F. Lopez De Silanes, A. Shleifer, R. Vishny, 'Law and Finance', 106(6) *Journal of Political Economy,* 1998, 1113-1155; Barca F. and Becht M., *The Control of Corporate Europe* (Oxford, 2001) 266-281.

[201] See Fama E., 'Agency Problems and the Theory of the Firm', 88 *Journal of Political Economy*, 1980, 290-292 where the author considers that a corporation does not have owners in any meaningful sense and the two functions of management and risk bearing have to be treated as naturally separate factors within the set of contracts called the firm. A possible solution is to make the management the ultimate beneficiary of the firm's success (or a "residual claimant") see this in Cheffins B., *Company Law: Theory, Structure and Operation* (Oxford: Clarendon Press, 1997) 35; for the management incentives see Davies P.L., *Introduction to company law* (Oxford University Press: Clarendon Law Series) 2002, 198-214.

[202] Jensen M. and W. Meckling, 'Theory of the Firm: Managerial Behavior, Agency costs and Ownership Structure', 3 *Journal of Financial Economics*, 1976, 305; Fama E. and M.C. Jensen, 'Separation between ownership and control', 26 *Journal of Law and Economics,* 1983, 301; Fama E. and M.C. Jensen, 'Agency Problems and Residual Claims', 26 *Journal of Law and Economics*, 1983, 327.

[203] Businesses are incorporated for specific purposes and those who invest in corporations have different expectations, rights and responsibilities depending on the legal nature of their investments.

why a "nexus of contracts" definition will apply in economic analysis whether we are concerned with the classical capitalist firm or the modern firm.[204]

The rich literature in this field emphasised that the corporation was simply a nexus for contracting between investors, factor suppliers and those responsible for managing the firm.[205] Every single contractual relationship in the corporation generates an agency relationship.[206] The "contract" determines the rights and obligations of the various stakeholders. However, economists, who first advanced this view, use "contract" in a much looser sense than lawyers to indicate all sort of voluntary arrangements and their various forms of governance, whether by legislation, by judge-made rules (e.g. fiduciary duties) or by private agreement (e.g. the articles).[207] They eschew the concept of corporate ownership in assessing shareholders' rights and directors' obligations in the corporate system.[208] Thus, they considered it anomalous to view the shareholders as corporate owners and untenable to claim that directors' obligations should be driven mainly by the need to maximise

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[204] Easterbrook F.H. and Fischel D.R., *The Economic Structure of Corporate Law* (Harvard University Press, Cambridge, MA, 1991) 12.

[205] The literature on the "nexus of contracts" theory and on the classical theory of property rights is considerable. See Williamson O.E., *The Mechanisms of Governance* (London, New York: Oxford University Press, 1999); Williamson O.E., *The Economic Institutions of Capitalism,* (New York: Free Press, 1985); Alchian A. and H. Demsetz, 'Production, Information Costs and Economic Organization', 62 *American Economic Review*, 1972, 779; Demsetz H., 'Toward a Theory of Property Rights', *American Economic Review,* May 1967, 354 ff.; Fama E. and M.C. Jensen, 'Agency Problems and Residual Claims', 26 *Journal of Law and Economics*, 1983, 327; Butler H.N., 'The Contractual Theory of the corporation', 11 *Geo. Mason U. L. Rev.*, 1989, 99; Wilson R., 'On the Theory of Syndicates', 36 *Econometrica*, 1968, 119-132; Berhold M., 'A Theory of Linear Profit Sharing incentives', 85 *Quarterly Journal of Economics*, 1971, 460-482; Ross S.A., The Economic Theory of Agency: the Principals problems, LXII *American Economic Review*, 1973, 134-139; Heckermann D.G., 'Motivating managers to make Investment decisions', 2 *Journal of Financial Economics*, 1975, 273-292.

[206] Jensen M. and W. Meckling, 'Theory of the Firm: Managerial Behavior, Agency costs and Ownership Structure', 3 *Journal of Financial Economics*, 1976, 308: "We define an agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties to the relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal."

[207] Many of these different contractual provisions come in a standard form, providing either mandatory or default rules. Because the aim of the standard form is simply to reduce transaction costs in private arrangements, it follows that mandatory rules should be kept to a minimum, leaving the parties free to make their own bargains in accordance with prevailing market forces, see Easterbrook F.H. and Fischel D.R., *The Economic Structure of Corporate Law* (Harvard University Press, Cambridge, MA, 1991) 21-22.

[208] *See* Fama E., 'Agency Problems and the Theory of the Firm', 88 *Journal of Political Economy*, 1980, 288.

profit for the shareholders.[209] Simply, they perceived corporate constituents as factor providers, whose interests in the corporation are defined and regulated by contractual negotiations with the corporation.[210]

Thanks to the theory of agency costs, the Coasian claim that defines the firm in terms of internalised contracts was united with the analysis of the separation of ownership and control, which was the reason behind the asymmetric distribution of information, and so becoming applicable to all kind of corporations. In particular, the theory of agency costs shed light on the nature of the transaction costs affecting particular contracts and how parties economised on these costs. Corporate governance trades off three things. The first is the advantages to specialisation in the performance of management functions and the bearing of residual risky by shareholders. The second is the complexity of management. The third is the transaction costs associated with implementing optimal governance to address contracting problems. The attributes of a firm, such as the diffuseness of its shareholder population, the separation of managerial functions from oversight functions and the structure of the board of directors, are treated by this literature as the equilibrium that the parties expect to optimise the outcome of this trade-off.[211]

The agency costs analysis identifies specific contracting problems in corporations and in particular, how investors of equity and debt capital find it difficult to observe the exercise of managerial discretion. As a result, the directors may put into practice opportunistic behaviours such as transferring firm resources to their own, consuming "perquisites", seeking higher than market salary or job security etc. For this reason, they need to be controlled and all the monitoring and bonding costs of auditing, formal control system, budget restriction and establishment of incentive compensation systems will be reflected in the company's

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[209] Freeman R.E. and W.M. Evan, 'Corporate Governance: A Stakeholder interpretation', 19(4) *The Journal of Behavioural Economics*, 1990, 337-340.

[210] *See* Williamson O.E., Corporate Governance, 93 *Yale L. J.*, 1984, 1197; Brudney V., 'Corporate Governance, Agency Costs, and the Rhetoric of Contract', 85 *Colum. L. Rev.*, 1985, 1404.

[211] See Davies P.L., *Introduction to company law* (Oxford University Press: Clarendon Law Series) 2002, 201; Cheffins B., *Company Law: Theory, Structure and Operation* (Oxford: Clarendon Press, 1997) 249; Blair M.M., 'A Contractarian Defence of Corporate Philanthropy', 28 *Stetson L. Rev.*, (1998) 26; Worthington S., 'Shares and shareholders: property, power and entitlements (Part 1 and 2)', 22(9) *The Company Lawyer*, 2001, 264 ff.; Macey J.R., 'Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective', 84 *Cornell L. Rev.*, 1999, 1266.

shares value.[212] However, the inefficiency is reduced the larger is the fraction of the firm's equity owned by the manager.[213] In public corporations where the managers are in control, the conflicts are between the managers and the shareholders as a whole and the agency costs are at their maximum, while in small private firms the conflicts, which are largely reduced, are between the majority and minority of the shareholders.[214]

These agency costs of equity can be mitigated by the existence of debt. In fact, the larger the part of the corporate finance financed by debt, the more control and pressure on the management the debt holders will exert and this will be useful for the shareholders too. Since debt legally obliges the firm to pay out cash in order to satisfy the bond-holders' contractual rights, the amount of "free" cash available to managers to spend on their benefits and perquisites is clearly reduced in the case of a leveraged company.[215] Managers have a strong incentive to avoid a financial distress situation, because, if the company is declared insolvent, they may lose all their benefits of control and reputation. Moreover, debt allows the company to raise new funds without diluting the shareholders' residual claim and to attenuate the adverse selection problem of outside equity by presenting a right to a fixed interest rather than a residual claim whose pay-off are less sensitive to the distribution of information.[216]

However, debt finance does not come without its own agency costs. In order to maximise shareholders' benefit, managers may invest in a way that transfers wealth

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[212] See Barnea A., Haugen R. and Senbet L., *Agency Problems and Financial Contracting* (Prentice – Hall, Englewood Cliffs, NJ, 1985) *passim*; Brander J.A. and M. Poitevin, *Managerial Compensation and the agency costs of debt finance*, in Managerial and Decision Economics, 13 (1992), at 55-64; Ross S.A., The Determination of Financial Structure: The Incentive Signalling Approach, 8 *Bell Journal of Economics*, 1977, 23-40, the author evolved an incentive-signalling model in which the capital structure can be considered as a mechanism that reduces the information asymmetries between manager and shareholders, demonstrating the robustness of financial and accounting signalling models. See also Davies P.L., *Introduction to company law* (Oxford University Press: Clarendon Law Series) 2002, 198 ff.

[213] Jensen M. and W. Meckling, 'Theory of the Firm: Managerial Behavior, Agency costs and Ownership Structure', 3 *Journal of Financial Economics*, 1976, 343.

[214] Barclay M.J. and C.W. Smith Jr., The Priority Structure of Corporate Liabilities, 50 *Journal of Finance*, (1955), 899; Klein W.A. and Coffee J.C. Jr., *Business Organization and Finance: Legal and Economic Principles* (New York, sixth ed. 1996) 353.

[215] Jensen M., 'Agency Cost of Free Cash Flow, Corporate Finance, and Take-overs', 72 *American Economic Review*, 1986, 323-329.

[216] Townsend R.M., 'Optimal contracts and competitive markets with costly state verification' 21 *Journal of Economic Theory*, 1979, 265; Lacker J.M. and J.A. Weinberg, 'Optimal Contracts under Costly State Falsification', 97 *The Journal of Political Economy*, 1989, 1345-1363.

from the bondholders to the shareholders. For example, managers may exploit the limited liability of the company to invest in riskier projects with higher returns instead of choosing more valuable investments with lower variance. In so doing, equity holders gain the most if an investment yields large returns well above the face value of the debt. Otherwise, their risk is limited. This problem is also called "asset substitution" by economists. Similarly, when the firm's cash flow from existing assets does not provide a sufficient return for the shareholders, managers have an incentive to discriminate and eventually turn down some profitable investment opportunities. In fact, management will choose to make an investment only if its net present value exceeds the face value of the debt, otherwise only creditors will benefit from this new project. This problem is called "underinvestment" or "debt overhang".[217] If the bondholders perceive the peril of being appropriated by an overinvestment in high-risk projects or by an underinvestment in low-value projects, they may well adjust downward the price they are willing to offer for the bonds or demand a higher interest rate for the credit and thus pass back the agency costs to the firm.[218]

There are other opportunistic behaviours that may generate agency costs. Managers may be able to transfer wealth from debt-holders to shareholders with excessive dividend payments. Increased dividends create a decrease in the market value of the existing debt, when the payout is financed through a reduction in investments.[219] Similarly, new borrowings of the same or higher priority to distribute a dividend expropriate debt value.[220] In addition, managers may conceal problems or situations of financial distress to prevent creditors from acting to enforce immediate bankruptcy or reorganization, expanding the effective maturity of the debt and increasing its risk.[221] In all these cases, important indirect costs occur even if

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[217] Myers S.C. , 'Determinants of Corporate Borrowing', 5 *Journal of Financial Economics*, 1977, *passim*; Myers S.C., 'Capital Structure', 15(2) *The Journal of Economic Perspectives*, 2001, 97.

[218] Jensen M. and W. Meckling, 'Theory of the Firm: Managerial Behavior, Agency costs and Ownership Structure', 3 *Journal of Financial Economics*, 1976, 335-336.

[219] Black F., The dividend puzzle, 2 *Journal of Portfolio Management*, 1976, at 5-8; Kalay A., 'Stockholder-Bondholder Conflict and Dividend Constraints', 10 *Journal of Financial Economics*, 1982, 211-233.

[220] Black, F. and M. Scholes, 'The Pricing of Options and Corporate Liabilities', *Journal of Political Economy* (May- June 1973), at 637-659.

[221] For examples of temptation at work see Asquith P. and D.W. Wizard, 'Event Risk, Covenants and Bondholder Risk in Leveraged Buyouts', 27 *Journal of Financial Economics*, 1990, 195-214.

bankruptcy itself is ultimately avoided.[222] According to the theory of agency costs thus, the equilibrium in the capital structure is given by the point of intersection between the curves of the marginal agency costs and of the demand for outside financing.[223] In other words, an optimal capital structure can be obtained by trading off the agency costs of debt against its benefits.[224]

3.3. Contract incompleteness and ex post conflicts

Ownership is important for economic efficiency in a real world where transaction costs are positive. This comes as a straight consequence of the relaxation of the main agency costs theory condition that transaction costs of contracting are nil because contracts are complete. Contractual arrangements are viewed as devices to mitigate *ex post* conflicts arising from managers' opportunism. They revolve around three things: information privileges, control and property rights. Thus, the parties are capable of choosing optimal governance through contracting.[225] However, contracts suffer from positive transaction costs. These costs have two specific effects: they may preclude trade or they may cause contracts to be incomplete. Contracts are incomplete either because terms are not specified or are not differentiated for certain

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[222] Fama E. and M.C. Jensen, 'Separation between ownership and control', 26 *Journal of Law and Economics,* 1983, 301; Fama E. and M.C. Jensen, 'Agency Problems and Residual Claims', 26 *Journal of Law and Economics*, 1983, 327. For a modern approach to the agency costs and the related legal strategies to reduce them see also Armour J., H. Hansmann and R. Kraakman, 'Agency Problems and Legal Strategies', in Kraakman R. et al. (eds) *The Anatomy of Corporate Law: A Comparative and Functional Approach* (OUP 2009, 2nd ed.) 35 ff.; Davies P.L., *Introduction to company law* (Oxford University Press: Clarendon Law Series) 2002, 111-280.

[223] Jensen M. and W. Meckling, 'Theory of the Firm: Managerial Behaviour, Agency costs and Ownership Structure', 3 *Journal of Financial Economics*, 1976, 357. This equilibrium is Pareto optimal, in other words, given a certain level of outside financing there is no way to reduce the agency costs without making someone worse off.

[224] Given a positive cash flow, high leverage can, at its equilibrium point, compensate the agency costs of debt and equity with its benefits. For this reason, industries in which the opportunities for asset substitution are more limited will have higher debt levels (these include tobacco corporations, steel, chemicals, brewing groups and television and radio broadcasting companies). See Harris M. and A. Raviv, 'Capital Structure and the Informational Role of Debt', 20 *Journal of Financial Economics,* 1990, 55-86; Harris M. and A. Raviv, 'The Theory of Capital Structure', 46 *The Journal of Finance*, 1991, 302 and 320. See also Stultz R., Managerial Discretion and Optimal Financing Policies, 26 *J. Fin. Econ.*, 1990, 3-27.

[225] The term used by Williamson O.E., *Market and Hierarchies: Analysis and Antitrust Implications* (New York: The Free Press, 1975) 70 to denote ex post opportunism.

possible states of the world.[226] The contract incompleteness is due not only to the cost of bargaining, but also because language is imprecise and opens itself to interpretation, foresight is limited and asymmetries in information between parties may discourage more specific bargaining.[227] While the law can address some of these incompleteness problems by providing standard terms that parties might be expected to agree to (for example, incorporation statutes of a low-cost company), some rules are impossible to emulate contractually since they apply to persons who are not parties to the corporate contracts (for example, the prohibition on the creditors of shareholders enforcing their debts against the assets of the company).[228]

Since corporations run their business in the presence of uncertainty, contracts may also be incomplete in the lack of contractible elements due to difficulties in contemplating in advance all possible future contingencies and measuring performance under each contingency. In addition, the states of the world on which the parties would like to condition their contractual payoff often cannot be verified by a court. An insufficiently state-contingent contract creates an incentive to renegotiate or to breach.[229] For example, “a promise to pay a fixed *interest* will mean the promisor must bear the risk that the production process fails, for whatever reason, to produce the expected surplus”.[230] After all, the firm’s actions are not perfectly controlled. Furthermore, it is common in practice for a firm to comply fully with all of the restrictions contained in its debt agreements while still being able to undertake many changes in corporate policy that affect the debt-holder’s wealth.[231] Similarly, “a contingent promise will mean the promisee must be able to observe and verify to a

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[226] Williamson O.E., *The Economic Institutions of Capitalism,* (New York: Free Press, 1985) 68-84.

[227] Schwartz A., Relational contracts in the courts: an analysis of incomplete agreements and judicial strategies, 21 *Journal of Legal Studies*, 1992, 271-318.

[228] Hansmann H. and R. Kraakman, The Essential Role of Organizational Law' 110 *Yale LJ,* 2000 387 and 407–408.

[229] Hart O., ‘One-Share One-Vote and the Market for Corporate Control’, 20 *Journal of Financial Economics*, 1988, 119–139; Williamson O.E., *The Economic Institutions of Capitalism,* (New York: Free Press, 1985) 298 ff. where he says contracts supported by idiosyncratic investments face difficult problems of ex post-sequential adaptation.

[230] Armour J. and M.J. Whincop, ‘The Proprietary Foundation of Corporate Law’, 27 *Oxford Journal of Legal Studies*, 2007, 447.

[231] Garvey G. and P. Swan, ‘The Economics of Corporate Governance: Beyond the Marshallian Firm’, 1 *Journal of Corporate Finance*, 1994, 141 where the authors say “so long as such explicit promises are fulfilled, the bondholders bear any losses and enjoy any gains that may flow from changes in corporate policy”.

court that failure to make the promised payments does not fall within the contractual exclusions".[232]

Therefore, the significance of property rights depends on other properties of the contracts and on the transaction subject to contracting, such as the verifiability of important variables and opportunities for renegotiation. By definition, *ceteris paribus*, a more complete contract confers less residual property rights. The parties will adopt an organisational structure that allows information about managers to flow to other constituencies of the firm in order to control managerial opportunism. The parties will allocate property rights in a way that allow managers to act in the interests of investors and to permit persons with comparative advantages in monitoring to capture benefits from acting to remedy problems they observe.[233]

3.4. The modern theory of property rights

The theory of the firm literature has been enriched by the development of the theory of property rights. This study offers a more complex picture of the firm than the nexus of contracts paradigm.[234] In contrast with the neoclassical assumption that common shareholders have control over corporate decisions because they "own" the corporation,[235] the theory of property rights reconceptualises the corporation as merely a nexus of contracts, asserting the company is not an entity to be owned but a legal fiction separate from the individuals involved in it, with its own interests. This

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[232] Armour J. and M.J. Whincop, 'The Proprietary Foundation of Corporate Law', 27 *Oxford Journal of Legal Studies*, 2007, 447. Compare to Triantis G.G. and A. Choi, 'Completing Contracts in the Shadow of Costly Verification', 37 *J. Legal Studies,* 2008, 503.

[233] Hart O., 'Corporate governance: Some Theory and Implications', 105 *The Economic Journal*, 1995, 95 ff.

[234] Hart O., *Firms, Contracts and Financial Structures* (Oxford University Press, 1995); Rajan R. and L. Zingales, 'Power in a theory of the firm', 108 *Quarterly Journal of Economics,* 1998, 387–432; Rajan R. and L. Zingales, 'The tyranny of inequality: An inquiry into the adverse consequences of power struggles', *Journal of Public Economics*, 2000, 1653 ff.. A similar point is made by Welch I., 'Why is bank debt senior? A theory of priority among creditors', 10 *Review of Financial Studies*, 1997, 1203–1236 in relation to the seniority structure of debt, where observes that banks being better at fighting in court, should hold senior debt, in order to minimise the resources wasted in legal battles; De Alessi L., 'Property Rights, Transaction Costs, and X-Inefficiency', 73 *American Economic Review,* 1983**,** 64-81; Harris M. and A. Raviv, '*Corporate Control Contests and Capital Structure*', 20 *Journal of Financial Economics*, 1988, 55-86.

[235] Garvey G. and P. Swan, 'The Economics of Corporate Governance: Beyond the Marshallian Firm', 1 *Journal of Corporate Finance*, 1994, 148. See also Kay J. and A. Silberston, *Corporate Governance,* National Institute Economic Review, August 1995, 88.

legal personality of a company is the tool to realise a bundle of relationships or a network of explicit as well as implicit bargains. This revived the question why one should vest voting control in only one set of contracting parties. If shareholders retain rights of control because they represent a residual interest in a corporation's value, it has to be said they are not the only risk-bearing group. Other groups also bear risk and this risk cannot be dealt with adequately by *ex ante* contracting. The property rights theory evolved to a pluralistic approach considering the investors in a firm not as shareholders or bondholders, but as stakeholders and all residual claimants although to different extents. The approach concedes the efficiency of linking governance and control rights to risk bearing.[236]

The theory of property rights studies the firm as combinations of contracts and productive assets, emphasizing the significance of the allocation of property rights to those assets for the governance of the enterprise.[237] The nature in which property rights are defined and enforced, fundamentally impacts the performance of an economy: *in primis* "by assigning ownership to valuable resources and by designating who bears the economic rewards and costs of resource-use decisions, property rights institutions structure incentives for economic behaviour within the society"; and *in secundis*, "by allocating decision-making authority, the prevailing property rights arrangement determines who the key actors are in the economic system".[238]

Property rights are defined as the rights to return streams and the rights to make strategic decisions in contingencies not explicitly contracted upon.[239] Grossman and Hart, in their seminal work, distinguish between specific rights, which are specified in contracts and residual rights, which cannot be directly contracted upon. Property

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[236] See Cheffins B., *Company Law: Theory, Structure and Operation* (Oxford: Clarendon Press, 1997) 31; Klein W.A. and Coffee J.C. Jr., *Business Organization and Finance: Legal and Economic Principles* (New York, ninth ed. 2004) 19-20 and 68; Blair, M. and Stout, L. (1999), 'A team production theory of corporate law', 85(2) *Virginia Law Review*, 247; Blair M., *Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century*, (Washington D.C.: The Brookings Institution, 1995) 371.

[237] See generally Hart O., *Firms, Contracts and Financial Structures* (Oxford University Press, 1995) 29 ff. See also Rajan R. and L. Zingales, 'Power in a theory of the firm', 108 *Quarterly Journal of Economics,* 1998, 387; Zingales L., Corporate Governance, in P. Newman (ed.), *The Palgrave Dictionary of Economics and the Law*, vol. 1 (London: Macmillan, 1998), at 497.

[238] Libecap G.D., *Contracting for Property Rights* (Cambridge University Press: New York., 1989) 10.

[239] Grossman S. and O. Hart, 'The Cost and Benefits of Ownership: A Theory of Vertical and Lateral Integration', 94 *Journal of Political Economy*, 1986, 691-719.

rights refer to residual rights. They refer to a legal definition of ownership, equivalent to delegation of control, as all rights to use an asset "not voluntarily given away or that the government or some other party has taken by force".[240] In other studies, these rights also refer to residual returns, i.e., the right to spend the firm's money, which has not been contracted for explicitly.[241] Residual rights of control are preferred to residual rights to income, since the former are not divisible and thus a stronger concept as a definition of ownership. Property rights also confer indirectly control over human assets by controlling non-human assets. For example, an employer can influence a worker by threatening to deprive him of the machine at which he works.[242]

Therefore, control in the property rights theory plays a central role. It refers to strategic decisions. By strategic decisions it means decisions with major implications for the cash flows generated by a firm. The exact definition of a strategic decision, and therefore of the scope of control, differs according to the adopted assumptions. Control may refer to the decision of whether to liquidate, to continue or to sell the firm in small companies and venture capital vehicles. The concept of control is expanded to include important decisions such as reorganizations of companies and decisions to hire and fire top management in larger companies with diluted shareholders.[243]

Throughout most of the analysis on property rights, control is assumed to be binary, i.e., actors either have all control or no control. Shared control in a particular

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[240] This distinction is made by Grossman and Hart, 1986, note above, 691-719; Wiggins S., *Possession, Property Rights and Contractual Enforcement*, Texas A & M University, 1988 where he distinguishes between property rights and contractual rights.

[241] Holmstrom B. and Tirole J., *The Theory of the Firm*, in Richard Schmalensee and Robert Willig (eds.), Handbook of Industrial Organization, Amsterdam, 1989, at 61-134**;** Barzel Y., *Economic Analysis of Property Rights* (Cambridge: Cambridge University Press, 2nd ed. 1997) 55–64**;** Alchian A. and H. Demsetz, 'Production, Information Costs and Economic Organization', 62 *American Economic Review*, 1972, **777.**

[242] In contrast with the agency theory and the traditional property rights school, the theory of the firm advanced by the property rights approach does not treat the employer-employee as symmetric; unlike the employee, the employer possesses property rights to the physical assets and can determine how these are used. The employer can fire the worker, but the worker usually cannot dismiss his employer See, Putterman L., On Some Recent Explanations of Why Capital Hires Labor, 33 *Economic Inquiry*, April 1984, 171-187; Hart O., *Firms, Contracts and Financial Structures* (Oxford University Press, 1995) 59; Hart O., 'An Economic Perspective on the Theory of the Firm', 89(7) *Columbia Law Review*, 1989, 1757-1774.

[243] cf. the distinction between decision control and decision management where the former refers to the right to hire and fire and the latter to the right to make allocative decisions, in Fama E. and M.C. Jensen, 'Separation between ownership and control', 26 *Journal of Law and Economics,* 1983, 301.

state of nature implies unconstrained ex post bargaining between the parties in control. Obviously, this binary definition of control is a simplification of reality. Control rights are seldom unambiguously defined; court proceedings determining these rights would then be unnecessary. Neither are these rights, as interpreted by public courts, absolute; legal restrictions may, for example, prevent individual decisions from being implemented without prior consultations with the parties affected or other stakeholders may be entitled to a veto on certain strategic decisions.[244]

Furthermore, the transfer of control from one party to another is often gradual, for example, when creditors take over control from shareholders in bankruptcy, creditors in many cases obtain influence prior to actual transfer and equity-holders often maintain influence over certain strategic decisions for some time. Despite these external constraints and qualifications of control rights, the party in control can in most cases be distinguished from other stakeholders. According to the property rights theory, there is a need to allocate the right to decide or the rights of control in the events not specified by the initial contract. This decision right affects the distribution of the *ex post* surplus created by an enterprise and, therefore, the incentives to generate this surplus.[245]

For delegation of control to be a viable alternative to unconstrained bargaining or other forms of intermediate contracts, there must be some safeguards against abuse of authority by the controlling party. The legal definition referred to by Grossman and Hart suggest that there are definite limits to the scope of control. Laws impose such constraints, but the parties could also come to an agreement as to the scope.[246] In fact, such an understanding of the limits of control, whether explicit or implicit, is necessary for the non-controlling party to accept the delegation of control in the initial contract. As demonstrated, such legal and moral constraints have

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[244] Triantis G.G. and A. Choi, 'Completing Contracts in the Shadow of Costly Verification', 37 *J. Legal Studies,* 2008, 503.

[245] Hart O., and J. Moore, 'Property rights and the nature of the firm', 98 *Journal of Political Economy*, 1990, 1119–1158. This is also confirmed by a recent corporate governance survey see Shleifer A. and R. Vishny, 'A Survey of Corporate Governance', 52(2) *Journal of Finance,* 1997, 737-783.

[246] Corporate law resolves disputes ex post either by contingent adjudication or by proprietary solution. An example of a proprietary resolution would be for the law to hold that it is impossible for a majority shareholder to expropriate a minority shareholder. This confers the property right on the minority shareholder. See Whincop M.J., *An Economic and Jurisprudential Genealogy of Corporate Law* (Ashgate Publishing Company, 2001) 21 ff.

been of major significance in the evolution of contractual arrangements throughout the history of modern capitalism.[247] Some scholars argued that the limits of control could also be left to arbitration; an arbiter may be preferable to specifying in great detail the *ex post* decision itself.[248] To conclude control is not only hard to define unambiguously, it is also hard to observe and measure in a precise manner. Financial instruments may differ from state to state in how they are valued, and the control component cannot be easily isolated. Furthermore, comparisons across countries are distorted by international differences in accounting conventions and statistical procedures.[249]

Recently, some legal scholars have sought to make further progress in bringing together the economic and legal conceptions of property in relation to corporate law. It has been suggested that company law not only provides standard terms for the parties but also allows assets partitioning in the firm that could not be achieved by private contract.[250] For other scholars, while proprietary rights better protect shareholders' claims than contracts, because they work more effectively as governance mechanisms within the firm, they generate costs for third parties.[251] According to the Coase's theorem, parties will bargain around inefficient allocations of property rights if transaction costs do not exceed the gains from trade. A similar argument applies to legal rules that serve a governance function. However, the parties are better placed than the lawmakers to decide whether or not the involvement of the law adds value, having regard to contractual or market

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[247] North D.C., Structure and Change in Economic History (New York, 1981) *passim*.

[248] Tirole J., *The Theory of Industrial Organization* (Cambridge: MIT Press, 1988) *passim*.

[249] Kay J. and A. Silberston, *Corporate Governance,* National Institute Economic Review, August 1995, 84-97; Armour J., S. Deakin and S. Konzelmann, 'Shareholder Primacy and the Trajectory of UK Corporate Governance', 41 *British Journal of Industrial Relations*, 2003, 531-555; Armour J., 'The Proprietary Foundation of Corporate Law', *ESRC Center for Business Research*, University of Cambridge, Working paper n. 299, March 2005, 25 ff.

[250] Hansmann H. and R. Kraakman, The Essential Role of Organizational Law' 110 *Yale LJ,* 2000, 387 and 407–8. See also Mahoney P.G., 'Contract or Concession? An Essay on the History of Corporate Law' (2000) 34 *Ga LR* 873; Blair M., Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century (2003) 51 *UCLA L Rev* 387; Ireland P., 'Property and Contract in Contemporary Corporate Theory', 23 *LS*, 2003, 453; Hansmann H., R. Kraakman and R. Squire, 'Law and the Rise of the Firm', 119 *Harv LR* (2006) 1333.

[251] Armour J. and M.J. Whincop, 'The Proprietary Foundations of Corporate Law', 27 *Oxford Journal of Legal Studies*, 2007, 429-465.

substitutes.[252] Therefore, the law should facilitate a freedom of bargaining and partitioning of entitlements between the parties in the firm, while at the same time minimising costs for third parties.[253]

3.5. Summary of the analysis

Economic theory has inspired two different perspectives to evaluate the relevance of a corporate financial structure and in particular of hybrid financial instruments. The first is from a company's point of view and concerns the optimum leverage namely the optimal debt to equity ratio for a given firm. The studies regarding this area deal with the potential advantages of the market-value approach. Accordingly, any investment project and its concomitant financing plan depends on the fact that this can raise the market value of the firm's shares and realises a return higher than the marginal cost of capital to the firm. From this perspective, interests of directors and shareholders are perfectly aligned towards the maximisation of the company's share value.

The second perspective tackles the problem from the investor's point of view and regards the economic theories on corporate governance targeted to mitigate the internal conflicts of interest in the firm. Agency costs theory considers all the intersections of the economic activities of a number of parties and, in particular, the economic agency relations existing among shareholders, directors and bondholders. According to this analysis, the optimum amount of debt and equity in a firm is the financial structure that reduces the costs arising from those relations to a minimum. The property rights theory relaxes the assumptions of perfect contracts and absence of litigation costs, which were at the core of the agency costs theory, and defines the optimal capital structure as the mix of equity and debt that reduces to a minimum the

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[252] Rules can be contractible or mandatory according the fact that they can be altered or not. However, some scholars regard the moral hazard problems arising from contracting out certain legal rules as insurmountable and maintain that markets cannot adequately "price" these terms. Compare Bebchuk L, 'The Debate on Contractual Freedom in Corporate Law', 89 *Columbia Law Review*, 1989, 1395-1415; Brudney V., 'Corporate Governance, Agency Costs, and the Rhetoric of Contract', 85 *Colum. L. Rev.*, 1985, 1402; Coffee J.C. Jr., 'No Exit?: Opting Out, The Contractual Theory of the Corporation, and the Special Case of Remedies, 53 *Brooklyn L. Rev.* (1988) 919.

[253] Armour J. and M.J. Whincop, 'The Proprietary Foundations of Corporate Law', 27 *Oxford Journal of Legal Studies*, 2007, 457; Triantis G.G. and A. Choi, 'Strategic Vagueness in Contract Design: The Case of Corporate Acquisitions', 119 *Yale L.J.,* 2010, 856 and 924.

hold-up problems and *disputes* generated by the contract incompleteness. These studies concern two parallel aspects of equal importance when internal corporate conflicts of interest are taken into considerations: the incentives' setting up and the proper allocation of control rights and residual rights.

On the one side, the firm is studied as a "nexus of contractual relationships", which are source of potential conflicts ("agency costs"), because the interests of directors and shareholders diverge. The financial structure plays a role in reducing these costs by creating the right incentives for all the parties involved in the firm. On the other side, the company is seen as a "joint ownership of common assets", which are jointly owned by shareholders and bondholders. The parties bargain for their rights and fix their objectives *ex ante* but may disagree on the same *ex post*. This creates hold-up problems. The internal corporate mechanism of insolvency optimises which party should retain the property, which is expressed as the right to control and decide over the assets.

Part I is dedicated to the first approach that is typically a classification approach. The law needs to apply a distinction between equity and debt. Tax, accounting as well as regulatory treatment of debt and equity are indeed important *drivers* behind many of the firms' decisions regarding their capital structure. However, economic theory shows very little justification for distinguishing between equity and debt. This is demonstrated by the ability of hybrid instruments to blur any artificial classification dictated by law and create opportunities of regulatory *arbitrage* in accounting, tax and insolvency law as well as in corporate law.

In order to take into consideration the governance implications of hybrid securities, the thesis sets out a new theoretical framework that puts more emphasis on the *agency relations* and the *property law claims* embedded in such "unconventional" financial instruments. The remaining chapters in Part II are entirely dedicated to this functional approach.

PART II – GOVERNANCE REGULATION OF HYBRID FINANCIAL INSTRUMENTS: THE FUNCTIONAL APPROACH

Chapter 4. From the Classification to the Functional Approach

The firm's capital structure through its financial instruments allocates the company's cash-flow rights among the firm's investors, specifying the times at which each investor is paid their allocation. An investor's claim may be fixed, or contingent on the value of a specified asset or a flow variable, at the discretion of the issuer as in the case of common stock dividends. An investor's claim may also be represented by a combination of these features as in the case of hybrid securities. In the same way, the financial contracts between the company and its investors assign the levers by which they may influence the firm's decisions. This is most obvious in the case of ordinary shareholders who have the right to vote for the appointment or displacement of directors, and who can enforce the directors' fiduciary obligations to the corporation. However, not all shareholders have control rights; some investors may have contracted them out in return for a higher payout, as for instance in the case of preference shareholders. Likewise, some powers of "voice", which may substantially constrain the firm's decisions, can be assigned to debt-holders through the use of "covenants" or so-called "appraisal rights". Sometimes these covenants may be quite broad or restrictive enough, depending on the situation, to require the assent of the security-holders to important decisions in the firm, as if they were the controlling shareholders. Finally, some financial contracts allow investors to convert their security into another security, providing them with the right to switch their position/role within in the company.

This section provides an outline of the main features of corporate law and corporate governance in particular. It aims to identify some key characteristics of hybrids, which are useful for understanding these securities in context. Accordingly, the thesis assesses how hybrids may constrain the board's discretion to change the fundamental allocation of financial and control powers among the firm's participants, and with what conflicts. This functional approach can provide an alternative insight into how hybrids can be better understood and the law related to them most effectively changed. The investigation of the corporate governance

implications that hybrids raise would be impossible under the classification approach, which relies on a legal distinction between equity and debt. The analysis has shown that hybrids blur this artificial dichotomy, facilitating the so-called "regulatory arbitrage". Conversely, from the point of view of corporate governance, a functional analysis of these financial contracts is likely to produce more meaningful findings.

4.1. Governance implications of issuing hybrid instruments

Two ratios should generally be observed in a corporation. The first is risk:return and concerns corporate finance, while the second is risk:control concerning corporate governance. This assertion comes from the analysis of a company's allocation of cash-flow rights and control power among its investors. Both these rights are relative to risk. Therefore, from a corporate finance perspective, a higher risk should involve a higher return on the investment, while from a corporate governance point of view, voting rights and control power should be allocated to the group of investors with the most residual claims in the company, that is the group supporting the highest risk of loss and therefore having the best incentives to promote firm value maximization.[254]

When a business is conducted through a company limited by shares incorporated under the CA 2006, its ordinary shareholders are generally considered to be suppliers of long-term finance, which by its nature is also considered as risky capital. Because the return on their investment is almost wholly dependent on the company's economic success, they are regarded as residual claimants. This does not mean that they are the only group to have residual claims on the company.[255] However, while ordinary shareholders hold mere expectations of a financial return from the company's business, the other groups protect themselves fully through contractual provisions.[256] Therefore, preferred shareholders, creditors, suppliers and

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[254] See Easterbrook F.H. and Fischel D.R., *The Economic Structure of Corporate Law* (Harvard University Press, Cambridge, MA, 1991) 63-72; Williamson O.E., *The Economic Institutions of Capitalism,* (New York: Free Press, 1985) 304-306.

[255] Ireland P., 'Company Law and the Myth of Shareholder Ownership', 62(1) *The Modern Law Review*, 1999, 32-57; Davies P.L., *Introduction to company law* (Oxford University Press: Clarendon Law Series) 2002, 257; Worthington S., 'Shares and shareholders: property, power and entitlements (Part 1 and 2)', 22(9) *The Company Lawyer*, 2001, 258 ff.; Fama E., 'Agency Problems and the Theory of the Firm', 88 *Journal of Political Economy*, 1980, 288-290.

[256] See Macey J.R., 'An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties', 21 *Stetson Law Review*, 1991, 23 and 25. A

even employees can use these contracts to bargain for whatever protections are efficient for the parties while common shareholders, who are mostly vulnerable to insider opportunism, thus need board control and fiduciary duty protection to advance and protect their interests. The allocation of voting rights to ordinary shareholders would also be confirmed by a practice of corporate finance. In fact, if a company needs risk capital it will not be able to acquire it on acceptable terms unless control rights are allocated to ordinary shareholders, or at least contractual entitlements to a higher return on investment are given to them as compensation.[257] If being the most residual claimants in the firm place ordinary shareholders in a full control position of the company at first when the company is set up, for the same reason, it is understandable why those control rights should be lost when the shareholder no longer has an investment to protect.[258] The law facilitates the granting of such control rights to ordinary shareholders but its mandatory contribution is to deprive them of the control rights they have contracted for at the point when their investment has disappeared. For this reason, bondholders, who normally have a contractual entitlement to regular interest on their loan to the company and to repayment of the principal at a fixed point in the future, do obtain control rights when certain events put in doubt the company's ability to pay the interest due or to repay the loan on time.

Studies on agency theory have underlined two main obstacles to a perfect allocation of cash-flow rights and control power in a company: information asymmetry and the resulting increased risk and opportunistic behaviour of parties, which generate costs for the company. These problems arise from contractual incompleteness, that is the impossibility of the parties writing a perfect contract because of the difficulty of covering in advance and specifying *ex ante* all the possible conduct of the parties in dealing with the various different situations the company could encounter. Because of the information asymmetry, some information

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different point of view comes from Hansmann H., *The Ownership of Enterprise* (First Harvard University Press, 2000) 53 ff., who has suggested that ordinary shareholders are allocated governance rights because they are in a position to discharge the governance function more efficiently than any other non-shareholder stakeholder group.

[257] Davies P.L., *Introduction to company law* (Oxford University Press: Clarendon Law Series) 2002, 267.

[258] This principle is firmly embedded in the insolvency law as the prime function of the law. See s. 214 of the Insolvency Act 1986.

is observable by only one party who cannot or does not want to communicate it to others. As a result, risk and uncertainty are enormously increased. Because of the agency costs, the parties cannot control post-financing behaviour by contract because either the behaviour itself or future states of the world cannot be verified by third-party arbiters. This results in the possibility of opportunistic behaviour. In fact, the risks and rewards of potential business opportunities may be differentially distributed across the stakeholder groups, so that the rewards, if the project is successful, will accrue predominantly to some groups, whilst the costs of failure will fall predominantly on other stakeholder groups.[259] These two problems greatly motivate the design of financial contracts and are the main reason for the use of hybrid financial instruments.

The implications of hybrids differ according to some particular features that may be frequently found in various companies. I am going to analyse two particular situations in which the issuance of hybrid financial instruments has different impacts. These are large publicly traded companies and small closely held start-up firms. The division between large and small groups is uniquely adopted in this thesis for practical purposes. Since it is sometimes not clear when a company no longer qualifies as small and becomes large, as for instance in venture capital businesses, it does not have to be seen has a categorical distinction. Similarly, the distinction between public and private companies must not be seen as categorical. Although these two typologies of company generally show contrasting features, it may be possible to find exceptions and similarities in both. For instance, public company shareholders, who hold their shares listed in a stock market, usually benefit from high liquidity. However, small growing public companies traded in the Alternative Investment Market (AIM) sometimes suffer from very low volumes of shares exchanged and low liquidity. In the same way, there may be a small private company governed by a centralised management of experts and not by the majority shareholders. However, it is useful to identify these contrasting core features because it is in relation to them that the impact of a hybrid instrument changes.

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[259] Davies P.L., *Introduction to company law* (Oxford University Press: Clarendon Law Series) 2002, 269.

4.1.1. Large publicly traded companies

As companies become larger, their needs for capital to carry on their business are also likely to increase, to the point where the public needs to be invited to provide risk capital for the company, either directly or via intermediaries such as pension funds or insurance companies. These companies present a large shareholding body, distinct from the management, which is centralised and entrusted to a small group of managers.[260] The choice of centralised management in public corporations comes from the necessity for the company to conduct its business efficiently. The independent board helps the company to reduce the costs of organisation and accelerates decision-making when business expands.[261]

From an economic perspective, the public corporation has the main advantage of providing the firm with a low-cost source of equity capital, because of its efficiency in spreading risk among well-diversified investors. In a way, the public corporation can be thought of as an ingenious risk-management device, a form of organisation that allows equity investors to specialise in bearing the residual risk of the firm without having to manage it, since they can diversify their own portfolios.[262] On the other hand, managers, who invest all their skills and time in running the firm, are risk averse and place high value on the growth, size, and diversification of the business. While for such corporations the arguments for centralised management are the strongest, it has to be said that centralised management is not without danger for shareholders. Since managers are risk averse, they prefer to keep the surplus generated by the annual cash flow inside the firm without considering the optimal amount of risk-taking and payouts to investors.[263] For this reason, the risk of opportunistic behaviour and the agency costs in large publicly traded companies are the highest, hence the need for corporate governance and incentive compensation to

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[260] Berle A. and G. Means, *The Modern Corporation and Private Property* (New York: Harcourt Brace and World, 1926) revised edn, 1968, 47. In their analysis, Berle and Means observe a great fragmentation of shareholdings in large companies that caused a separation between ownership and control, mainly due to the development of a specialised function of managing the company separate from that of providing risk capital and to a shareholdings dilution in the company.

[261] Davies P.L., *Introduction to company law* (Oxford University Press: Clarendon Law Series) 2002, 111-113.

[262] Wruck K.H., 'Private Equity, Corporate Governance and the Reinvention of the Market of Corporate Control', 20(3) *Journal of Applied Corporate Finance*, 2008, 8.

[263] Easterbrook F.H. and Fischel D.R., *The Economic Structure of Corporate Law* (Harvard University Press, Cambridge, MA, 1991) 21-22.

help ensure that managers serve the interests of the residual risk-bearing investors.[264] Therefore, in a publicly traded company, centralised management raises issues mainly concerned with how the directors can be made accountable to the shareholders.

Indeed, the phenomenon of the separation between ownership and control found fertile ground in publicly traded companies thanks to the easy mechanism of transferability of shares existing in the stock market. According to this, the entry and exit process of an investor in a corporation is facilitated contrary to what happens in small firms or even in medium-large companies not listed. A dissatisfied shareholder may simply sell his stake in the stock market if his expectations are not satisfied. Therefore, investors in public companies are generally more concerned about the liquidity of the stock market, so they can diversify their portfolios, than they are in control power. Furthermore, the takeover may work as a mechanism of governance for public companies while it is of very little importance for private groups. In certain countries such as the United Kingdom, in which the law facilitates the removal of directors in the case of takeover, the market for corporate control may represent quite a strong incentive for managers to strive for the company's success, maximising its shares market price. However, this may not be the same in the United States of America, where law provides directors with effective defensive tools against hostile tender offers that make their removal without an agreement from their side extremely difficult.[265]

Regarding the investment policies, public companies show a greater propensity to invest in transparent assets and assets-in-place than private companies. Transparent assets are supposed to be assets that are easier to measure. In fact, low visibility of corporate assets brings high risk and may constrain the market for finance. This is probably one of the reasons why public companies often play a weak role in innovation, at least in a direct visible way. Since managers, who are risk averse, prefer to diversify their assets and grow according to the economies of scale, they will only finance research and development (R&D) or growth opportunity

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[264] Jensen M. and W. Meckling, 'Theory of the Firm: Managerial Behaviour, Agency costs and Ownership Structure', 3 *Journal of Financial Economics*, 1976, 349-350.

[265] Romano R., *A Guide to Takeovers: Theory, Evidence and Regulation,* in K. Hopt and E. Wymeersch (edn), European Takeovers: Law and Practice (London: Butterworths, 1992) *passim*; Davies P.L., *Introduction to company law* (Oxford University Press: Clarendon Law Series) 2002, *passim*.

projects if they know the investment will not unreasonably reduce the future company's cash flows. In fact, growth opportunities, options and R&D projects may involve in a great amount of finance with the result of lowering profits for some years. Shareholders would only accept that if they had a clear understanding of the inputs and likely outputs of innovation. Finally, given that negotiations in the stock markets are based principally on the discounted value of future expectations related to companies, they are particularly influenced by any kind of news or action. Thus, changes in the corporate financial structure may be an incentive for managers who want to send a positive signal to the market.

To summarise, large public companies represent centralised management, the free transferability of shares and diversified and transparent (hence tangible) assets. Therefore, the uncertainty created by the information asymmetry problem between managers and investors, concerning the nature of the business and the strategy of the company, is reduced by the transparency of its assets and the disclosure rules, aimed at protecting the stock market's investors, that are mandatory for public companies. In addition, the easy exit for a dissatisfied investor guarantees a lower level of risk than in private start-up firms. Thus, investors in these cases are less concerned about control. In contrast, the agency costs created by the separation of ownership and control and, consequently, the potential opportunistic behaviour of managers are at a high.

4.1.2. Small closely held start-up firms

Start-up firms generally have a small number of shareholders, all or most of whom expect to be involved in the management of the company. This choice of governance may also reflect the need to avoid all the public disclosure requirements and to minimise the agency problems associated with a centralised management. In fact, the opposite problem could arise, namely whether it is worthwhile to require a company to have two separate decision-making bodies (board and shareholders' meetings) when the same people crop up on both occasions.[266] While vesting the management

[266] In UK, the current law keeps the two-centre decision-making structure in existence, and so still requires those running small companies to distinguish between what they do as directors and what they do as shareholders, while making it more convenient for them to operate the company. A more radical approach would be to permit the company to opt for rolling the two decision-making bodies

in the shareholders may solve one problem that is related to the shareholder-managers relationship, it is at the potential cost of creating another, namely the risk of oppressive conduct on the part of the majority of shareholders against the minority.[267]

The peculiar flexible governance structure of small private firms has led to them being favoured as the most suitable vehicles for investments in innovation. The bulk of successful venture capital is invested in the high-technology sector and the value of these start-up firms lies in their growth options rather than in their marketable assets. For many such firms, the principal assets consist of ideas, human capital and growth opportunities, which will be completely worthless, and thus unavailable for creditors, in the case of default.[268] Therefore, information asymmetries are more severe in such firms than in large public companies. Fewer factors are observable, and far less verifiable. Indeed, in the absence of tangible assets, the opportunity for misbehaviour is greater, and monitoring is more difficult.

High ratios of intangible to total assets with low liquidation values, as it is the case in the R&D investments, may create uncertainty – and consequently high risk – in the business of the firm and this constrains the market for finance. This seems to be confirmed by the difficulties raising debt finance showed by many private start-up firms developing new technologies. They commonly do not generate steady cash flows that can be used to make interest payments on debt. Venture capital investments often face negative cash flows in the first years. Investors only come forward if they have a clear understanding of the inputs to and the likely outputs of innovation. When the visibility of innovation is low and there is asymmetric information, entrepreneurs and financiers need to engage closely with the firm, to develop a firm-specific understanding in order to find the key for future innovative

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into one, as is permitted in some US jurisdictions. Thus, s. 351 of the Delaware General Corporation Law permits a close corporation to opt for its affairs to be run solely by the shareholders.

[267] Not surprisingly, company law has developed rules against minority oppression, most strongly in the small company context where control of the company is most likely to be in the hands of the majority shareholders. See Davies P.L., *Introduction to company law* (Oxford University Press: Clarendon Law Series) 2002, 215-254.

[268] See, for example, Armour J., 'Personal Insolvency Law and the Demand for Venture Capital', 5 *EBOR*, 2004, 87 – 118; Berger A.N. and G.F. Udell, 'The economics of small business finance: The roles of private equity and debt markets in the financial growth cycle', 22(6-8) *Journal of Banking & Finance,* 1998, 613-673; Carpenter R.E. and B.C. Petersen, 'Capital Market Imperfections, High-Tech Investment, and New Equity Financing', 112 *Economic Journal*, 2002, F54-F72.

success.[269] Small private start-up firms, which are constituted *ad hoc*, present the perfect vehicle where investors are aware of the risk they support and engage closely with the firm in order to develop a firm-specific understanding. At the same time, managers can have a high degree of autonomy because investors maintain ultimate control over the company in case events become unfavourable.

These companies are also referred to as "closely held" or "close" companies because the transferability of shares will usually be restricted by their statutes and the identity of any new shareholder will be regarded as a matter of concern for all the shareholders. The company's control is firmly locked in the hands of the entrepreneur who is generally unwilling to cede control rights to outsiders. However, when the firm is wealth constrained or needs new finance to expand, the equilibrium financial contract will be one that reduces the information asymmetries without surrendering control to the financier.

In summary, small private start-up firms, commonly used in venture capital and private equity transactions, present several clear features: an entrepreneur-manager, a constrained market for finance and investments in illiquid or intangible assets with growth opportunities but low visibility. While vesting the management in the shareholders reduces some agency costs, the conflict between majority and minority shareholders or between shareholders and bondholders is exacerbated. This is due to the combination of limited liability and locked-in control that can lead to shareholders' opportunistic behaviour. In addition, the low visibility of assets, especially when they are represented by human capital or technical know-how, generates an even larger information asymmetry problem and uncertainty than in the case of publicly traded companies. Therefore, the risk in these investments is generally very high.

4.2. The structure of Part II

While in publicly traded companies, centralised management raises issues mainly concerned with how the directors can be made accountable to the shareholders, in a closely held start-up, there is a greater risk that some of the shareholders will co-ordinate their activities so as to control the board and run the company without regard to the interests of the non-controlling shareholders or the creditors. The analysis of corporate relationships in the case of hybrids is complicated by the fact

[269] See examples Armour J., 'Personal Insolvency Law and the Demand for Venture Capital', 5 *EBOR*, 2004, 87 – 118.

that such securities do not always attribute a "clear" status in the company to their holders. For example, sometimes their position may be swapped for another as in the case of convertible securities, or they may receive a fixed "dividend", which is automatically deducted from the firm's profits as a cost, or their interests may be subordinated to the achievement of a final positive result. This complicates the task of the law to protect their rights. It is often arguable how far their protection is a matter of contract and how far a mandatory matter of company law. British law has traditionally permitted broad access on the part of shareholders to the shelter of limited liability and has left creditors to protect themselves, largely by contract, against the risk of opportunistic behaviour. In this strategy the role of company law has been to place creditors in a position where they can bargain effectively with companies, for example by requiring the disclosure of relevant information.[270]

Indeed, the quantity and quality of information contained in the accounts has been improved over time, notably by the development largely by the accounting professions of accounting standards, which both reduce the directors' discretion as to how transactions are presented in the accounts and promote comparability across companies. Nevertheless, it can be argued that the information contained in the public accounts is often out of date, and many large lenders no doubt require the production of more up-to-date information as part of the pre-contractual process. In addition, as we discussed in Part I, the growing use of hybrid instruments has further complicated the role of accounting law with regard to the classification "equity-debt". The company law effort to facilitate creditor self-help is mostly evident in the case of small private start-up firms in venture capital looking at the flexibility of the company's constitution. In fact, it is at the incorporation stage that shareholders often enable financiers to secure representation within the governance organs of the company, even in advance of default, if that seems to them an appropriate course of action. In any case, the shareholders by ordinary majority can remove a director at any time, whether that director was appointed by them or not. Conversely, the nominator has no redress other than that which it has stipulated for in the contract, which might include, of course, the right to call for repayment of the loan and to

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[270] In the UK by 1948, the filing obligation was applied to the profit and loss account as well as to the balance sheet. Both these documents had to be audited by external and professionally qualified persons, and the obligation to produce accounts was applied in the case of corporate groups, to the group as a whole as well as to the individual companies within it. See CA 2006 at Part 15.

appoint a receiver. Equally, the courts have insisted that the nominee director owes duties to the company, in the same way as any other director, rather than the nominator. Despite this, the greater weight of the policy for dealing with opportunism in this strategy lies with private rather than public ordering.[271]

The peculiarities of private contracting do not have to be seen only as confined to opting out of limited liability. Contract has an equally important role in dealing with the consequences of transacting on the basis of limited liability. The lender may seek to control the actions of the corporate borrower by inserting provisions in the loan contract, requiring the lender's prior consent to certain courses of action that the lender judges might adversely affect the prospects of the loan being repaid. Alternatively, the lender may introduce in the terms of the contract anti-dilution clauses in order to protect their participation and control in the company. Furthermore, a lender may contract for governance rights. The vote attributed to shareholders may be conferred to creditors by covenants, the breach of which results in the sanction of a default, thereby encouraging compliance, or in the automatic appointment of some directors to the board. The variety of protections for creditors that can be created in this way is large and will be discussed below.

This said, keeping in mind the core features of corporate governance and finance, I will examine preference shares, convertible bonds and bonds holding restrictive covenants for their state-contingent combination of features and their function, each in several significant situations arising during the life of a firm according to the instrument's relevance to the particular case studied. The study will include the rationale of using hybrids in particular situations where the risks of opportunism are evident and so the conflicts of interest among the parties. For each case, I will also discuss the legal strategies available for protection in the UK and US systems, where these securities are common, with the aim of comparing and evaluating them.

The analysis shows that hybrids of debt generally prefer to bargain for contractual protection. In fact, certain clauses included in this kind of financial contracts are nowadays standardised in the markets. Conversely, preference shareholders, who are often a class of the equity share capital, benefit from the

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[271] In 1982 the *Report of the Review Committee on Insolvency Law and Practice* (Chairman: Sir Kenneth Cork), Cmnd. 8558, made some use of direct control of opportunistic behaviour. However, the Government did not act to follow some recommendations of the Committee (for example to set aside 10 per cent of the company's assets for unsecured creditors in the event of winding up). See paras 1523-1549.

protection of statutory rules or from *ex post* remedies, as for instance the regime of the variation of class rights and the petition for unfair prejudice or for breach of directors' fiduciary duties. However, the financial entitlements of these securities are considered by courts to be contractual in nature. Moreover, when their privileges pose limits for the amount of dividends and the repayment of capital in liquidation, they are considered as not being part of the equity share capital as defined by s. 548 of the Companies Act. Therefore, they may not have the protections they relied on. At the same time, they have a weaker contractual position compared with creditors. Since, as the analysis shows, there are situations in which the interests of ordinary and preferred shareholders diverge, they may have a strong incentive to contract for their protection. This is particularly true in start-up businesses in private equity and venture capital, where the economic environment of the firm can evolve very quickly.

Chapter 5. Significant corporate decisions

I begin my analysis in this part by discussing some significant corporate decisions that can create fundamental changes in the relationship between the holders of hybrid financial instruments and the other participants in the firm. These situations need special attention because they are the main source of conflicts of interest among the company's constituencies. I will discuss when the use of hybrids reduces the

opportunities for conflict and when, by contrast, it enhances them. At the same time, I will analyse and evaluate how corporate law mitigates the opportunism that can accompany these changes, whether a further intervention of the regulator is needed or whether these conflicts would be better avoided contractually by the parties through free bargaining.

This chapter concerns the law in the UK and compares it with the evolution of the corresponding law of the US. The analysis shows that there is a strong rationale for hybrids in private equity and venture capital financing, because the investors in these businesses need to modulate the original (normal) allocation of cash-flow rights and control rights. At the same time, the simple standard protection provided by the law, which acts efficiently for minority shareholders, may not be adequate for covering the sophisticate necessities of the parties involved in hybrid financial contracts. The study suggests a careful contractual design.

5.1. Contracting for governance rights at a company's start-up

Many of the relationships between participants in the firm are structured by contract, including contracts with creditors and shareholder agreements, and it is through the articles of association that company law can balance the different interests of the main participants, allowing for flexibility, constitutional commitments and publicity.[272] The role of bargaining is clearly observable at the time a business is incorporated in a venture capital start-up. The contractual arrangements for venture capital are much more complex than for most types of finance. Normally, they involve the both sides sharing the up-side potential of the project, providing for both equity-type characteristics.[273] The entrepreneur and the venture capitalist are only concerned with the effective allocation of cash-flow and control rights between them and not the formal labels attached to these rights. Whether they invest in a business through equity or debt is something they care about only if something depends on it. Venture capitalists often invest in several different countries each of which has its own legal systems. The details of these legal systems are important only insofar as

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[272] Kahan M. and E. Rock, 'Corporate Constitutionalism: Antitakeover Charter Provisions as Precommitment', 152 *University of Pennsylvania Law Review*, 2003, 473.

[273] See Kaplan S.N. and P. Strömberg, 'Financial contracting meets the real world: an empirical analysis of venture capital contracts', 70 *Review of Economic Studies*, 2003, 281 and 306-308.

the investment contracts must consider them.[274]

Start-up firms display a high degree of "informational opacity".[275] Investors in this sector face severe information asymmetries. This asymmetric information generates a great "adverse selection" problem. Therefore entrepreneurs, who are generally better informed than outside investors as to the true level of skills and abilities to take on a given task, may misrepresent their abilities to them and, these misrepresentations may go undetected. Banks, financial intermediates and investment funds lacking the information to identify firms with the highest expected returns relative to the degree of risk, find it difficult to use the price mechanism to distinguish between firms[276] and ask for higher interest rates to offset the risk incurred in lending money to a company in the absence of collateral. This problem may constrain the market for finance of technology-based firms.[277]

The adverse selection problem is enhanced in small private companies because they are generally unable to provide collateral or adequate guarantees for the funds they require and, unlike public companies, they are characterised by lock-in capital for a long period of time. The transferability of shares – an essential mechanism in public companies for imposing discipline upon managers – is strongly limited in private firms, where the rights of exit may be non-existent. Non-management purchasers of stock in public companies are passive investors; if they do not like the way the company is being run, their solution is to sell their shares. However, venture capital operates on an entirely different set of principles. The entrepreneur possesses the idea and so he has the incentives and the know-how to develop the

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[274] Kaplan S.N., P.J. Strömberg and M. Frederic, 'How Do Legal Differences and Learning Affect Financial Contracts?' (June 16, 2004) available at SSRN: http://ssrn.com/abstract=557007. In contrast to the empirical research carried out by La Porta et al., the variable measuring law and order is negatively related to the importance of venture capital finance. The authors found that venture capital grows in countries with less law and order.

[275] Berger A.N. and G.F. Udell, 'The economics of small business finance: The roles of private equity and debt markets in the financial growth cycle', 22(6-8) *Journal of Banking & Finance,* 1998, 613-673.

[276] Prior to advancing funds, if the investor offers average terms these will be attractive to low-quality entrepreneurs, and unattractive to high-quality entrepreneurs, see Myers S.C. and N.S. Majluf, 'Corporate Financing and Investment Decision When Firms Have Information That Investors Do Not Have', 13 *J. Fin. Econ.*, 1984, 187-221.

[277] As Lund M. and J. Write of the Bank of England Domestic Finance Division stated: "It has frequently been argued in economics literature that such problems can lead to credit rationing for small and medium-sized enterprises, that is, finance is not made available to all firms with viable projects whose net present value is positive", 'The Financing of Small Firms in the United Kingdom', Quarterly Bulletin May 1999, 195. See also Stiglitz J.E. and A. Weiss, 'Credit rationing in markets with imperfect information', *American Economic Review*, 1981, 407-408.

concept and bring it to market. For this reason, he generally likes to maintain control of the business and is unwilling to cede it to outsiders.[278] While an entrepreneur is strongly motivated by private benefits of control, the venture capitalist is more concerned about future revenues. However, the typical founder is an incomplete businessman, with gaps in experience in matters such as financial management and marketing. These gaps are expected to be filled by the venture capitalist or by the venture pool of funds, who are generally professional managers and can provide access to networks and foster credibility through the signal of their reputation. Indeed, the venture capitalist benefits from every potential efficiencies improvement when the firm is performing well.[279]

The lock-in feature, added to the company's limited liability, is a source of conflict between the entrepreneur-shareholder and the venture capital fund.[280] This phenomenon is also known as the "moral hazard" problem. If the firm's income realised is inadequate because the business does not succeed, the investor may not be able to recognise whether this was due to the entrepreneur's lack of effort or pursuit of private benefits, or simply by bad cyclical economic conditions.[281] Such a scenario will reduce the entrepreneur's incentives to apply effort and pursue joint benefits, while it will increase his motivation to misallocate the raised funds by spending on items that disproportionately benefit him.[282] For instance, an entrepreneur-scientist may choose to invest finance in research activities that increase the fame of the scientist, but produce little return for the investor.[283]

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[278] Managing the firm confers private non-verifiable benefits to the entrepreneur that are related to a reputation that he may use in other business situations. Of course, private benefits accrue only in good states of nature given that an entrepreneur does not gain in reputation running a poorly performing company.

[279] Black B. and R. Gilson, Venture Capital and the Structure of Capital Markets: Bank versus Stock Markets, 47 *J. Fin. Econ.,* 1998, 243-277; Bartlett J.W., *Equity Finance: Venture Capital, Buyouts, Restructurings and Reorganizations*, (Aspen Publishers, 1995) 229-230.

[280] See Williamson O.E., Corporate finance and corporate governance, 43 *J. Fin.*, 1988, 567-591; Klein B., R.G. Crawford A.A. Alchian, 'Vertical integration, appropriable rents, and the competitive contracting process', 21 *Journal of Law and Economics*, 1978, 297-326. For a practical example see Joskow P., 'Vertical integration and long-term contracts: The case of coal-burning electric generating plants', Fall. 33 *Journal of Law, Economics, and Organizations,* 1985, 32-80, where the decision to locate a coal-fired power plant next to a coal mine left the owners of the power plant vulnerable to expropriation and *ex post* renegotiation.

[281] Jensen M. and W. Meckling, 'Theory of the Firm: Managerial Behavior, Agency costs and Ownership Structure', 3 *Journal of Financial Economics*, 1976, 348.

[282] Green R., 'Investment incentives debt and warrants', (1984) 13 *J. Fin. Econ.*, 115-117.

[283] Denis D.J., 'Entrepreneurial finance: an overview of the issues and evidence', 10 *J. Corp. Fin.,* 2004, 301– 326.

Thus, asymmetric information at the time of start-up, and moral hazard, can also lead to costly agency conflicts between transacting parties in the form of *ex ante* underinvestment and *ex post* opportunistic behaviour, also known as "hold-up" problems. Knowledge-based start-up firms on a rapid growth trajectory and in the need of external finance face a clear trade-off. On one hand, they are often unable to issue long-term debt on economic terms due to high financial distress costs, especially when these are highly innovative technology-based firms supposed to generate a negative cash flow for several years. On the other hand, if plain vanilla bonds can be very costly in these circumstances, pure ordinary shares could also have significant costs. The management of firms in the early stage of a potential successful and innovative business may believe that the current stock price fairly reflects the firm's growth opportunities. Therefore, the issuance of equity would be expected to cause an excessive dilution of existing stockholders' claims and the owner-manager may be reluctant to carve in outside investors at today's stock price. At the same time, the venture capitalist invests at risk in situations where a high degree of uncertainty exists as to how the venture will develop over time and the aptitude and intentions of the entrepreneur cannot be gauged with accuracy.[284]

The financing provided for start-up firms differ in risk from the funds lent to public companies. This is due to two main factors: first, start-up firms investing in high technology usually hold intangible and illiquid assets; second, the investors in this sector contribute, in proportion, most of the funds needed to run the business without holding the related ownership interests. Therefore, even if these funds are provided as senior debt, they generally face the same risk as shares being locked in the company for the entire duration of the business development's cycle and having no collateral for satisfying their credit. The absence of collateral means the investors cannot simply leave the entrepreneurs to their own devices. Investing in risky assets can generate incremental distress costs for sponsoring firms, a problem which is referred to as risk management. When these indirect or collateral distress costs are sufficiently large, at least in expectation, they can exceed the asset's net present value, thereby turning a positive project into a negative investment. Not surprisingly, venture capital funds are concerned about resolving the uncertainty of cash flows and they prefer to retain at least residual rights of control in the business' strategy. For these reasons, in venture capital there is a much greater involvement of the providers

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[284] Jensen M. and W. Meckling, 1976, note 385, at 349-350.

of funds than is the case with other forms of lending in an attempt to avoid the problems arising from asymmetric information and agency relationships.[285]

Initially, by isolating the asset in a stand-alone special purpose vehicle, the venture capitalist reduces the possibility of risk contamination, the phenomenon where a failing asset drags an otherwise healthy sponsoring firm into distress. It also reduces the possibility that a risky asset will impose indirect distress costs on a sponsoring firm even short of actual default. However, ordinary limited liability is not sufficient to solve agency problems and the uncertainty of future cash flows. The corporate finance literature in this area has underlined two important issues: first, incentive contracts must be designed in a way that optimises the sensitivity of the entrepreneur's wealth to some observable signals of the entrepreneur's effort (for example, output or profits); second, this contract has to include a decision, not only on how claims on cash flows should be prioritised among all the participants, but also on who has to take control in the various states of nature.[286]

5.1.1. Limits to the control power of a lender

There are two limits on the role that lenders can be expected to play as monitors of corporate management that, as I have already mentioned, also depend on the type of company they are investing in. The first is their self-interest, meaning the lenders' pursued aims. Where lenders perform the mere function of investors, they will

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[285] The argument that financial innovation helps to complete financial markets is an uneasy case to beat when the novel security can be priced by equating it to a combination of existing securities. See Hakanssan N.H., 'The Fantastic World of Finance: Progress and The Free Lunch', 14 *J. Fin. & Quantitative analysis*, 1979, 717 and 722-724. It may be, however, that the firm can combine existing claims to satisfy investor tastes at a lower cost than financial intermediaries providing this service and this would suggest a transaction cost explanation for hybrid instruments. See Merton R.C., *On The Application of the Continuous-Time Theory of Finance to Financial Intermediation and Insurance,* 14 Geneva Paper on risk and insurance, 225 (July 1989), where the author sets forth a transaction cost explanation for the role of intermediaries in financial derivatives markets. Furthermore the development by Merrill Lynch of liquid yield option notes (LYONs), which are puttable convertible zero coupon bonds, seems to have been motivated by such an attempt to provide retail investors with an attractive package of debt and stock options. See McConnell J.J. and E.S. Schwartz, 'The Origin of LYONs: A Case Study in Financial Innovation', *J. Applied Corp. Fin.,* Winter 1992, 40 and 41-42; Triantis A.J. and G.G. Triantis, 'Conversion rights and the design of financial contracts', 72 *Wash. U. L. Q.*, 1994, 1236 ff.; *Contra* DENT G.W., 'The Role of Convertible Securities in Corporate Finance', 21 *J. Corp. L.,* 1996, 250 ff.

[286] See Denis D.J., 'Entrepreneurial finance: an overview of the issues and evidence', 10 *J. Corp. Fin.,* 2004, 310; compare with Kaplan S.N. and P. Strömberg, 'Financial contracting meets the real world: an empirical analysis of venture capital contracts', 70 *Review of Economic Studies*, 2003, 286-295; Aghion P. and P. Bolton, 'An "Incomplete contract" Approach to Financial Contracting', 59 *Review of Economic Studies*, 1992, 473; Hart O., 'Financial Contracting', 39(4) *Journal of Economic Literature*, 2001, 1081-1085.

probably opt not to monitor but instead to employ other risk-management techniques such as portfolio diversification principles. In fact, since shareholders rather than creditors benefit from capital growth, a lender has no incentive to invest resources in employing and training staff to monitor a corporate borrower beyond the extent necessary to satisfy itself that the company's ability to meet its obligations under the loan is not impaired or placed under threat. However, it is a different case when a lender invests in private equity or venture capital. In fact, in private start-up firms, the amount of money a financier may contribute is generally the largest share of the company's capital and the incentive to be involved in the governance of the company is usually great.[287]

The second limit to the power of banks, financiers and institutional investors to monitor and control firm decisions to enhance their position, is represented by the doctrine of shadow director. When a bondholder exercises control power over the firm and, because of this, the firm goes into financial distress and finally insolvency, the bondholder may be at risk of being held to be a shadow director.[288] In the UK, under various statutory provisions, shadow directors may be made liable as if they were directors. The main concern is caused by s. 214 of the Insolvency Act 1986. According to this provision, directors, including shadow directors, of a company that is in insolvent liquidation, may be ordered by the court to make such contribution to the company's assets as the court thinks fit.[289] As a result, the bondholder's

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[287] In the UK, various commentators have described the British banks' role in corporate governance to be negligible as compared with the banks' involvement in other countries such as Germany and Japan where, according to the conventional view, closer relationships tend to exist between banks and industrial companies and banks are more willing than within the British model to provide long-term debt and equity finance and to participate in the monitoring of management through supervisory board structures. Compare Edwards J. and Fischer K., *Bank Finance and Investment in Germany* (Cambridge University Press, 1996) 178-195 and Ferran E., *Company Law and Corporate finance* (Oxford University Press, 2008) 341.

[288] For the UK doctrine see Millett P., 'Shadow Directorship: A Real or Imagined Threat to the Banks', *Insolvency Practitioner*, 1991, 14; Fidler P., Banks as Shadow Directors, 3 *JIBL*, 1992, at 97; Turing D., Tender Liability, Shadow Directors and the Case of Re Hydrodan (Corby) Ltd, 6 *JIBL*, 1994, 244; Bhattacharyya G., 'Shadow Directors and wrongful Trading Revisited', 16 *Co Law*, 1995, 313 commenting on *Re* PFTZM Ltd, 2 *BCLC*, 1995, at 354. For the US doctrine see Bartlett and Lapatin, 'The Status of a Creditor as a "Controlling Person"', 28 *Mercer L. Rev.*, 1977, 639; Douglas-Hamilton, Creditor Liabilities Resulting From Improper Interference with the Management of a Financially Troubled Debtor, 31 *Bus. Law.,* 1975, 343; Enstam R.A. and H.P. Kamen, 'Control and the Institutional Investor', 23 *Bus. Law.*, 1968, 289; Lundgren K.T., 'Liability of a Creditor in a Control Relationship With Its Debtor', 67 *Marq. L. Rev.*, 1984, 523..

[289] Under US corporate law, when a creditors, acting in that capacity, exercise control power over the firm, they become control persons under the federal securities laws, and thus potentially liable for false and misleading statements by the company at risk of losing its limited liability

contribution when being considered a shadow director may be even larger than his credit with the company. Applications to the court under this section may only be brought by liquidators and it must be established that the person from whom a contribution is sought knew, or ought to have concluded,[290] that there was no reasonable prospect that the company would avoid going into insolvent liquidation and that the person was a director at that time.[291] The court may not make an order against someone who it is satisfied took every step that ought to have been taken with a view to minimising the potential loss to the company's creditors (assuming this person knew that there was no reasonable prospect that the company would avoid going into insolvent liquidation).

A shadow director in relation to a company is a person in accordance with whose directions or instructions the directors of the company are accustomed to act, but someone is not deemed a shadow director only because of advice given by him in a professional capacity.[292] In fact, a bondholder, in order to qualify as shadow director, has to control the whole board, or at the very least a governing majority.[293] The directors must act on that person's instructions or directions as a matter of regular practice and not just on isolated occasions.[294] Nevertheless, a safer course for lenders may be to express proposals for the rehabilitation of the company in the form of conditions to the continuation

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status with the result of been held personally liable to other creditors or even to the stockholders. See the Securities Act of 1933 § 15, 15 U.S.C. § 770 (1982); Securities Exchange Act of 1934 § 20(a), 15 U.S.C. § 78t(a) (1982). The classic case, *Martin v. Peyton*, 246 N.Y. 213, 158 N.E. 77 (1927), concerns a loan to a partnership. See, also *K.M.C. Co. v. Irving Trust Co.,* 757 F. 2d 752 (6th Cir. 1985); *State Nat'l Bank of El Paso v. Farah Mfg. Co.,* 678 Sw. 2d 661 (Tex. Ct. App. 1984). See also Douglas-Hamilton, 1975, note above, 343.

[290] The standard by which a director is judged is based on the general knowledge, skills and experience that may reasonably be expected of a person carrying out these functions and also the director's own knowledge, skills and experience: Insolvency Act 1986, s. 214 (2).

[291] Insolvency Act 1986, s. 214 (2).

[292] Insolvency Act 1986, s. 251.

[293] That is why the appointment of few bondholders' representatives on to the board of a borrowing company should not expose a lender to shadow directorship liability. Furthermore, in the absence of fraud or bad faith, a person appointing a director owes no duty to take care that the director so appointed discharges their duties as a director with due diligence and competence.

[294] *Re Unisoft Group Ltd* (No 2) [1994] BCC 766, 775. See also *Re Hydrodan (Corby) Ltd* [1994] BCC 161, 163, where the judge ruled that to establish that a defendant is a shadow director it is necessary to allege and prove: (i) who are the directors of the company, whether de facto or *de jure*; (ii) that the defendant directed those directors how to act in relation to the company or that he was one of the persons who did so; (iii) that those directors acted in accordance with such directions; and (iv) they were accustomed so to act.

of their support. In fact, although giving advice in a professional capacity does not leave the adviser exposed as a shadow director,[295] the line between "advising" and "instructing" or "directing" may be difficult to draw.[296]

It is not surprising that because of the heavy debt structure of leverage buy-out transactions, the doctrine of equitable subordination is much discussed in that arena. However, in venture capital start-ups, where there is a close involvement of the financier with the entrepreneur in the management of the company, the risk of being considered a shadow director does not represent a major limit to their monitoring and control power. Corporate governance plays a different role in private equity and venture capital than it does in the public equity and bond markets.[297] In fact, high-risk and high-growth businesses at the early stage of their business development seem to be the only users of hybrid financial instruments motivated by elements outside the world of regulatory arbitrage. When the business grows and becomes more stable, the venture capital fund, someone whose comparative advantage lies in monitoring young companies, exits and is replaced by public shareholders and by public and private bondholders.[298]

*5.1.2. The use of hybrid instruments to align the "*ex ante*" incentives of managers: stage financing and contingent convertible debt*

The venture capitalist and the entrepreneur must deal with the fact that their incentives may not be always completely aligned. The entrepreneur receives private benefits from retaining ownership of the company that are unrelated to the company's value. Therefore, entrepreneurs may be "inclined to continue and expand their ventures even when their contraction or termination is efficient."[299] Conversely, the venture capitalist is only interested in its financial returns, which must be

[295] Insolvency Act 1986, s. 251.

[296] See *Re Company* (No 005009 of 1987) [1989] BCLC 13. The circumstances that led to the shadow directorship allegation against the company's bank were such that the company had reached its overdraft limit and the bank had commissioned a report on its financial affairs, which included recommendations that the company then took steps to implement.

[297] Baird D.G. and R.K. Rasmussen, 'Private Debt and the Missing Lever of Corporate Governance', 154 *University of Pennsylvania Law Review*, 2006, 1209.

[298] Shleifer A. and R. Vishny, 'A Survey of Corporate Governance', 52(2) *Journal of Finance,* 1997, 737-783.

[299] Triantis G.G.. 'Financial contract design in the world of venture capital', 68 *The University of Chicago Law Review*, 2001, 305 and 308.

adequate to the risk incurred and in line with its investment policy. Therefore, venture capital funds may be expected to seek exit too early because of their own liquidity or publicity needs. In such a scenario, if one party retains unilateral decisions power, that party will be able to extract wealth at the expense of the other. In private equity and venture capital investments, funds are generally invested for less than ten years, with short extensions from one to three years allowed. During this time, some important exit mechanisms, which also represent the best means for initial investors to obtain a return, are the initial public offering (IPO) of the company,[300] although IPOs are costly in a number of ways, and the outright sale of the start-up to a large firm.[301] In order to align the interests of the parties and provide each party with the right incentives, a start-up business needs to tailor its governance structure to fit the specific application, which means it has to create asset-specific governance systems that allow an optimal allocation of financial and control rights in the firm. This purpose is achievable only if hybrid financial instruments are issued.[302] The sophisticated contractual terms of these securities can be designed both to give the management appropriate incentives and to give the investors a significant role in the governance of the firm.[303]

Venture capitalists generally invest incrementally in companies so as to wrest control from entrepreneurs. Therefore, the investment involves a number of stages: if a firm is successful, its needs for capital grow rapidly through time. At each stage, the funds invested are expected to carry the firm through until the next stage. Investors may provide funds for all or some of these stages, which in any case are

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[300] Black B. and R. Gilson, Venture Capital and the Structure of Capital Markets: Bank versus Stock Markets, 47 *J. Fin. Econ.,* 1998, 243-277 where the authors, comparing the United States and Germany, point out that "the existence of an active IPO market is the most important determinant of the importance of venture capital in a country".

[301] An important aspect of venture capital contracts is the allocation of cash flow between the parties. Financiers typically receive a fixed fee, usually between 1.5 and 3 per cent of the net asset value, in addition to share of the profits. The expected return is around 20 per cent of the profits. See Cumming, 'Contracts and Exit in Venture Capital Finance', 21(5) *Rev. Financ. Stud.*, 2008, 1978; Sahlman W.A., 'The Structure and Governance of Venture Capital Organizations', 27 *J. Fin. Econ.,* 1990, 473-521.

[302] Cornelli F. and O. Yosha, 'Stage Financing and the Role of Convertible Securities', 70 *Review of Economic Studies*, 2003, 1-32 look at the combined use of convertible securities and staged infusion of capital, which are so common in venture capital financing; Berglof E., 'A control Theory of Venture Capital Finance', 10 *Journal of Law Economics and Organization*, 1994, 261-263.

[303] Gompers P.A. and J. Lerner, 'The Venture Capital Revolution', 15(2) *Journal of Economic Perspectives*, 2001, 145-168; Triantis G.G. and R.J. Daniels, 'The Role of Debt in Interactive Corporate Governance', 83 *California Law Review*, 1995, 1076-1079.

limited in time. For this reason, investors may be inclined to contribute just enough working capital to provide the management with sufficient time to either seek the sale of the company or achieve a particular business objective or milestone that will increase company value so that a future "flat" or "up" round becomes more feasible. By staging the advance of funds, venture capital investors make sure the correct continuation decision is made. This means that they preserve their ability to limit losses by abandoning portfolio companies that are not making satisfactory progress or by demanding majority board control in exchange for additional finance.[304] These control rights granted to the investor are not incompatible with the entrepreneur's preference for control. These rights are used to "add value" to their portfolio businesses and not simply to protect the investment value from the entrepreneur's diverging objectives.[305]

Start-up firms would typically issue ordinary common shares to the entrepreneur and hybrid capital such as preference shares or convertible subordinated debt, as profit participating or payment in kind loans, to the venture capital investor. In so doing, the entrepreneur retains discretion over the business through the voting rights and has a strong incentive to maximise the company's profits. The entrepreneur's incentives to maximise quickly the potential of the company come from the threat of abandonment, coupled with the prospect of dilution from repeated outside investments, when the venture capital converts its debt into equity to repay its interests[306] or takes the control of the board.[307] On the other hand, the venture capitalist is able to attract, at the end of every tranche financing, most of the company's cash flows, including in the contracts its liquidation preferences in multiples of the purchase price. Depending upon each party's leverage during the negotiations, the deal could involve the issuance of participating preference shares or

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[304] See Table 2 in Sahlman W.A., 'The Structure and Governance of Venture Capital Organizations', 27 *J. Fin. Econ.,* 1990, 479; Smith, D.G., 'The Exit Structure of Venture Capital', 53 *UCLA Law Review,* 2005, 315 and 316; Gompers P.A., Optimal Investment, Monitoring and the Staging of Venture Capital, 50 *J. Fin.*, 1995, 1461; Triantis G.G.. 'Financial contract design in the world of venture capital', 68 *The University of Chicago Law Review*, 2001, 305-323.

[305] Armour J., 'Personal Insolvency Law and the Demand for Venture Capital', 5 *European Business Organization Law Review*, 2004, 104 ff. See also Black B. and R. Gilson, Venture Capital and the Structure of Capital Markets: Bank versus Stock Markets, 47 *J. Fin. Econ.,* 1998, 243-277.

[306] Cornelli F. and O. Yosha, 'Stage Financing and the Role of Convertible Securities', 70 *Review of Economic Studies*, 2003, 4.

[307] Smith, D.G., 'The Exit Structure of Venture Capital', 53 *UCLA Law Review,* 2005, 325-329.

convertible debt with senior liquidation preferences, which investors would presumably value more if the possibility of a relatively worthless common stock is considered likely.

In venture capital, the cash claims of every participant are prioritised in the most efficient way, allowing the parties to renegotiate and readjust the expected rate of return on the investment according to the changes in the business' performance. Therefore, important factors for venture capitalists are the conversion price, which can be contingent on firm performance; preferred return in shareholders' distribution of profits, including a description of critical events that trigger liquidation; dividend or interest rate, which is not paid on a current basis, but is usually deferred; payment terms, which can sometimes state the dividends or the interests accrued and are not paid in cash, but the liquidation preference entitles the holders to the face value and the accrued payment and voting rights typically on an as-if converted basis.

5.1.2.1. Preference shares as incentive contracts

Private equity and venture capital funds often invest in businesses that strongly depend on human capital. For example, when the activities financed are research and development, the assets may be represented by a group of experts, scientists, doctors, or engineers working simply on ideas or intuition. Similarly, the registration of licences or patent rights and their exploitation need a specific asset-management expertise. In such cases, the human capital, meaning the entrepreneurs in technology-based start-up firms, is often the key to the business' success. Since the business of private equity and venture capital investors is to manage funds and investments made with those funds, and not to run companies, the involvement of the management becomes extremely important, which also provides it with the right incentive to make the business succeed. These incentives may be a share stake in the business. A well-motivated management will reduce costs to the minimum needed and invest adequately in capital expenditure in order to maximise profits and thus enhance the value of the company's shares.

Preference shares can be used as incentive contracts because they allow the setting up of a financial structure targeted to optimise corporate governance and at the same time to allocate the cash flows generated by the business. In practice, the private equity fund generally invests in the company mostly through the issuance of

preference shares or other hybrids of debt and only in small part in the equity share capital, while a large stake of the company's shares, also referred as "sweet equity", is allocated to the management. The economic price at which the management acquire their stake in the business is lower than that paid by the private equity investor because the latter has to subscribe to loan notes in addition to its equity. Depending on how strong an incentive you want to give the management, the private equity fund decides to invest most or all of its additional capital as subordinated capital so that the company has all the capital needed and the ownership is not diluted.[308]

This "sweet equity" advantage is not intended to go to anybody other than the management. As a result, there will be a series of prohibitions on the transfer of shares by the management to anybody else. The shares will only be transferable to some extent to members of the management's family in order to undertake tax planning for capital gains tax and inheritance tax purposes. The private equity investor will also wish to have the right to transfer its shares among its own group. It is however important that, where permitted transfers are allowed, the ultimate owner of the shares falls within the scope of any pre-emptive transfer procedure or compulsory transfer procedure.[309]

In addition, from the financier's point of view, the investment is tax deductible because the company issues loan notes or preference shares with a fixed cumulative return. The hybrid instruments issued will be deeply subordinated to any other bank loan and redeemable on a date in the future. Furthermore, the securities will usually be subject to the same form of permitted transfer restrictions as apply to the shares held by the private equity investors so that the loan note is not freely transferable. Often the loan note may be "stapled" to the ordinary shares so that any transfer of ordinary shares must be accompanied by the transfer of a corresponding percentage of the loan notes.

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[308] See Beddow S., *The Equity Deal*, in C. HALE, *Private Equity: a Transactional Analysis* (Globe Business Publishing, 2007), 46.

[309] Since managers may change during the life of a company and the objective of the sweet equity is to incentivise them to make the business perform to enhance its capital value, if a manager leaves the business, he or she no longer requires the incentivisation. Thus a departing manager will be obliged to sell his or her stake to an incoming manager, so that the total number of shares in issue does not need to increase and the ownership is not diluted.

*5.1.3. The use of hybrid instruments to reduce the "*ex post*" hold-up problems*

In theory, as far as information asymmetry between the entrepreneur and the venture capitalist is concerned, the best option for the firm would be to issue short-term debt that matures at the time favourable information is expected to be revealed to the market.[310] At that time, the firm may refinance on better terms either by borrowing at a lower rate or by issuing equity at a higher price. However, the informational advantages of short-term debt financing must be weighed against the risk that the borrower may be unable to refinance the debt when it matures or to meet periodic coupon obligations during the term of the debt.[311] It also has to be said that no company that wants to run a stable business could survive without long-term debt finance.

From the other point of view, the venture capitalist prefers to use long-term contracts to avoid the "fundamental transformation" that takes place following investment in transaction-specific assets.[312] In fact, the "bidding situation" that exists before the investment is made, becomes a "bargaining situation" after it is made.[313] This uncertainty may threaten the ability of venture capitalists to capture project cash flows, thereby reducing expected returns as well as *ex ante* incentives to invest. For this reason, venture capitalists try to structure project companies to limit managerial discretion over future decisions as well as to free cash flow. They use financial contracts to constrain managerial discretion. Contracts both prescribe and proscribe certain actions by involved parties. One of the fundamental agreements in every venture company is the so-called "cash flow waterfall", which defines what the various claims of the participants on cash flows are and allocates cash flows

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[310] See Flannery M.J., 'Asymmetric Information and Risky Debt Maturity Choice', 41 *Journal of Finance*, 1986, 19; Myers S.C. and N.S. Majluf, 'Corporate Financing and Investment Decision When Firms Have Information That Investors Do Not Have', 13 *J. Fin. Econ.*, 1984, 187-188 and 209-210.

[311] Stein J., Convertible bonds as backdoor equity financing, 32 *J. Fin. Econ*., 1992, 3; Constantinides G.M. and B.D. Grundy, 'Optimal Investment with Stock Repurchase and Financing as Signals', 2 *Rev. Fin. Stud.*, 1989, 445.

[312] Coase R., 'The nature of the firm', 4 *Economica*, 1937, 386-405; Williamson O.E., Corporate finance and corporate governance, 43 *J. Fin.*, 1988, 567-591.

[313] This is common when the company's assets are represented by human capital, but it may also happen with the related parties of the firm that supply critical inputs or buy primary outputs, and host nations that supply the legal system and contractual enforcement. Because so many projects involve bargaining situations between bilateral monopolists, there is a need to discourage opportunistic behaviour before making a large, durable, indivisible capital investment.

accordingly. Through the cash flow waterfall, parties agree in advance to virtually all capital expenditures, maintenance expenditures, debt service, reserve accounts, and shareholder distributions. However, although contracts work well as a first line of defence, they are, inevitably, incomplete.[314]

Contract incompleteness exists whenever the contracting parties are unable *ex ante* to specify fully the actions to be taken in every possible future "state of nature". On the one hand, some information is observable by only one party, as in the case of the entrepreneur who has information about the technological and economic prospects of a potential business, but a portion of that is too soft to be communicated to investors in a credible manner. This asymmetric information increases the cost of capital for the entrepreneur. On the other hand, the parties cannot control post-financing behaviour by contract because either the behaviour itself or future states of the world cannot be verified by third-party arbiters and this generates the well-known agency problems. Hence, from an incomplete contracting perspective, residual risk bearing is inescapable in an *ex post* sense for all parties contracting with the firm. Thus, the incompleteness of contracts means that although only shareholders are entitled to the residual profits after all other legally binding claims to other parties have been met, in terms of economic consequences any differences in the residual claimant status of the various contracting parties is simply a matter of degree.

The problems of information asymmetry and agency costs in an environment of uncertainty and high risk may be resolved by the use of convertibles, these securities being the best substitutes for equity or debt finance. The explanation of why convertibles are so commonly used in venture financing has to be sought in the exercise of the conversion feature. In fact, convertible securities address these problems by endogenously allocating residual cash flow rights to both the entrepreneur and the venture capitalist as a function of the realised value of the company.[315]

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[314] Hart O., 'Corporate governance: Some Theory and Implications', 105 *The Economic Journal*, 1995, 84-97.

[315] Denis D.J., "Entrepreneurial finance: an overview of the issues and evidence", Journal of Corporate Finance 10 (2004) 312. See also Schmidt K.M., 'Convertible Securities and *Venture Capital* Finance', 58 *J. Fin.*, 2003, 1139; Kaplan S.N. and P. Strömberg, 'Financial contracting meets the real world: an empirical analysis of venture capital contracts', 70 *Review of Economic Studies*, 2003, 286-295.

First of all, there are some evident advantages for an investor stemming from the fact that convertible bonds enable their subscribers to change their status in the company. As long as they do not convert their securities into equity hold a pure debt obligation and as such are entitled to receive a fixed interest and be repaid at maturity. The conversion option included in the debt security presents an important opportunity for the investor to evaluate the convenience of converting into equity or not. In this way, the investor will be able to consider whether to convert into equity during the different phases of the company's life, knowing that if the company is not performing well and its share market value is not increasing they can enjoy the benefits of a bond.[316]

Second, the financier subscribing to convertibles may adjust the conversion price according to the achievement or non-achievement of the targets for the period, which are set up in the terms of the contract. In so doing they are able to transfer part of their risk (but also opportunities because the company will be better priced) to the entrepreneur.[317] In fact, the use of convertible securities may defer the sale of equity or the repayment of debt until private information is revealed to the market, for instance, providing funding in tranches against established milestones.[318] The parties may also agree on a variable conversion price defining, for example, periods within which the holder may convert and the issuer may force conversion by exercising its call privilege. Therefore the conversion can always be state contingent.[319] To summarise, convertibles provide the parties with the optimal trade-off between the need to make efficient exit decisions and allocate cash flow rights to the venture

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[316] Green R., 'Investment incentives debt and warrants', (1984) 13 *J. Fin. Econ.*, 124-125.

[317] For example, in practice it is a common clause the reset mechanism (reset convertibles). According to this, the conversion price is initially fixed but adjusts or resets to the share price, not on a continuous basis but at defined intervals based on the then existing market price of the issuer's common stock or in case of the (non) occurrence of predetermined events, if the company is for example not listed on a stock market.

[318] The use of convertible debt may be simpler from a compliance point of view, and cheaper in terms of legal fees than an issue of convertible cumulative preference shares. However, venture capitalists subscribing to convertible debt may request aggressive terms as for instance personal guarantees from the founders or drastic measures upon an event of default, while there seem to be more standardised contracts for convertible preference shares (or Series A financing).

[319] Triantis A.J. and G.G. Triantis, 'Conversion rights and the design of financial contracts', (1994) 72 *Wash. U. L. Q.,* 1238; Gompers P.A., Optimal Investment, Monitoring and the Staging of Venture Capital, 50 *J. Fin.*, 1995, 1461-1489; Sahlman W.A., 'The Structure and Governance of Venture Capital Organizations', 27 *J. Fin. Econ.,* 1990, 473-521.

capitalist.[320]

5.2. The manager-shareholder conflict in charter amendments: variation of class rights

Corporate charters serve the function of establishing a basic governance structure, making it public and accessible to any interested investor. Corporate charters deal with the company's share capital in a significant way by stating the number of share classes, their par value and the powers, rights qualifications and restrictions on these shares.[321] Furthermore, corporate charters allow the entrenchment of terms, typically through a special amendment process.[322] However, unlike ordinary contracts, the parties to the charter can amend them with less than unanimous approval. Thus, the extent to which charter provisions entrench governance rules may be a matter of the management's opportunistic behaviour towards the totality of the shareholders, where shareholdings are dispersed, or the minority shareholders, in companies with concentrated holdings.[323]

To amend a charter, UK rules require a supermajority shareholder vote, without board initiative.[324] This allows large minority shareholders to veto proposed charter amendments, but gives no formal say in the matter. By contrast, the US rules create a bilateral veto to charter amendments and neither the board nor the shareholders can amend it alone.[325] By means of charter provisions, shareholders can make credible pre-commitments, as is the case under the Delaware approach where shareholders can approve an anti-takeover provision in the charter, such as a classified board, which maximises the bargaining role of the board in an attempted takeover by

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[320] Kaplan and Strömberg, 'Financial contracting meets the real world: an empirical analysis of venture capital contracts', (2003) 70 Review of Economic Studies, 289; Cumming, 'Contracts and Exit in Venture Capital Finance', (2008) 21(5) *Rev. Financ. Stud.*, 1947-1982; Hellmann T., 'IPO's, Acquisitions and the Use of Convertible Securities in Venture Capital', (2002) Stanford Working Paper, 14-15.

[321] CA 2006, s. 10.

[322] CA 2006, ss. 21-22.

[323] Rock E. Davies P., Kanda H. and Kraakman R., 'Fundamental Changes', in Kraakman R. et al. (eds) *The Anatomy of Corporate Law: A Comparative and Functional Approach* (OUP 2009, 2nd ed.) 183 ff.

[324] UK Companies Act 2006, s. 21. Although in practice most proposals for charter amendments originate from the board.

[325] Delaware General Corporation Law (DGCL) at s. 242.

reducing the likelihood that they would accept or that an acquirer would make a takeover offer with the approval of the board.[326] This would not be possible in UK where the law requires the unanimity of all the members to make a provision for entrenchment.[327]

Although, a charter amendment that adversely affects a class of shareholders must be approved by a majority of that class voting together, the statutory law has sometimes failed to protect minorities in the same way as the preferred shareholders who often lack voting rights and who rely in consequence on the charter and the rules governing its amendment to protect their interests. The special entitlements reserved for the preferred shares have had the consequence of creating a divergence of interests among preferred and ordinary shareholders. Therefore, additional contractual protections have been attached to these securities. However, such protections must be carefully drafted to protect the preference shareholders and to not be simply illusory. Historically, the British courts have drawn a sharp distinction between variations of the formal rights of a class of shareholders, which requires separate approval and changes in the charter that reduce the value of those rights without changing them formally.[328]

5.2.1. The position of preference shareholders and their protections: a UK-US comparative analysis

Since the 1920s at the time of the Great Depression in the USA, variations of class rights carried out by ordinary shareholders on preference shares have become very common. After a period of depressed earnings due to the crisis, many companies were becoming profitable again but the management could not declare common stock dividends before it paid the often-sizeable preferred stock arrearages that had accrued. Since directors often owned common stock, generally the only class of stock entitled to elect directors, they were inevitably more responsive to the common

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[326] Kahan M. and E. Rock, 'Corporate Constitutionalism: Antitakeover Charter Provisions as Precommitment', 152 *University of Pennsylvania Law Review*, 2003, 473.

[327] s. 22 of the UK CA 2006.

[328] Davies P.L., *Gower and Davies' Principles of Modern Company Law* (Sweet and Maxwell, 8th ed. 2009) paras. 19-11 ff.; Kershaw D., *Company Law in Context: Text and Materials* (OUP, 2009) 668. Similar approach has been taken in the US States, see Bratton W., 'Venture Capital on the Downside: Preferred Stock and Corporate Control', 100 *Mich. L. Rev.,* 2002, 891, 922-939.

shareholders' interests than to those of the preferred shareholders. In order to pay dividends on the common stock, they devised ways to eliminate preferred arrearages so that they could immediately declare common stock dividends. This was carried out through certificate amendments such as the cancellation or reclassification of certain categories of shareholders, mergers with shell corporations or the voluntary exchange of new preferred stock without arrearages for old preference shares.[329]

Although statutes and certificate provisions often empowered the preference shareholders to block these proposals by class vote, many factors prevented them from doing so.[330] In fact, the class of preference shares was frequently induced to cast the necessary votes for what appear to be detrimental and sometimes disastrous consequences. For instance, directors were used to create new prior preferred stock or increase existing prior preferred stock and offer it in exchange for outstanding preference shares. The prior preferred stock was not entitled to arrearages owed on the outstanding preference shares and thus, when outstanding preference shareholders exchanged their shares, their arrearages were eliminated. However, preference shareholders were widely dispersed and lacked control over the proxy mechanisms by which they were informed of the terms of the proposed arrearage elimination. Thus, managers could obscure essential information concerning these proposals in proxy statements. Directors normally controlled the manner in which a plan was presented to the shareholders, and even if they were subject to some limitations imposed by the usual proxy rules, they could emphasise any real advantages that the plan conferred on the preference shareholders, while at the same time minimising its disadvantages.[331] Furthermore, dividend arrearages were usually so large that statutorily they could not be paid without a formal reduction of capital and such a reduction often required the common shareholders' consent. For this

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[329] Dewing A., *The Financial Policy of Corporations* (New York: Ronald Press Co. 5th ed.., 1953) 1195; Cary W.L. and Eisenberg M., *Cases and Materials on Corporations* (5th ed., Mineola, 1980) 1605.

[330] As both the commentators of that time and the Securities and Exchange Commission (SEC) argued, preference shareholders often lacked the power to secure their rights to dividend arrearages. See Securities and Exchange Commission, *Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees,* pt. VII, 1938, at 109; Brudney V., 'Standards of Fairness and the Limits of Preferred Stock Modifications', 26 *Rutgers L. Rev.*, 1973, 445, 446 and 450.

[331] Dodd E.M., 'Fair and Equitable Recapitalizations', 55 *Harv. L. Rev.*, 1942, 780 and 792.

reason, common shareholders often had the opportunity to demand unfair concessions from preferred shareholders.[332]

In the US, the courts chose not to intercede on behalf of the preference shareholders, permitting the elimination of arrearages by certificate amendment or merger in accordance with the theory that preference shareholders purchased their stock knowing that their rights were statutorily variable by amendment or merger. Similarly, they upheld offers of prior preferred stock without provision for payment of past arrearages in exchange for the existing preferred stock on the grounds that any exchange was purely voluntary.[333] However, in truth, the exchange was often more coercive than voluntary: any preference shareholder who refused the exchange was left with shares subordinated to the new class of prior preference and, therefore, with little hope of ever receiving any payment of the arrearages.[334]

To avoid this unfair treatment and to impose equitable limits on the bargaining away of arrearages by the preference shareholders, some standards of fairness have been developed, although unsuccessfully, by legal scholars. The funding theory, the liquidation standard, the investment value doctrine and the surplus test standard were supposed to evaluate the fairness of the consideration given in exchange.[335] Unfortunately, these efforts proved to be useless and inappropriate, so that the courts almost never adopted them. Instead, the law in this area became practically mechanical and all the arrearage eliminations that were minimally consistent with

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[332] Gower L.C.B., *Principles of Modern Company Law* (4th ed. London: Stevens & sons, 1979) 364 points out the need for protection for the preference shareholders because "though they share the disadvantages of debenture-holders they lack their advantages".

[333] *Johnson v. Fuller*, (3d Cir.1941), 121 F. (2d) 618; *Kreicker v. Nayor Pipe Co.*, 374 Ill. 364, 29 N.E. 2d 502 (1940).

[334] Cary W.L. and Eisenberg M., *Cases and Materials on Corporations* (5th ed., Mineola, 1980) 1620.

[335] See Brudney V., 'Standards of Fairness and the Limits of Preferred Stock Modifications', 26 *Rutgers L. Rev.*, 1973, 469 n. 56 where he says "the funding theory measures the arrearage claim by the discounted present value of its anticipated payment over a period of years. See Note, The Doctrine of Strict Priority in Corporate Recapitalization, 54 *Yale L. J.*, 1945, 840 where it is explained the liquidation standard would entitle preference shareholders to their liquidation preference upon approval of a proposal to eliminate arrearages. Arrearages elimination would be treated as triggering the maturation of the preference shareholders' liquidation priority. See Dodd E.M., 'Fair and Equitable Recapitalizations', 55 *Harv. L. Rev.*, 1942, 812 and 816 where he says the investment value doctrine would reduce arrearages as well as a stock's projected dividend stream to present values. These values would then be added together and the sum would constitute the consideration the preference shareholders must receive in exchange for their arrearages.

statutory and certificate provisions were permitted.[336] In merger transactions, when "constructive fraud", "bad faith" or "gross unfairness" of the management could not be demonstrated, courts did not void arrearage eliminations.[337] The sole source of protection for preference shareholders against questionable arrearage elimination was the preference share contract, namely the applicable statutory provisions and the company's certificate of incorporation.[338]

Despite the fact that some commentators argued that the market price of preference shares already reflected the arrearage elimination risk inherent in owning preferred stock and thus the prospective investors were fully informed of these risks,[339] in many cases, recapitalisation was only a remote possibility at the time that preference shares were issued and artificial structure built up by the ordinary shareholders in order to avoid the dividend payments to the preferred shares was an even more remote expectation.[340] The law cannot or at least need not assume that market pricing processes make arrearage elimination fair. Every case has to be analysed separately to understand where a real abuse of the majority has occurred. Arrearage elimination alters a fundamental characteristic of a preferred stock, that is the right to receive a preferential dividend.[341]

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[336] *Johnson v. Fuller*, (3d Cir.1941), 121 F. (2d) 618; *Barrett v. Denver Tramway Corp.,* 53 F. Supp. I98 (D. Del. 1944); *Western Foundry Co. v. Wicker*, 403 Ill. 260, 85 N.E.2d 722, (1949); *O'Brien v. Socony Mobil Oil Co*., 207 Va. 707, 152 S. E. 2d 278, cert. denied, 389 U.S. 825 (1967).

[337] *Porges v. Vadsco Sales Corp.,* 27 Del Ch. 127, 32 A.2d 148 (1943); *Hottenstein v. York Ice Mach. Corp.,* I36 F.2d 944 (C. C. A. 3d I943); *Bove v. Community Hotel Corp. of Newport, R. I.,* 105 R.I. 36, 249 A.2d 89 (1969). See Buxbaum R.M., 'Preferred Stock—Law and Draftsmanship', 42 *Cal. L. Rev.,* 1954, 301: "Lack of fairness of a particular plan independently of the admitted power to promulgate it is no longer an independent criterion of validity in most jurisdictions".

[338] Buxbaum R.M., 1954, note above, at 243.

[339] This view follows from the efficient-market hypothesis under which stock prices reflect all securities information in the public domain. See Posner R., *Economic Analysis of Law* (Boston, 1986) para 15.4.

[340] For empirical evidence showing "no statistically significant market reaction to any of … seven major decisions" of the Delaware courts studied see Weiss E.J. and L.J. White, 'Of Econometrics and Indeterminacy: A Study of Investors' Reactions to "Changes" in Corporate Law', 75 *Calif. L. Rev.*, 1987, 551 and 553.

[341] In fact, non-cumulative preference shares are very rare, considering that they cannot be easily sold to the public since they do not guarantee any fixed dividend to their shareholders and they subordinate the payment of a dividend, first to the existence of the profits in the final accounts of a firm and then to the discretion of the board of directors. See Cary W.L. and Eisenberg M., *Cases and Materials on Corporations* (5th ed., Mineola, 1980) 1118.

Most US states however, though not Delaware,[342] provide appraisal rights for charter amendments that materially affect the rights of dissenting shareholders.[343] They allow dissenting shareholders to have the fair value of their shares determined by a court appointed appraiser offering them an exit option. In such cases, shareholders are then entitled to receive the price determined by the appraiser to be the fair value of their shares from the corporation.[344]

In addition, the law has facilitated a fair bargaining between the company and the preferred stockholders, leaving the parties free to include extra provisions in their contract. Most preferred issues stipulated that the preferred stockholders could elect directors, normally two, if the preferred dividends were in arrears for a period of six quarters.[345] In exchange offers transactions, three types of covenant were commonly used to protect the preference shareholders: the requirement of consent to create new prior stock, to increase existing amounts of preferred stock and to increase existing amounts of prior preference shares. However, these covenants proved to be quite ineffective, since it was possible and common for a company, when it issued a new class of shares, to delegate to the directors the power of setting privileges for each series issued without amending the articles, simply by nominating a "series" of an already authorised blank class.[346]

In contrast with the American experience, British company law has in fact made little use of the appraisal rights. In order to protect minorities in relation to

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[342] Not all the states have adopted the Act's provisions or similar provisions with regard to all the devices used by the companies to vary preference shareholders' class rights, because they felt the appraisal rights to be too costly to pursue or too difficult to perfect when they required severance of the dissenting shareholder's interest in the corporation. Manning B., The Shareholder's Appraisal Remedy: An Essay for Frank Coker, 72 *Yale L. J.,* 1962, 223 and 226; Stamler J.F., 'Arrearage elimination and the preferred stock contract: a survey and a proposal for reform', 9 *Cardozo L. Rev.,* 1988, 1354-1359; Lattin N.D., 'Minority and Dissenting Shareholders' Rights in Fundamental Changes', 23 *Law & Contemp. Probs.*, 1958, 307 and 312; Note, *Valuation of Dissenters' Stock Under Appraisal Remedy: An Essay for Frank Coker*, 72 Yale L.J., 1966, at 1453; Note, *Protection for Shareholder Interests in Recapitalizations of Publicly Held Corporations,* 58 Columbia Law Review, 1958, at 1040, 1058 and 1068.

[343] Model Business Corporation Act ss. 13.01-13.31 (3rd ed. Supp. 1987). Although the Act is designed to "motivate the parties to settle their differences in private negotiations", see Introductory Comment at 1354.

[344] Henn H.G., *Handbook of the Law of Corporations and Other Business Enterprises* (St. Paul, Minn. 3rd ed., 1983) 997 and 1002.

[345] Exceptions to this listing policy are frequent. See *New York Stock Exchange Company Manual*, 1984, A-282.

[346] Buxbaum R.M., 'The Internal Division of Powers in Corporate Governance', 73 *Cal L Rev,* 1985, 1685.

their class rights, British regulators introduced the provisions contained in ss. 125 to 127 of the CA 1985 and now ss. 630 to 633 of the CA 2006. These provisions applied only to companies "whose share capital is divided into shares of different classes", but the new legislation at s. 631 (CA 2006) extended to all companies following a recommendation of the CLR.[347] Unlike the CA 1985, under the new Act it is no longer possible for class rights to be set out in the memorandum,[348] and where class rights attaching to shares in an existing company are specified in the memorandum, these will be deemed, by virtue of s. 28, to be a provision in the company's articles. Class rights can be attached to the shares by the articles, the terms of issue, an agreement or a resolution. Under the previous CA, while it was clear that when the articles contained a procedure for the variation of class rights, that procedure had to be followed, it was uncertain whether in the absence of such a procedure class rights were not variable at all without the consent of each individual shareholder affected or whether they could be varied simply by using the normal variation procedure set out in s. 21 of the CA 2006 (previous s. 9 CA 1985), which would give the minority members of the class very little protection.[349]

If the company's articles do not provide a variation procedure, section 630 subs. (2) and (4) provide that class rights may be varied either where holders of at least three-quarters in nominal value of the issued shares of that class consent in writing, or if a special resolution passed by the holders of that class sanctions the variation. This means that the articles may specify a less demanding procedure for a variation of class rights than the statutory scheme or a more onerous regime. However, the provisions of s. 630 are expressed to be "without prejudice to any other

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[347] Final Report, para. 7.28. Eventually these recommendations have been introduced in the new Company Act 2006 where the new s. 125A extends the statutory provisions on variation of class rights to companies without a share capital, as for instance the companies limited by guarantee that, since December 1980, cannot be formed with a share capital. These companies may, for example, have different classes of members with different voting rights. Before, the question of how members' rights could be varied depended to a large extent on whether provision had been made, either in the memorandum or articles, for their variation. This clause inserts a new provision, comparable to those for companies with a share capital. Thus there is a minimum requirement that class rights may be varied if three-quarters of that class consent in writing or a special resolution of those members sanctions the variation. Again, where there is a higher requirement in the articles or elsewhere, this would apply. This protection goes towards the direction of *Cumbrian Newspapers Group Ltd v Cumberland & Westmorland Herald Ltd* [1987] Ch. 1. See Davies P.L., *Gower and Davies' Principles of Modern Company Law* (London: Sweet and Maxwell, 7th ed. 2003) 502; Kershaw D., *Company Law in Context: Text and Materials* (OUP, 2009) 670.

[348] See the Companies Act 2006, s. 8.

[349] Ref. *Cumbrian Newspapers Group Ltd v Cumberland & Westmorland Herald Ltd* [1987] Ch. 1.

restriction on the variation of rights".[350] Therefore, if and to the extent that the company has adopted a more onerous regime in its articles for the variation of class rights, for example by requiring a higher percentage than the statutory minimum, the company must comply with it. In addition, if and to the extent that the company has protected class rights by making provision for the entrenchment of those rights in its articles,[351] that protection cannot be circumvented by changing the rights attached to a class of shares under this section.[352]

This procedure contained in s. 630 of the CA 2006 does not apply to corporate actions that may affect the rights of a particular class of shareholders without varying those rights. The courts has generally drawn a distinction between the rights themselves and the mere enjoyment of those rights, namely between rights affected as a "matter of law" and as a "matter of business".[353] Whether the rights are affected as a matter of law, the remedy included in s. 633 of the CA 2006 confers a right on dissenting preferred shareholders holding not less than an aggregate of 15 per cent of the issued shares of the class in question to object to a variation of class rights applying to the court, within 21 days after the consent was given, for the variation to be cancelled. The appeal to the court freezes the effects of the variation made. The court on hearing the application may disallow the variation or confirm it and the "decision of the court is final".[354]

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[350] See CA s. 630 (3).

[351] See CA 2006 s. 22.

[352] See CA 2006 s. 630 (5). In the previous CA, the function of the memorandum was to provide a way of entrenching class rights, and the level of protection for the preference shareholders depended on it. If there was no variation of rights clause in the company's constitution applicable to those rights, then the rights were variable only with the unanimous consent of the members (s. 125 n. 5) or under a scheme of arrangement (s. 126 and s. 425 of the CA 1985). If the rights were attached by the memorandum and their variation was expressly prohibited, only a scheme of arrangement would have been effective to vary the rights. Even if there was a variation procedure applicable to the rights attached by the memorandum, it would have provided the operative procedure only if the variation clause was part of the articles at the time of the company's incorporation and the variation was not concerned with the giving authority for the allotment of shares or with a reduction of capital (s. 125 n. 4). If one of these conditions was not satisfied, the statutory procedure was required (s. 125 n. 3).

[353] The words are those of M.R. Greene in *Greenhalgh v Arderne Cinemas* [1946] 1 All E.R. 518. See also *In White v Bristol Aeroplane Co Limited* [1953] 1 All ER 518; *Dimbula Valley (Ceylon) Tea Co Ltd v Laurie* [1961] Ch 353.

[354] See CA 2006 s. 633 (5). However, according to ss. 459-461 "a member of a company may apply to court by petition for an order under this Part on the ground that the company's affairs are being or have been conducted in a manner which is unfairly prejudicial to the interests of its members …" (s. 459). See *Re Suburban and Provincial Stores Ltd* [1943] Ch. 156, CA. See also *Re Sound City (Films) Ltd* [1947] Ch. 169, which seems to be the only officially reported case on s. 127 and its predecessors.

5.2.2. What constitutes a variation of class rights?

There has been much controversy and confusion as to what constitutes a variation of class rights, especially in relation to the negative effect that a "variation" could generate. Generally no problems have ever arisen when a majority decided a variation of class rights by adding new rights or enhancing some existing rights without reducing any other powers to that class of shareholders. However, a distinction is made between the rights themselves and the mere enjoyment of those rights, namely between rights affected as a "matter of law" and as a "matter of business".[355]

An act of the company, which impinges only on the enjoyment of rights as for instance a subdivision or increase of one class of shares, will not amount to a variation of the rights, even if the result can be the alteration of the voting equilibrium of the classes.[356] In the same way, mere economic disadvantage to preference shareholders is not sufficient to amount to a variation.[357] When preference shares are non-participating with respect to dividend, but participating with respect to capital on a winding up or reduction of capital, a capitalisation of undistributed profits in the form of a bonus issue to the ordinary shareholders is not a variation of the preference shareholders' rights, notwithstanding that the effect is to deny them their future participation in those profits.[358]

The restrictive approach taken by the courts is also clear in other cases regarding operations on the equity capital. For instance, a reduction of capital by

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Cases in which it might have been invoked (*Rights & Issues Investment Trust v Stylo Shoes Ltd* [1965] Ch. 250) have been taken instead under ss. 459-461.

[355] M.R. Greene in *Greenhalgh v Arderne Cinemas* [1946] 1 All E.R. 518.

[356] *Greenhalgh v Arderne Cinemas* [1946] 1 All E.R. 512, CA, where the result of the subdivision was to deprive the holder of one class of his power to block a special resolution. See also *White v Bristol Aeroplane Co* [1953] Ch. 65, CA, *Re John Smith's Tadcaster Brewery Co* [1953] Ch. 308, CA. See recently, *Citco Banking Corporation NV v. Pusser's Ltd* [2007] UKPC 13.

[357] See for example *Adelaide Electric Co v Prudential Assurance* [1934] A.C. 122, HL, where the alteration in the place of payment of a preferential dividend from England to Australia did not vary the rights of the preference shareholders, notwithstanding that the Australian pound was worth less than the English one.

[358] *Dimbula Valley (Ceylon) Tea Co v Laurie* [1961] Ch. 353. Also see *Re Mackenzie & Co. Ltd* [1916] 2 Ch. 450 in Davies P.L., *Gower and Davies' Principles of Modern Company Law* (London: Sweet and Maxwell, 7th ed. 2003) 500 and fn.89; Kershaw D., *Company Law in Context: Text and Materials* (OUP, 2009) 671.

repayment of irredeemable preference shares in accordance with their rights on a winding up was not regarded as a variation or abrogation of their rights;[359] nor was an issue of further shares ranking *pari passu* with the existing shares of a class.[360] And where there were preference and ordinary shares, an issue of preferred ordinary shares ranking ahead of the ordinary but behind the preference was not a variation of the rights of either existing class.[361] Because the approach of the courts was more targeted at guaranteeing a company's flexibility in its going concern than a full protection of the minority, it has become common to introduce special provisions into a company's articles to protect preference shareholders and it is possible to construct a variation of rights clause covering actions affecting the value of the shares as a matter of business.[362] In such cases, very careful drafting will have to be used if such a provision is to be construed as affording any greater safeguards.[363] In a famous case of variation of class rights,[364] the relevant clauses referred to class rights being "affected, modified, dealt with or abrogated". Even if, in the first instance, the judge considered their rights to be affected by the decision of the ordinary shareholders, the Court of Appeal reversed the decision because it believed only the holders' enjoyment of those rights was affected.[365]

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[359] *Scottish Insurance Corp v Wilson & Clyde Coal Co* [1949] A.C. 462, HL; *Prudential Assurance Co v ChatteRailway Whitfield Collieries* [1949] A.C. 512, HL, and this is so even if they are participating as regards dividends: *Re Saltdean Estate Co Ltd* [1968] 3 All ER 829; *House of Fraser v AGCE Investments Ltd* [1987] A.C. 387, HL (Sc.) (this of course does not apply if they are expressly given special rights on a reduction of capital). But contrast with *Re Old Silkstone Collieries* [1954] Ch. 169, CA where confirmation of the repayment was refused because it would have deprived the preference shareholders of a contingent right to apply for an adjustment of capital under the coal nationalisation legislation.

[360] This is expressly provided in Table A 1948, Art. 5, but the position seems to be the same in the absence of express provision: see the case cited above, but contrast with *Re Schweppes Ltd* [1914] 1 Ch. 322, CA, which, however, concerned s. 45 of the 1908 Act, which forbade "interference" with the "preference or special privilege" of a class.

[361] *Hodge v James Howell & Co* [1958] C.L.Y. 446, CA, *The Times*. December 13, 1958. See also *Underwood v London Musical Hall Ltd* [1901] 2 Ch 309, where an issue of preference shares ranking *pari passu* with existing preference shares was not a variation of class rights.

[362] *Re Northern Engineering Industries Plc* [1994] 2 B.C.L.C. 704, CA, where a clause in the articles deeming a reduction of capital to be a variation of rights was upheld and enforced when the company proposed to cancel its preference shares.

[363] See *White v Bristol Aeroplane Co* [1953] Ch. 65, CA, *Re John Smith's Tadcaster Brewery Co* [1953] Ch. 308, CA.

[364] *White v Bristol Aeroplane Co* [1953] Ch. 65, CA.

[365] In Australia, the result of *White v Bristol Aeroplane Co* has been reversed by s. 197 n. 8 of the Corporations Law, which deems the allotment of preference shares ranking equally with existing preference shares to be a variation of the rights attached to existing preference shares unless it was expressly authorised when the existing preference shares were allotted.

5.2.3. Legal strategies for preference shareholders

In fundamental changes and especially in mergers, preference shareholders can potentially be victims of the management's opportunistic behaviour favouring their self-interest or the majority shareholders. The law provides certain requirements that give shareholders, included preferred shareholders, the means to challenge a merger driven by managerialism. In the EU rules contain a requirement for an expert's report.[366] In addition UK company law provides two valuable tools to deal with corporate restructuring and mergers.[367] These are the possibility to use a scheme of arrangement under s. 895 of the Companies Act 2006 or, especially for small companies, a solvent winding up under s. 110 of the Insolvency Act 1986 to transfer or sell the whole or part of a company's business or property to another company.

A scheme of arrangement involves several stages. When an arrangement is proposed, the main concern is whether the members and creditors should be split into different classes for the purposes of voting on the scheme. Following the issue of the Practice Statement in 2002, any potential problems must be drawn to the court's attention by the applicant company at the initial stage.[368] Then meetings of those parties impacted by the scheme are held. If an issue of identifying classes is brought to the court's attention, the court will then decide whether to postpone the meeting in order to resolve the issue and evaluate how those particular parties would be affected by a scheme. The dissenting parties could argue that the majority did not fairly represent the class. The court has full discretion whether to sanction the scheme even if meetings have approved it. However the approach of the court to date has always been to reduce the chances of success of the dissenting parties opposing the scheme on this ground.[369] The rationale is that an increase of the class meetings would

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[366] If the requisite of the substantial approval is not obtained or the meetings have not been properly conducted the court approval of the scheme can be made mandatory. See Davies P.L., *Gower and Davies' Principles of Modern Company Law* (Sweet and Maxwell, 8th ed. 2009) para. 29-8. See the requirement in Council Directives 78/855/EEC and 82/891/EEC later amended by Directive 2007/63/EC where in art. 10 it is stated: "Neither an examination of the draft terms of merger nor an expert report shall be required if all the shareholders and the holders of other securities conferring the right to vote of each of the companies involved in the merger have so agreed."

[367] Davies P.L., 2009, note above, 1073-1079.

[368] *Practice Statement (Ch D: Scheme of Arrangement with Creditors)* [2002] 1 WLR 1345.

[369] The test was set by Bowen LJ in *Sovereign Life Assurance Co v Dodd* [1892] 2 QB 573, 583 and then refined by Chadwick LJ in *Re Hawk Insurance Ltd* [2001] EWCA Civ 241; [2002] BCC 300.

undermine the scheme's effectiveness and consequently weaken its usefulness as a statutory tool for companies.[370]

Schemes, therefore, could raise issues of minority oppression. In fact, if a scheme is approved it will bind all of the affected creditors and members, even if they dissent. It is the court's role to take into account all the reasons and exigencies of the parties and counterbalance the minority protection with the company's interest. In order to do it, the court has generally drawn a line of distinction between solvent and insolvent schemes for the purpose of finding the correct comparator to define the classes impacted by the scheme. In fact, not all the company's securities may be affected by a scheme. In cases in which the company was in bad financial distress, the court approved a scheme despite the lack of consent of the ordinary shareholders.[371] The same principle was used to exclude a group of deferred creditors[372] and a group of mezzanine lenders where the value of the assets of the company was significantly and demonstrably less than the value of the senior debt.[373]

Despite of all, in practice schemes are predominantly adopted as an alternative to a takeover or to effect an arrangement between a company and its creditors where the company is in financial distress. This is for several reasons. Firstly because a scheme used to effect a merger is more uncertain in its success. While in a transfer of shares by way of a takeover, shareholders can decide on the transfer approval, in a scheme of arrangement, each category, whether members or creditors, has an opportunity to veto it. Moreover, in certain circumstances, mergers and divisions of public companies share additional requirements imposed by the EU company law directives.[374] However, these constraints do not apply where a scheme is used to effect a takeover because the bidder and the target remain separate companies after the scheme has been effected.

Furthermore, for smaller companies wishing to effect a merger a more appealing alternative may be provided by s. 110 of the Insolvency Act 1986.

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[370] It has not occurred to date that the court accepted not to sanction a scheme on this basis.

[371] *Re Tea Corporation Ltd* [1904] 1 Ch 12.

[372] *Re British & Commonwealth Holdings plc (No 3)* [1992] BCL 323.

[373] *Re Bluebrook Ltd* [2009] EWHC 2114 (Ch); [2010] BCC 209.

[374] Counsel directives 78/855/EEC and 82/891/EEC also known as Third and Sixth directives.

Accordingly, a solvent winding up can be effected to transfer the business of the company. In contrast with the scheme, as long as a members' voluntary liquidation is used, no confirmation by the court is required. However, in this case the company must be solvent. In addition, whereas under a scheme of arrangement, once the court has sanctioned it, dissenters are bound, under s. 110 procedure the parties retain a right to exit at a fair value.[375]

In the US, public companies pursuing a merger customarily seek to protect themselves from shareholder suits by soliciting fairness opinions from investment bankers, which shareholders can peruse before they vote.[376] This increases the efficiency of shareholder voting. The US also protects shareholders, providing appraisal rights that allow dissatisfied shareholders to escape the financial effects of organic changes approved by the majority, by selling their shares back to the corporation at a reasonable price in certain circumstances. The appraisal remedy also protects shareholders as a class by making unpopular decisions more expensive for management to pursue. In practice, however, cumbersome procedures, delay and uncertainty discourage small shareholders from seeking appraisal rights. In addition, many US states further limit appraisal rights by introducing a so-called "stock market exception" to their availability in corporate mergers.[377] Accordingly, shareholders do not receive appraisal rights if the merger consideration consists of stock in a publicly traded company rather than cash, debt, or closely-held equity. There are two reasons for this: appraisal rights ought to protect the liquidity rather than the value of minority shares, and the valuation provided by the market, while imperfect, is unlikely to be systematically less accurate than that provided by a court. However, in light of this, it is unclear why appraisal rights are available when shareholders receive cash, this hypothesis being the most liquid merger consideration possible. Therefore, appraisal rights are of little use to shareholders who wish to challenge the price they receive in stock mergers between public companies.[378]

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[375] Insolvency Act 1986, s. 111. However, a reorganization under s. 110 can be extremely expensive if a certain number of members elect to be bough out.

[376] See for example, *Smith v. Van Gorkom*, 488 Atlantic Reporter (A.2d) 858 (Delaware Supreme Court 1985) where the sale of a company without a valuation report and with little deliberation is grossly negligent despite the premium price.

[377] s. 13.02 RMBCA; s. 262 DGCL.

[378] See Mahoney, P. and M. Weinstein, 'The Appraisal Remedy and Merger Premiums', 1 *American Law and Economics Review*, 1999, 239 where the authors observe 1,350 mergers involving public

These difficulties may explain why community law does not require appraisal rights as an element of the merger process, although they are offered on a limited basis in some jurisdictions.[379]

5.3. Shareholder-convertible bondholder agency problems

There are situations in which the management has the incentive and the ability to increase the company's level of risk through the adoption of significant decisions or investment policies that do not necessarily maximise the value of the firm as a whole but simply benefit shareholders by transferring wealth away from bondholders. In so doing, the risk of loss passes to the bondholders, since the shares are protected by the company's limited liability, but the potential gain mostly benefits the shareholders because the return on bonds is limited.[380] Asset substitution or the risk-shifting problem is opportunistic behaviour that concretises when managers liquidate some assets to reinvest the money in additional risky projects, increasing the grade of risk for which the investors accepted to finance the company.[381] This manager-creditor conflict is a typical agency cost of debt.[382]

This opportunism is common, for instance, in the sale of assets, especially when it reaches the level of disposal of substantially the whole of the company's assets. This type of occurrence is usually the result of corporate restructuring or is a prelude to a merger or to the cessation of business. Such a transaction may jeopardise the lender because it literally separates the assets for which the loan was contributed from the company that contracted the debt contract, leaving the lender with no sufficient collateral for satisfaction. Any sale of producing assets raises

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companies from 1975-1991; SELIGMAN J., 'Reappraising the Appraisal Remedy', 52 *George Washington Law Review*, 1984, 829, where he observed 20 mergers from 1972-1981.

[379] Rock, Davies, Kanda and Kraakman, 'Fundamental Changes', in Kraakman R. et al. (eds) *The Anatomy of Corporate Law: A Comparative and Functional Approach* (OUP 2009, 2nd ed.) 191.

[380] Green R., 'Investment incentives debt and warrants', (1984) 13 *J. Fin. Econ.*, 115-136; Narayanan M.P., 'On the Resolution of Agency Problems by Complex Financial Instruments: A Comment', 42 *J. Fin.* 1987, 1083; Haugen R.A. and LW Senbet, 'Resolving the Agency Problems of External Capital Though Options', 36 *J. Fin.*, 1981, 629 and 640.

[381] See Lewis C.M. Rogalski R.J. and Seward J.K., 'Agency Problems, Information Asymmetries and Convertible Debt Security Design, 7 Journal of Financial Intermediation, 1998, at 32-59 where the authors state "the relevant risk is not only the risk of the company's existing operations, but also the risk of any future operations in which the company may become involved over the life of the bond".

[382] Jensen M. and W. Meckling, 'Theory of the Firm: Managerial Behavior, Agency costs and Ownership Structure', 3 *Journal of Financial Economics*, 1976, 350.

questions concerning the adequacy of the sale price and the reinvestment of the proceeds. A similar result is obtained if managers, looking for an increased access to liquidity, actively trade subsidiaries and divisions in a market for going concern assets, often through asset securitisation. The danger is that assets that would previously have been available to repay the borrower's creditors will be claimed first by the creditors of the transferee subsidiary.[383]

A lender cannot explicitly direct the use of asset sales proceeds to a particular project viewed with favour, because of the limited liability constraint, which prevents the dictation of positive instructions. However, the borrower company can be restricted, subject to limited exceptions, by actions such as making acquisitions or disposals, changing the nature of its business and by merging with other companies.[384] Mergers and consolidations, included takeovers, pool the assets and liabilities of two or more corporations into a single corporation, which is either one of the combining entities ("the surviving company") or an entirely new company ("the emerging company"). The result is that the conversion right would be destroyed for all practical purposes, given that after the merger or takeover becomes effective, there will be no market in the shares of the issuer, which would have become a subsidiary of the bidder. A merger could damage a lender even though the surviving corporation is a larger firm, because its claim will be diluted and subordinated to other claims. In all the above mentioned cases, the convertible bondholders need to protect the fragile nature of the conversion privilege.[385]

5.3.1. The protection of convertible bondholders in mergers and acquisitions

European jurisdictions offer special protections to creditors when firms undergo mergers and similar organic changes. Although creditors lack the power to stop mergers, they are entitled to demand adequate safeguards when a merger puts their

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[383] Ferran E., *Company Law and Corporate finance* (Oxford University Press, 1999) 517-520.

[384] See Myers S.C. , 'Determinants of Corporate Borrowing', 5 *Journal of Financial Economics*, 1977, 156-158; Smith C.W. and J.B. Warner, 'On Financial Contracting: An Analysis of Bond Covenants', 7 *Journal of Financial Economics*, 1979, 153.

[385] Bratton W.W., 'The Economics and Jurisprudence of Convertible Bonds', 1984 *Wis. L. Rev.*, 700 ff.

claims at risk.[386] These safeguards often extend to a requirement that their claims be secured by the surviving or emerging company or that their claims be discharged before the merger, which may act as a disincentive to merger. In the US, where the jurisdictions seem to be less creditor-friendly than in the EU, the protection of creditors can be achieved contractually in two ways: prohibiting some types of conduct that would dilute or destroy the conversion privilege with the use of appraisal rights,[387] or requiring notice to convertible bondholders in advance of a particular event, such as merger or reconstruction, which would enable exercise of the privilege prior to the event taking place. While the latter is a more flexible approach, the former largely reduces corporate management discretion and issuers often resist the imposition of such clauses in practice. It may also be the case that under the law of the place of incorporation a fetter on corporate power by such contractual provision is void.[388] Covenants dealing with prospective mergers range from very permissive to very strict. Available modes of regulating these transactions are to subordinate the permission of the merger to the compliance of the borrower with all covenants *ex post* the merger or to a right of redemption in the lender (put option).[389] Alternatively, a notice provision clause requires the issuer to give specific notice to convertible bondholders after the public announcement of an impending takeover, merger, consolidation or reconstruction, so that convertible bondholders may exercise their conversion option, if they so wish.[390]

In the case of an occurrence similar to a takeover bid, notice provisions are usually linked to an obligation on the part of the issuer of the convertible to procure a like offer that is extended to the holder of any ordinary shares allotted or issued to

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[386] Art. 13 Third Company Law Directive

[387] Generally, voting rights are not an exclusive prerogative of shareholders. Other stakeholders may also have the right to vote in certain determined situations. See 56 Del. Laws, c. 50, s. 221 (1967), which states: "every corporation may in its certificate of incorporation confer upon the holders of any bonds, debentures or other obligations issued or to be issued by the corporation the power to vote in respect to the corporate affairs and management of the corporation to the extent and in the manner provided in the certificate of incorporation […]". A similar provision is contained in the New York Business Corporations Law.

[388] As for example in many European jurisdictions.

[389] Bratton W.W., 'Bond Covenants and Creditor Protection: Economics and Law, Theory and Practice, Substance and Process', 7 *EBOR*, 2006, 55 ff. and 63 ff.

[390] Notification prior to the announcement of such an event may breach provisions in applicable insider dealing laws such as the UK's Company Securities (Insider Dealing) Act 1985 and the comparable rules in the US developed under rule 10b-5 of the US Securities Exchange Act 1934.

convertible bondholders who exercise their conversion rights during the period of such an offer. This obligation would be owed primarily to the trustee of the bond issue if there were a trust deed and would in practice be contained in the trust deed. In the case of mergers, consolidations and reconstructions, which result in the issuer ceasing to exist as an entity, the notice provisions are linked to a clause that imposes on the issuer an obligation to procure that the corporation which results or survives from the merger executes legal instruments or documents legally necessary to ensure that each convertible bondholder is not prejudiced by the mergers, consolidations or reconstructions. This is achieved by requiring the issuer to ensure that convertible bondholders shall have rights of convertibility into the amount of shares or other securities or property that they would have received had they converted prior to the merger, consolidation or reconstruction. It is important to point out that these provisions are only of benefit to the convertible bondholder when the market price of the issuer, at the date of the announcement of the transaction, is above the conversion price. If the market price were below the conversion price the consequences for the convertible bondholder would be highly disadvantageous, even with the benefit of the clauses.[391]

On the other hand, according to the courts of common law, convertible bondholders are entitled only to such shares, cash or other property that the trust deed provides for. It would be impossible under English law, by appropriate clauses in a convertible bond instrument or trust deed, to impose direct obligations on a bidder in a takeover offer for the issuer of the convertible bondholders in the company, due to the absence of contractual privity. For this reason, the bond instrument and the trust deed impose obligations only on the issuer and the trustee when the issuer is subject to a takeover bid. As regards convertible securities issued by UK companies, a degree of protection against the takeover of an issuer is provided in Rule 15 of the City Code on Takeovers and Mergers. Although express

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[391] See the US case of *Broad v. Rockwell International Corporation* 642 F2d 929 (1981), where Collins, a radio company incorporated in the State of Iowa, issued $40 million aggregate principal amount of convertible bonds maturing in 1987 at a low coupon rate. Collins' stock was trading at around $60 per share at the time of the issue and the conversion price of the bonds was fixed at $72.5 per share. In 1971, however, the share price had fallen to $21 per share and had on occasion fallen to $9.75 per share during that year until two years later when the company was acquired by Rockwell International Corporation at $25 per share.

consent is generally not required in convertible bond issues,[392] under Rule 15 where an offer is made for the equity share capital of a company, an "appropriate offer" must also be made to the holders of convertible securities and equality of treatment is required.[393]

According to Rule 15(a), the adequacy of an offer or proposal is measured by its "see-through" value, which is the value of the Rule 15 securities by reference to the value of the voting equity offer.[394] In the case of "options, warrants and other rights to be subscribed to, these should be calculated net of any exercise price".[395] In the case of convertibles, which do not have an exercise price, the "see-through value will always be positive and an offer or proposal at no less than see-through value will be required, even if that offer or proposal is below the market price of the convertible securities".[396] If a convertible security's market price (if any) is higher than its see-through value, because for example the convertible is trading as a fixed income security, a Rule 15 offer or proposal does not need to be at market price or above.[397] Similarly, as long as the offer is made at no less than see-through value, a proposal addressed to holders of Rule 15 securities does not need to include the same form of consideration as offered under the voting equity offer.[398]

Where the voting equity offer is a securities exchange offer and offeror securities are also being offered to the holders of Rule 15 securities, the exchange ratio offered to holders of Rule 15 securities shall be no less favourable than that offered under the voting equity offer. Alternatively, if the convertible securities include an adjustment mechanism that affects the exercise terms of the securities in the event of an offer for the offeree company, an "appropriate" offer or proposal should normally take the adjusted exercise terms into account.[399]

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[392] However, this consent is usually required for convertible preference shares issued in private companies.

[393] See Rule 15(a) of the City Code on Takeovers. The same concept is stated in the Company Act 2006 at s. 989 under Part 28 Ch. 3 where convertible securities and voting debentures (s. 990) are treated as shares in the company for the purposes of a takeover bid.

[394] Rule 15, s 2.1.

[395] Rule 15, s 2.2.

[396] Rule 15, s 2.5.

[397] Rule 15, s 2.6.

[398] Rule 15, s 2.7.

[399] The Takeover Panel, *Appropriate offers and proposals under Rule 15,* amended 30/03/09, practice statement No. 24, ss 2.8-2.11.

This protection can be formalised in the terms and conditions that may permit bondholders to convert their bonds at an adjusted conversion price (to compensate for early conversion) on announcement that a bid has been declared unconditional in all respects.[400] Under Rule 15(b), the board of the offeree company "must obtain competent independent advice on a Rule 15 offer or proposal and the substance of such advice must be made known to the holders of Rule 15 securities, together with the board's views on the offer or proposal".[401]

Whenever practicable, the offer or proposal should be sent to holders of convertible securities at the same time as the offer document is published or as soon as possible thereafter, after the voting equity offer becomes or is declared wholly unconditional.[402] The offer or proposal must be open for at least 21 days following the date on which the relevant documentation is sent to convertibles' holders and for no less than 14 days after the date on which it would otherwise have expired, if the voting equity offer has become or is declared unconditional with regard to acceptances.[403]

A company may decide to implement a takeover in the UK also by means of a scheme of arrangement. In such a case a certain set of rules under the Company Act 2006 applies.[404] A scheme of arrangement is a statutory procedure under s. 897 that permits a company to propose an arrangement to its shareholders or creditors or any class of them. Provided that the scheme is approved by the requisite majorities of shareholders or creditors or any class of them and subsequently approved by the court, it is binding on the totality of those shareholders or creditors or any class of them who were entitled to vote, irrespective of whether or how they voted.[405]

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[400] In continental jurisdictions, provision may have to be made for events such as a French *fusion*, a merger mechanism where the issuer may cease to exist as a separate legal entity and holders receive an interest in the merged entity.

[401] Rule 15, s 3.1.

[402] Rule 15(c) of the City Code on Takeovers.

[403] The Takeover Panel, *Appropriate offer, ult. cit.,* at 7-8.

[404] In the Company Act 2006, Part 26 deals with arrangements and reconstructions and Part 27 deals with mergers and divisions of public companies (previously s. 425 of the Company Act 1985).

[405] In UK the scheme of arrangement has become the structure of choice for implementing takeovers and its trend is extremely positive. In 2007, 47 targets were acquired, worth in aggregate approximately £58 billion (*The Times*, 14 January 2008). In addition, of the UK public M&A deals announced in 2007 with a value of £250 million and above, 28 were announced or subsequently structured as schemes of arrangement while just eight were structured as contractual takeover offers. See for example, the mergers of Iberdrola SA and Scottish Power Plc, Glaxo Wellcome and

Following the announcement of a recommended offer by an acquirer company to the shareholders of a target company, the trustees of the bond issues have to notify the bondholders that a document setting out the full terms of the Scheme has been sent to the shareholders and that a copy of this document can obtained from the specified offices of the Paying, Transfer, Conversion and Exchange Agents and the Registrar. Included in that document are details of the impact of the proposed acquisition on the bonds in order to provide that bondholders, who convert their bonds after the date in which the scheme becomes effective, will automatically receive consideration.

5.3.2. The protection of convertible bondholders in assets disposal

The law offers creditors protection, particularly in the case of corporate division, which happens when the assets and liabilities of a single corporation are divided into two or more surviving corporations, one of which may be the dividing corporation itself. The risk is that creditors' claims will be impaired because the division of assets and liabilities, which is determined in the division contract, is not pro rata as between the receiving companies. To this end, EC law makes companies receiving assets through a division jointly and severally responsible to pre-division creditors, even though the liability of the receiving companies other than the one to which the debt was transferred may be limited to the value of the assets transferred.[406] However, the law in assets disposal transactions provides little protection.

Nevertheless, it could be argued that if an investor holds a convertible bond the above-mentioned scenario differs. The advantage of a well-drafted convertible is that its value is not affected much by changes in company risk. In fact, while the risk reduces the value of the bond portion of a convertible, it also increases the value of the option included by increasing volatility of the share market price, thus providing the investor with a hedge if the firm turns out to be riskier than expected. In other words, it could be concluded that convertibles are relatively insensitive to the variance of the firm's returns because they can always participate in the firm's

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SmithKline Beecham, Halifax and Bank of Scotland, and the bid announced for Scottish & Newcastle Plc by Heineken and Carlsberg on 25 January 2008.

[406] Art. 12 of the Directive 82/891/EEC (Sixth Company Law Directive) [1982] O.J. L 378/47 (applicable to open companies).

profits through their conversion privilege.[407]

In truth, these types of transactions could virtually destroy the value of the conversion privilege. In asset disposals or cessation of business, where a company transfers all its assets but not its liabilities to another company in consideration of shares in that company or cash, the company that issued a convertible bond is still legally capable of effecting the conversion but the conversion privilege will be of little value if the company is listed in a stock market. This is because the transaction would probably cause downward pressure on the market price of the shares of that company.

The problem could be handled by introducing in the debt contract a clause that establishes a partaking adjustment to the conversion price. In particular, this clause requires that, if a substantial asset transfer is effected by the issuer of convertibles, the holder of convertibles will be given the and amount of shares and other securities and property, including cash, as were issued upon such a sale to a holder of the number of shares of common stock into which such convertible security might have been converted immediately prior to the assets sale. Shareholders do not receive any property upon the company's sale of all, or substantially all, of its assets, though they may receive property if the company is liquidated or dissolved following a sale. However, in cases where stockholders are cashed out or receive debt securities, the partaking clause is inadequate to avoid the risk dilution. In other words, if the ordinary shareholders of the issuer are not given rights to convert their shareholdings into the shares of the purchasing company, the convertible bondholder is without remedy.[408] Furthermore, the wording of this anti-dilution provision with respect to assets sales has often created ambiguity. The clause is uncertain as to how the bondholder has protection only if the sale is followed by liquidation or dissolution, or also where the issuer who sells off assets receives a shareholding in the purchasing corporation as consideration without completing the merger. In a seminal

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[407] Since higher risk makes the equity component more valuable while decreasing the value of the straight debt component of convertible debt, post-conversion equity ownership should be higher in riskier firms or in firms in which uncertainty and risk are key-factors. See Brennan M. and E.S. Schwartz, 'The Case for Convertibles', 1 *J. Applied Corp. Finance*, 1988, 58; Green R., 'Investment incentives debt and warrants', (1984) 13 *J. Fin. Econ.*, 130.

[408] Kahan M., "Anti-Dilution Provisions in Convertible Securities", 2 *Stan. J.L. Bus. & Fin.* (1995), 159-162.

US case,[409] the issuer of convertibles transferred 75 per cent of all its assets for cash. The trust indenture contained the usual provision that the convertible bondholder would be entitled to common stock in the corporation that made substantial purchases of the issuer's assets. The court held that the clause did not apply in the event of a cash transfer but applied only where stock of the purchases was exchanged for assets in the seller. The court's reasoning was influenced by the notion that the convertible bondholders could still convert the bonds into the stock of the issuer.[410] However, this ignores the diluting effect of such a substantial assets transfer for a cash consideration, since cash is a non-performing asset in a company's balance sheet and does not facilitate stock appreciation by profit generation.[411]

Nowadays, the practice in the "straight" sterling bond market has also highlighted the benefit to bondholders of the so-called "Spens clause", which provides for a termination payment that compensates the bondholders when a bond is redeemed before its maturity or where a substantial part of the assets of the issuer or a material subsidiary is disposed of (as an event of default), and/or following a "restructuring event". Such an event might occur when there is a sale or cessation of the major part of the issuer's business typically in conjunction with a "negative rating event" (normally where bonds fall below the investment grade status of BBB-Baa3).

Finally, especially in private firms, the practice has evolved of the use of loan covenants. The content of these covenants may vary in their intensity. Financiers generally protect themselves by limiting the aggregate amount of assets that a company is allowed to sell yearly through the use of a book value or fair value cap along with a fair value standard to govern the terms of permitted sales, or by barring

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[409] *BSF Co v Philadelphia National Bank,* 42 Del Ch. 106, 204 A2d 746 (Sup. Court 1964).

[410] The judgement of the US Courts seems homogeneous in that direction. See more recently: *Hollinger v Hollinger Int'l* (Del Ch 2004), *US Bank NA v Angeion Corp* (Ct App Minn 2000), *General Motors Class H Shareholders Litigation* (Del Ch 1999), *Apple Computer Inc v Exponential Technology Inc* (Del Ch 1999), *Cyrix Corp v Intel Corp v SGS Thomson* (ED Texas 1992), *Sharon Steel Corp v Chase Manhattan Bank* (2d Cir 1982), *Story v Kennecott Copper Corp* (NY Sup C 1977).

[411] See Kling L.R. and E. Nugent, *Negotiated Acquisitions of Companies, Subsidiaries and Divisions* (New York, 2005) Vol.1, 4.09 and footnotes; Bratton W.W., 'The Economics and Jurisprudence of Convertible Bonds', 1984 *Wis. L. Rev.*, 695.

sales of assets in excess of, say, 10 per cent of net worth per year.[412] Furthermore, a transfer from a wholly owned subsidiary to another group company could also be problematic in that the other shareholders in the transferee company or undertaking will acquire an interest in the assets which ranks equally with that of the borrower. Hence, if the covenant is qualified so as to permit intra-group transfers, this will usually exclude transfers by the borrower itself and may also exclude or restrict transfers other than between wholly owned subsidiaries. In the latter case, a limitation on the subsidiary indebtedness clause is also generally included, particularly if the loan issue has been carried out at the holding company level whereas the business is conducted through the holding company's operating subsidiaries. Of course, a disposals covenant must necessarily be qualified so as to permit disposals of assets in the ordinary course of business, although the introduction of a substance test may sow the seeds of potential future difficulties in interpretation and application. Nevertheless, stricter clauses may forbid any sale of assets without the consent of the creditors, preventing managers from dissipating them.[413]

5.3.3. Other situations of potential dilution: the distribution of dividends

Another significant corporate decision that can dilute the conversion privilege of a convertible bondholder concerns the distribution of dividends and the ordinary dividend policy adopted by the managers. The parties rarely contract for anti-dilution provisions because it is often arguable whether the convertible bondholders really suffer from dilution. It has been said that whether a distribution of dividends must be considered an abuse of the shareholders over the creditors or simply the concretisation of a dividend policy, may be a subjective thing to decide. A payment of dividends, whether in cash or kind, can indeed deprive the company's share value, because part of the equity capital is repaid to the shareholders. If a dividend policy is such that, alter the issue of the convertible, the rate of dividend payments is increased so that the conversion privilege is diluted due to a much slower increase

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[412] Bratton W.W., 'Bond Covenants and Creditor Protection: Economics and Law, Theory and Practice, Substance and Process', 7 *EBOR*, 2006, 55 ff.

[413] Gompers P.A. and J. Lerner, 'The Use of Covenants: An Empirical Analysis of Venture Partnership Agreements', 39 *Journal of Law and Economics*, October 1996, 463-98.

in the appreciation of the market value of the underlying shares, the result is similar to a subdivision of shares – a so-called "stock split". Such prejudicial behaviour could result not only in a decrease of the conversion privilege but also in the detriment of the safety capital made available for the repayments to the ordinary bondholders.[414]

The law intervenes in this sense to protect the creditors with a set of rules on capital maintenance. In UK company law – as introduced by the implementation of the Second EU Directive[415] – a public company can distribute a dividend only out of profit,[416] provided that the distribution does not reduce the amount of net assets to an amount less than the aggregate of its called-up share capital plus its non-distributable reserves.[417] However, a distribution of dividends may still dilute a company's share value while complying with the rules on capital maintenance. A method of control would be a clause that restricts dividend payments to a particular percentage of the net corporate revenues or an adjustment of the conversion price on the occurrence of such an event.

The main difficulty in connection with the adjustment of the conversion price is to determine what is meant by capital distribution. In order to identify a "diluting" capital distribution, it is necessary to define what constitutes an "ordinary" distribution of dividends. Generally, the conversion price of a convertible bond is initially set with the presumption that an anticipated level of dividend will be paid each year. An adjustment to the conversion price based upon payment of that dividend would violate the "fixed for fixed" requirement as the relative economic rights of the convertible bondholders and the ordinary shareholders would not be preserved – i.e. it would change the capital structure.[418] However an adjustment to

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[414] See Berle A., *Corporate Devices for Diluting Stock Participations, 31 Columbia L. Rev.,* 1931, 1239; Hills G.S., 'Convertible Securities Legal Aspects and Draftsmanship', 19(1) *California L. Rev.*, 1930, 21-22 and 36; Kaplan S.N., 'Piercing the Corporate Boilerplate: Anti-Dilution Clauses in Convertible Securities', 33 *Univ. of Chicago L. Rev.*, 1965, 3 n.7; Glover S.I., Solving Dilution Problems, 51 *Bus. Law.,* 1996, 1269.

[415] Directive 77/91/EEC

[416] s. 830(1) of the UK Company Act 2006.

[417] s. 831 of the UK Company Act 2006. The position is similar in some US states. See Model Business Corporations Act s. 40 and s. 2; Virginia Corporation Law of 1956 s. 43, which prohibited the so-called "nimble dividend", which is the payment of dividends from current earnings while there is no accrued revenue surplus.

[418] See IAS 32.11 of IFRS 7.

the conversion ratio for a dividend in excess of the anticipated level – for example a special dividend that is effectively a return of capital that is a proportional reduction of all ordinary shares – is unlikely to violate the "fixed for fixed" requirement. Such an adjustment would be viewed as preserving the relative economic rights of the convertible bondholders and the ordinary shareholders.[419]

A practice has evolved whereby a "diluting" dividend is identified as a "capital distribution" and thereby affects the conversion price of the bond. Mainly, a capital distribution usually includes any extraordinary or special dividend, distribution or similar, in cash or in kind, which is something over certain normal thresholds.[420] The board of directors, which makes the decisions with respect to these types of transactions, has a fiduciary duty to common stockholders, but not necessarily to holders of convertible securities.[421] Consequently, one can expect to see protection against structural changes in the underlying common stock in all types of convertible securities issued by both public and private issuers. However, since some of the anti-dilution clauses may excessively limit the power and the discretion of the management, it is normally easier to find covenants as the "dividend stopper" in loans to private companies and in high-yield securities. Provisions usually seen in practice in bond instruments and trust deeds in the international markets do not seek to control this type of dilution.[422]

Courts in the US applying ordinary English common law principles have refused to interfere with corporate dividend policy in the absence of express clauses in the bond instrument or trust deed and in the absence of fraud.[423] A convertible

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[419] Bratton W., *Corporate Finance, Cases and Materials* (5th ed., New York, 2003) 452-453.

[420] Fuller G., *Corporate Borrowing: Law and Practice,* (Jordan Publishing, 4th ed., 2009), 318.

[421] Glover S.I., Solving Dilution Problems, 51 *Bus. Law.,* 1996, 1248-49. See also Irvine J.M., 'Some Comments Regarding "Anti-Dilution" Provisions Applicable to Convertible Securities', 13 *Bus. Law.*, 1958, 732; Hills G.S., 'Convertible Securities Legal Aspects and Draftsmanship', 19(1) *California L. Rev.*, 1930, 21-23; Kaplan S.N., 'Piercing the Corporate Boilerplate: Anti-Dilution Clauses in Convertible Securities', 33 *Univ. of Chicago L. Rev.*, 1965, 4-5.

[422] See Wood P., *International Loans, Bonds, Guarantees, Legal Opinions*, (Sweet & Maxwell, 2007) 92.

[423] See *Harff v. Kerkorian,* 324 A.2d 215 (Del. Ch. 1974), aff'd in part and rev'd in part, 347 A.2d 133 (Del. Supr. 1975), where the court refused to interfere at the insistance of convertible bondholders even though the cash dividend was unusually large in the context of dividend policy in the previous years. The court's intervention was sought based on a breach of fiduciary duty given the absence of any fraud or any contractual provision controlling dividend policy. However, the *Harff* ruling does not rule out interpreting the concept of "fraud" as meaning a duty of good faith towards convertible bondholders. Such an interpretation would give the courts a power to intervene on behalf of convertible bondholders in the face of acceleration in the site and/or frequency of dividend

bondholder is assumed to be already protected because the convertible security is remunerated with a fixed interest agreed by contract and its holder can always convert it into common shares of the company if he or she likes. Therefore, a privilege holder is not entitled, upon the conversion of a corporate obligation, to receive accrued interest thereon to the conversion date. Likewise, the corporation cannot require the privilege holder to reimburse it for dividends accrued or earned on the shares issued or on account of the undivided surplus represented by such shares. In fact, immediately upon conversion the privilege holder abandons his right to receive interest and acquires such dividend rights as the stock issued to him may carry. A privilege holder who effects conversion and becomes a stockholder is thereby entitled to share with other stockholders of the same class in all subsequent cash or stock dividends.[424]

Pursuant to the provisions of practically every conversion instrument, however, an adjustment of interest is made upon the conversion of bonds or debentures into common or preferred stock, but in approximately half of such cases, the instrument makes no provision for an adjustment of dividends.[425] The computation of interest adjustments upon coupon obligations or fully registered obligations without coupons is comparatively simple as in each case the interest is computed from the last interest payment date to the date of conversion at the established rate. Accrued interest, whether represented by not-yet matured coupons or not, is abandoned upon conversion as the obligation itself and all not-yet matured coupons are surrendered. Generally, the conversion instrument requires no adjustments of dividends on the shares surrendered or on the shares issued, but if adjustments are made with respect

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distributions. For an analysis of this case, see Bratton W.W., 'The Economics and Jurisprudence of Convertible Bonds', 1984 *Wis. L. Rev.*, 695-97 and Mitchell L.E., The Fairness Rights of Corporate Bondholders, 65 *N.Y.U. L. Rev.*, 1990, 1203.

[424] Hills G.S., 'Convertible Securities Legal Aspects and Draftsmanship', 19(1) *California L. Rev.*, 1930, 37 ff.; Ferran E., *Company Law and Corporate finance* (Oxford University Press, 1999) 521-522.

[425] *See* Kahan M., "Anti-Dilution Provisions in Convertible Securities", 2 *Stan. J.L. Bus. & Fin.* (1995), 154 where the author writes […] "About 42% of... the sample offered no [anti- dilution] protection to [convertible] bondholders for [cash] dividends." *See also* Bratton W.W., 'The Economics and Jurisprudence of Convertible Bonds', 1984 *Wis. L. Rev.*, 695 n.114 where the author notes that of a sample of forty-six convertible bonds, thirty-five permitted cash dividends out of surplus without adjustment and eleven permitted all cash dividends without adjustment, while forty-four provided for adjustments for distributions in kind.

to one class of shares, they are also made with respect to the other. It is unusual to have adjustments of dividends on one class alone.[426]

The adjustment of dividends on common or preferred stock is more difficult, as several matters must be considered: dividends on preferred stock may or may not be cumulative; common stock dividends may be regular or extraordinary, and may be payable in cash or stock; dividends may be passed or reduced on the next dividend payment date following the conversion date. Moreover, where distributions are made to shareholders by way of capitalisation issues or capital distributions, or where a rights issue or securities issue by way of rights is made to existing shareholders, the question arises whether bondholders who convert immediately prior to such events would be given the same rights to receive such distributions.

As a matter of strict law, since they are not shareholders as of the record date of the distribution they would not receive the benefit of the distribution. However, provision can be included in the trust deed to permit bondholders who exercise their conversion rights immediately after the record date for such distribution or issue to have the same rights to the distribution or issue possessed by existing shareholders.[427] In such an event, while no adjustment to the conversion price is to be made, the convertible bondholder acquires rights to the distribution or issue that will be commensurate with the amount of shares he would have received if an adjustment had been made to the conversion price immediately after the record date of the distribution. The converting bondholder does not, however, get the additional benefit that would accrue from a conversion price adjustment.[428]

Thus, the issuer is usually required to give notice to convertible bondholders in the event of rights issues, issue of shares for cash, or when the issue of any other securities (e.g. warrants to subscribe) to shareholders is made at a subscription price below the current market price of the shares or where the conversion or subscription

[426] Klein W.A., The Convertible Bond: A Peculiar Package, 123 *U. Pa. L. Rev.* (1975), 565.

[427] Sometimes the period allowed for conversion after the date of decision of a dividend distribution may be 15 days, and sometimes it is expressly stated in the terms of the contract that a bondholder shall not convert his bonds into shares of the company during the period starting from the day after the date of declaration of a dividend distribution until the date of payment of the dividends.

[428] See the Lloyds Banking Group plc ECN deed poll paragraph (b)(iii) of the GBP7.5 billion (aggregate value) Enhanced Capital Notes or contingent capital bonds (Cocos)) issued by LBG Capital No.1 plc or LBG Capital No.2 plc, 3 November 2009.

price of securities already in issue is altered so that it is less than the market price for the underlying shares prevailing at the time of the alteration. Two types of notice are usually required to be given for the benefit of convertible bondholders. The first requires the issuer (or the guarantor as the case may be) to give notice to the trustee by issuing a certificate stating that a particular event that gives rise to the adjustment has occurred. In the certificate, the issuer has to specify the date on which such an adjustment takes effect and any other information required by the trustee. The second requires the issuer (or the guarantor), within a specified time (usually 14 days) after the notice is given to the trustee, to give a second notice through a financial newspaper to the bondholders informing them of the event and the adjustment of the conversion price. This covenant, however, does not protect the conversion rights of a bondholder who may have exercised his conversion option during the 14-day period prior to notice being given to bondholders. The trustee may be under a fiduciary obligation to notify bondholders immediately so that some do not expose themselves to incurring losses by converting their bonds prior to the adjustment date. This need for advance notice to bondholders is dealt with in a separate clause, but only with respect to certain adjustment events.[429]

5.4. An evaluation of the rationale and protection for hybrids

This analysis shows that, in private equity and venture capital financing, where funds are often contributed in businesses that strongly depend on human capital, preference shares can be used as incentive contracts to align management and investors' interests. Furthermore, the research demonstrates that convertible instruments present an optimal solution to the trade-off between the firm's need to allocate cash flow rights to the venture capitalists and the need to make efficient exit decisions. Regarding the protection available for preference shareholders and convertible bondholders, the law in the UK and US tries to facilitate bargaining between the parties without interfering too much in business decisions. In fact, for the protection of preference shareholders, both the legal systems prefer to adopt *ex post* standards strategies, although US jurisdiction provides an exit strategy, in the form of appraisal

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[429] Hills G.S., 'Convertible Securities Legal Aspects and Draftsmanship', 19(1) *California L. Rev.*, 1930, 20; Kaplan S.N., 'Piercing the Corporate Boilerplate: Anti-Dilution Clauses in Convertible Securities', 33 *Univ. of Chicago L. Rev.*, 1965, 12-14; Bratton W.W., 'The Economics and Jurisprudence of Convertible Bonds', 1984 *Wis. L. Rev.*, 680-681.

rights for dissatisfied shareholders while, in the UK, companies' restructuring and mergers are also dealt with in accordance with a scheme of arrangement. For creditors' protection in public companies, contractual rights seem to be sufficient, although British law also implemented the EU directives on capital maintenance and on mergers and demergers that provide a further safeguard for creditors.[430]

However, the analysis also shows that the practice of the markets has developed especially in the US but also in the UK, contractual standard clauses for convertible bondholders to protect the conversion privilege that, in certain crucial situations, would be otherwise destroyed by the shareholder-manager's opportunism. Conversely, the UK statutory protection for preference shareholders regarding the variation of the class rights regime appears inadequate to fully protect the special class of investors in start-up businesses where particular financial and control rights are assigned for achieving particular objective targets. The UK courts make a distinction between rights affected as a "matter of law" and as a "matter of business", concluding that if an act of the company impinges only on the enjoyment of those rights, it is unlikely to amount to their variation. However, in private equity and venture capital transactions, a right affected even as a matter of business may completely change the incentives of the parties and create conflicts in the firm. This study therefore highlights the importance of careful contractual design in such cases.

Chapter 6. Financing through hybrid instruments: risks opportunism and legal strategies for mitigation

The analysis continues in this chapter, where convertible preference shares, convertible bonds and bonds with restrictive covenants are studied. Convertibles show a strong rationale for their use in reorganisation and restructuring transactions because they largely reduce the agency costs of debt and the asymmetric information that can be a critical factor in the presence of great uncertainty in the business. Instead, bonds and preference shares holding restrictive covenants and veto rights,

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[430] Respectively the Second Directive 77/91/ECC O.J. L 26/1, the Third Directive 78/855/EEC O.J. L 295 and the Sixth Directive 82/891/EEC O.J. L 378/47.

which are becoming common in the US markets, provide the investors with strong protection against claim dilution. However, these advantages do not come without costs. On the one hand is the need of the founder investor (angel) not to be excessively diluted in their control and financial rights; on the other is the danger that an excess of veto rights can hinder a company's capitalisation. I discuss these conflicts in this chapter, highlighting some common legal strategies to avoid these problems. These strategies show the importance of contractual design in order to avoid the economic and ownership dilution of interests in the firm. Although this chapter concerns primary UK company law, the use of certain contractual clauses in relation to hybrids it is adaptable to the corporate law of other jurisdictions and especially in the Unites States where these provisions are already common.

6.1. The use of convertible bonds to reorganise and restructure a firm

Corporate capital structure may have a decisive signalling role in stock markets, since a company's grade of risk also depends on its financial obligations. Assumed managers have insider information that outside investors do not know and, to the extent that they aim to maximise the wealth of the company, such managers have an incentive to issue new equity when they believe the company is overvalued or at least not undervalued. Investors, who are aware of these managers' behaviour, respond to announcements by lowering their estimates of the issuers' value to compensate for their informational disadvantage. The result is a negative market reaction to new equity offerings and a dilution of the value of the existing shareholders' claims.[431]

When directors decide to issue debt notes, however, they suggest to the market that they have private information, which is an optimistic belief in the future business of the company. They would not issue debt notes if they were not aware of the company's capacity to generate cash flows sufficient to repay the passive interests on bonds. In light of this, the unwillingness of such companies to issue straight equity, when viewed together with their inability to issue long-term debt, and

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[431] Asquith P. and D.W. Mullins, 'Equity Issues and Offering Dilution', 15 *Journal of Financial Economics*, 1986, 61 and 70-71; see also Myers S.C. and N.S. Majluf, 'Corporate Financing and Investment Decision When Firms Have Information That Investors Do Not Have', 13 *J. Fin. Econ.*, 1984, 187-188 and 209-210.

the consequent issue of convertible bonds instead, send a positive "signal" to the market about the management's confidence in the future. The company in so doing decides to conserve value by raising deferred equity on better terms in the future instead of issuing undervalued equity today.[432] The issue of convertibles provides the market with a positive signal, thus reducing the negative impact on the shares price following the announcement. Although the negative effect will remain, economic research shows that it is likely to be less pronounced than if the ordinary stock was issued directly.[433] At the same time, this is an indirect way to increase equity at times when some private information will be revealed to the market. For this reason, some authors have argued that convertible securities are "backdoor equity" finance.[434]

Directors may have a further tool for signalling when a call provision is included in the terms of the convertible contract. If the equity price does rise, the issuer can typically accelerate the debt by exercising their call privilege and thereby forcing the conversion into equity. Based on its favourable private information, the firm expects that the debt-holder will choose to convert. The benefit from deferring the issuance of equity through convertible debt financing is qualified by the effect of the firm's exercise of its call privilege. A firm that calls its convertible debt in order to force conversion communicates to the market its expectation that impending difficulties may make the firm's debt obligations more difficult to service or that its equity is now overvalued. However, the delay in calling the debt has a cost: the risk of financial distress until conversion, which the holder usually has the incentive to defer until the last possible moment.[435]

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[432] See Lewis, C. M., Rogalski, R. J. and Seward, J. K., "Understanding the Design of Convertible Debt", 11 Journal of Applied Corporate Finance, (1998), 45–53; Ross S.A., The Determination of Financial Structure: The Incentive Signalling Approach, 8 *Bell Journal of Economics*, 1977, 23-40; Myers and Majluf, 1984, note above, at 187-221; See Harris M. and A. Raviv, 'Capital Structure and the Informational Role of Debt', 20 *Journal of Financial Economics,* 1990, 55-86; Harris M. and A. Raviv, 'The Theory of Capital Structure', 46 *The Journal of Finance*, 1991, 302 and 320.

[433] In response to the announcement of new equity issue, a company's stock price falls by about 3 per cent on average, while stock price falls from 1-2 per cent in the case of an announcement of convertible debt. See Smith C.W., *Investment Banking and the Capital Acquisition Process,* 15 Journal of Financial Economics, 1986, at 8-10. Some authors have shown that the issuance of callable convertible debt may not avoid, but rather simply postpone, the negative information effect of equity financing unless the firm refrains from calling the debt and waits for the holder to convert. See Mikkelson W.H., 'Convertible Calls and Security Returns', 9 *J. Fin. Econ.*, 1981, 237; Asquith P. and D.W. Mullins, 'Convertible Debt: Corporate Call Policy and Voluntary Conversion', 46 *J. Finance*, 1991, 1273 and 1277.

[434] Stein J., Convertible bonds as backdoor equity ¸financing, 32 *J. Fin. Econ*., 1992, 19-20.

[435] See Lewis C.M., 'Agency Problems, Information Asymmetries and Convertible Security Design', Journal of Financial Intermediation, 1998, 50 where "the intuition for the role of convertible debt as "backdoor equity" financing rests on the trade-off between the sale of mispriced corporate securities and the costs of financial distress".

In addition, there are some evident advantages for an investor stemming from the fact that convertible bonds enable their subscribers to change their status in the company. Managers could invest too much in potentially negative net present value projects in order to guarantee the continuation of the business, although this may imply a decrease in the cash flow (also called an overinvestment problem). Alternatively, the company's business may prove to be less profitable than expected. However, convertible bondholders as long as they do not convert their securities into equity hold a pure debt obligation and as such are entitled to receive a fixed interest and be repaid at maturity. The conversion option included in the debt security presents an important opportunity for the investor to evaluate the convenience of converting into equity or not. Convertibles are generally issued with a conversion price that guarantees their holders a premium over the present share market value on conversion of the securities. In this way, the investor will be able to consider whether to convert into equity during the different phases of the company's life, knowing that if the company is not performing well and its share market value is not increasing they can enjoy the benefits of a bond.

6.2. The manager-convertible bondholder conflict

The use of convertible bonds to provide finance to a firm in its start-up phase or in a time of restructuring can reduce asymmetric information problems and give parties the right incentives. However, this is not immune from conflicts of interest (and it may be arguable whether, in such cases, these categories of investors are adequately protected by the law). The motive for investors to acquire convertible bonds is the desire to secure an opportunity to participate in the business of the issuing corporation for a fixed price. The bargaining the investors usually think they are engaging in is based on their perception that the value of the shares into which the bond may be converted will rise due to the future commercial and financial performance of the corporate entity in question, and the general upward trend of share values in the stock markets where the shares are traded. However, the value to investors of convertibles may be difficult to analyse comprehensively and any simplification of their value may be a misconception.[436]

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[436] See Kahan M., "Anti-Dilution Provisions in Convertible Securities", 2 *Stan. J.L. Bus. & Fin.* (1995), 147, 148 n.3; Brennan M.J. and E.S. Schwartz, 'Analyzing Convertible Bonds', 15 *J. Fin. and*

Corporations are not static. Their capital structure changes and the share of stock of today, while legally an identical unit to the share of yesterday, commercially, may have become entirely different. Within the time that the corporation issues the bond and the privilege of conversion comes into effect, the assets and the surplus already accumulated at the beginning and forming a part of the book value of the stock can significantly change. A company can decide to proceed with actions that may be detrimental for the holders of a convertible bond because this opportunistic behaviour could reduce the value of the conversion privilege. For instance, a company may have decided to distribute its entire surplus as dividends or have paid a dividend in kind issuing additional shares of the same class, or have created an issue of preference shares placing the ordinary shares in a highly unattractive position with regard to both assets and dividends. Moreover a company may have reduced the par value of its shares, divided them into many shares of a less par value, or made them over into non par value shares. A company may have carried out transactions that could have influenced its shareholding, such as having merged, consolidated or even dissolved. The entire capital structure may have been radically altered without changing the nature or ending the existence of the shares themselves. Any such behaviour could be fatal for the hopes of the privilege holder.[437]

In the relationship between convertible bondholders and managers, the conflict of objectives revolves around the conversion privilege. The investor's objective is to preserve and maximise the value of the conversion privilege and he has an interest in deterring any action by the issuer that would devalue or destroy that privilege. The issuer is not concerned with the value of the conversion privilege after the bonds have been placed with investors, although he has an interest in the timing of the conversion. In a rising market for the underlying shares, the investor would like to postpone conversion as long as possible to a point just prior to the

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Quantitative Analysis, 1980, 407; Fuller G., *Corporate Borrowing: Law and Practice,* (Jordan Publishing, 4th ed., 2009) 64 ff.; Bratton W.W., 'The Economics and Jurisprudence of Convertible Bonds', 1984 *Wis. L. Rev.*, 681-689; Buxbaum R.M., 'Preferred Stock—Law and Draftsmanship', 42 *Cal. L. Rev.,* 1954, 243; Hills G.S., 'Convertible Securities Legal Aspects and Draftsmanship', 19(1) *California L. Rev.*, 1930, 20-39; Klein W.A., The Convertible Bond: A Peculiar Package, 123 *U. Pa. L. Rev.* (1975), 547; Berle A., *Studies in the Law of Corporate Finance* (Chicago: Callaghan & Co. 1928) 131 ff.

[437] Fuller G., *Corporate Borrowing: Law and Practice,* (Jordan Publishing, 4th ed., 2009) 65; Bratton W., *Corporate Finance, Cases and Materials* (5th ed., New York, 2003) 420.

final maturity of the bond. This would enable the investor to maximise the gain on the exchange of the bond for shares. From the issuer's viewpoint the sooner he can compel the bondholders to convert the bonds into the underlying shares the more advantageous it is for him. An issuer may also wish to redeem the convertibles to prevent a continuing equity "overhang", namely the contingent obligation to issue further equity on conversion.[438] The higher the options overhang of a company the higher the level of growth the company must generate to compensate its investors, because the overhang may reduce the cash flow diluting the investors' returns.[439]

6.2.1.The timing of the conversion and the issuer's call option

The first area of potential conflict between issuer and bond investor concerns the timing of the conversion. The timing conflict is resolved by conferring on the issuer a call option or early redemption option, with respect to the convertible that enables him to redeem all or some of the bonds from time to time, prior to maturity, during a specified period in the life of the bond. This call option in effect enables the issuer to force the convertible bondholder to exercise his conversion option. This is because in the exercise of the issuer's option of redemption prior to conversion, the bond instrument must by its terms be tendered by the holder to the issuer for payment and cannot thereafter be converted by the bondholder. If the bondholder wishes to derive any benefit from the conversion privilege, he must exercise the conversion option prior to redemption of the bonds by the issuer.[440]

Nevertheless, the conversion privilege will be of little value to the bondholder if the redemption option can be exercised by the issuer prior to a time at which the market price of the shares exceeds the conversion price for the underlying shares. Thus, in order to enable the issuer to force conversion without harming the value of the conversion privilege, some contractual agreements and covenants have been

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[438] In fact, stock-based compensation awarded to executives, directors and key employees of the company dilutes the shareholdings of common shareholders.

[439] Brennan M.J.M. and E.S. Schwartz, 'Convertible Bonds: Valuation Operational Strategies for Call and Conversion', 32 *J. of Fin.,* 1977, 3699, but see Klein's response in Klein W.A., The Convertible Bond: A Peculiar Package, 123 *U. Pa. L. Rev.* (1975), 547 and 558-9.

[440] Otherwise, it would be as if the investor lent money at a cheaper rate without having anything in return.

developed by legal practitioners.[441] In the international markets, an issuer is usually not permitted to make a call until a set period after issue, often between one and three years. Alternatively, the issuer is prohibited from calling the bond until the average market price for the underlying shares over a given period exceeds the conversion price, usually by about 15-30 per cent but sometimes by up to 50 per cent. Such a provision is usually applicable in the three-year period immediately after the issue of the bond. In addition, whether or not the issuer exercises his call option, he usually has to pay a "call premium" to the holder. This is an amount in excess of the principal or face value of the bond. This premium is usually on a sliding scale, being at its highest in the first year when a call is permissible (that is, at the end of the three-year period), and diminishing as time lapses.[442]

When an issuer decides to exercise its right to call the convertibles, it must give notice of redemption to convertible bondholders in advance. A notice period is usually a minimum of 45 days and not more than 60 days but this may vary in practice. This enables the bondholders to exercise their conversion option prior to the actual redemption of bonds after the call has been published.[443] The issuer is usually required to specify the conversion price and the current stock market price of the shares. In the markets' practice, to ensure bondholders are not prejudiced by a failure to exercise their conversion option, trust deeds are usually used to confer a power on trustees (within a certain number of days after the date for redemption) to subscribe to shares on behalf of such bondholders. This power is operative only where the trustee is satisfied that such shares could be sold on the open market during the subscription period at a price that would exceed the principal and interest on the bonds. The trustee is given the discretion to effect the exercise on their behalf, normally where the proceeds of exercise and sale of the resulting shares would be in excess of 5 per cent above the redemption value of the bonds. If the trustee decides to exercise this power, he then has a duty to sell the shares, which are allotted in

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[441] In the US the period seems to be two years. See Bratton W.W., 'The Economics and Jurisprudence of Convertible Bonds', 1984 *Wis. L. Rev.*, 678; Wood P., *Law and Practice of International Finance* (England: Sweet & Maxwell, 2008) s. 9.07(8).

[442] See examples in Bratton W., *Corporate Finance, Cases and Materials* (5th ed., New York: Foundation Press, 2003) 438, 440-452; Brudney V., and Bratton W.W., *Brudney and Chirelstein's Corporate Finance* (5th ed. Foundation Press 2003) 248 ff.

[443] Katzin J.S., 'Financial and Legal Problems in the use of Convertible Securities', *Business Lawyer*, January 1969, 366.

accordance with the un-presented bonds, and credit the net proceeds to an account for the benefit of such bondholders. The paying agent for the issue is then required to distribute the proceeds pro rata to all bondholders who are entitled.[444]

The usual rule is that bondholders will be entitled to the proceeds if they present their bonds to the paying agent with all un-matured coupons. This clause is referred to as the "widows and orphans" clause and is intended to protect the interests of those bondholders who may not be as vigilant as others in exercising their rights of conversion. Such a clause is also of benefit to the issuer. The company exercises its call option with the aim of forcing bondholders to convert their bonds and not trigger the payment obligations of the company regarding bonds, which are being redeemed or called. It is, indeed, undesirable from the issuer's point of view if some recalcitrant bondholders refuse to convert and do not present bonds by the date fixed for redemption. This is because, while a bond cannot be converted under its terms after redemption date, the bond survives as a debt obligation of the issuer and must be redeemed by the issuer through payment in full of the principal value.[445]

The conversion premium is sensible to the conversion's privilege durability, the longer its life, the greater its value. Conversely, the premium is reduced if the issuer retains the power to shorten the duration of the conversion privilege. However, even if its issuer does not redeem a convertible bond before maturity, the holders of the conversion privilege may still worry about the protection of the conversion premium. Indeed certain forms of corporate action may adversely affect, dilute or even completely destroy the value of the conversion option. The conflicts in this regard arise when the issuer tries to retain its complete freedom of corporate action and the bondholder seeks to preserve the value of his option, limiting the issuer's discretion instead. Typically, convertible securities convert into a number of shares of common stock, calculated by dividing the initial purchase price (sometimes plus accrued but unpaid interest or dividends) by a fixed conversion price. As a consequence and without a provision to the contrary, actions taken by an issuer that

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[444] For a recent sample of convertible bond structure see the offering circular dated October 2010 of Hengdeli Holding Limited with the Trustee in London and the registrar in Luxembourg at http://info.sgx.com/listprosp.nsf/1ac605da77093c4648256c6100174f0a/b4e8e27164538514482577d500249b4b/$FILE/Hengdeli%20-%20Offering%20Circular%20(2010.10.13).pdf (accessed January 2011).

[445] Ferran E., *Principles of corporate finance law* (Oxford University Press, 2008) 520 ff.

increase the number (or decrease the value) of shares of its common stock outstanding will also decrease or "dilute" the value of the conversion right.[446] In fact, when the convertible bondholder has a right to convert his bond at a fixed conversion price per share and the value of the underlying shares has been halved, the bondholder's ability to convert at a profit has been diminished.[447] The date on which the necessary adjustment takes place will be the date giving rise to the adjustment or, if earlier, the record date for determining which shares and shareholders are to participate in the event. This is to protect bondholders, who have converted before the event.[448]

6.2.2. Value dilution of the conversion option

Another type of company behaviour that would normally depress share values and thus prejudice the value of the conversion option is the issuance of additional shares for less than a fixed consideration.[449] In this way while the number of shares in the market increases, the value of the company's equity decreases, diluting the future participation of the convertible bondholder.[450] Likewise, the issuance of other securities, convertible into the same class of shares at a lesser rate or price, and the

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[446] A company incorporated under the UK Companies Act 2006 with a share capital may subdivide its shares into shares of a smaller amount by ordinary resolution if authorised by its articles to alter the memorandum of the company; see s. 618 of the Companies Act 2006. In the US these are called "stock splits".

[447] Let's assume, for example, that a company has a market value of £15 per share while the conversion price of its convertible bonds is £10. Thus the conversion right is "in the money". However, if the issuer decides to split the share capital giving 5 new shares to any holder of 1 old share then the market price of each share will fall to £3 and so doing it will extinguish the value of the conversion right.

[448] Let us assume, for example, that a company carries out a share split on 1 June of each share held by each person on the Register of Members on 1 May and the bondholder exercises their right to convert on 2 May. Despite converting on 2 June while the record date for adjustment was 1 May, the bondholder will receive the benefit from the adjustment to the conversion price.

[449] Under the provisions of s. 561 of the UK Companies Act 2006 such equity securities must usually be issued to existing shareholders. See, however, the exceptions in ss. 564-566. The position is similar under the laws of New York and most American states. See the New York Business Corporations Law s. 622 and the comments of J. Hallows in *Fuller v Krogh* 15 Wis 2d 4121962 where he said: "A pre-emptive right of a shareholder in a corporation is recognised so universally as to have become axiomatic in corporation law." Although the doctrine of pre-emptive rights was not known to English common law, it has been known to American law at least since 1807 after *Gray v Portland Bank* 3 Mass 364 (1807). See Gower L.C.B., 'Some Contrasts between British and American Corporation Law', 69 *Harvard L. Rev.*, 1956, 1369.

[450] For example, a company has an issued capital of £200, consisting of 100 shares trading at £2 per share. The company has also issued a convertible bond giving the holders the right to convert for £2.50 per share. It issues 20 new shares for £1.60 each and receives £32 for them. The new conversion price will be 2.50x((100+16)/(100+20))=£2.42.

issuance of other classes of shares having a preference upon redemption, liquidation or dissolution are also detrimental for convertible bondholders. In fact, the position of the common stock in respect of which the privilege was granted, may become far less valuable than was the case when the privilege holder purchased his warrant or his convertible obligation.[451]

In start-up business, though not exclusively, the investor usually makes their investment by way of instalments conditional on the achievement of certain firm's objectives that, if achieved, will open the way to another tranche of investor's finance. However, if, for example, because of economic downturn periods, the milestones for the subsequent instalments are not achieved, the investor may have an option to subscribe to the next tranche at a discounted price to the first. This stage of financing is known as the "down round", a round of investing when fortunes for the start-up have declined. The rationale underlying a down round is to provide the company with necessary cash to survive the current difficult economic times long enough to achieve additional business milestones, in order to increase its potential value either for the next round of financing or an ultimate liquidity event.[452]

The clear painful consequence of a down round is the dilution experienced by existing and future shareholders including any holder of convertible securities. In order to protect the convertible bondholders, a number of anti-dilution clauses may be incorporated into the terms and conditions of the convertible security depending on the particular circumstances of the issue. The anti-dilution provision is triggered each and every time the company decides to raise new funds from its investors, offering securities at a price below that previously paid by the company's investors. However, not all issuances of new shares are a cause of value dilution. For instance, when a new investor subscribes at a price equal to, or more than, the price paid by the existing investor, the anti-dilution provision will not operate, as the existing investor is happy to accept dilution on this basis. This stage of capital financing is known as the "up round".

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[451] However, see Ratner D.L., 'Dilution and Anti-Dilution: A Reply to Professor Kaplan', 33 *Univ. Of Chicago L. Rev.*, 1966, 494 who argues persuasively that there is no dilution effect when the new issuance is at or above market price but below the conversion price. See also Glover S.I., Solving Dilution Problems, 51 *Bus. Law.,* 1996, 1281.

[452] Birdthistle W.A. and Henderson M.T., 'One Hat Too Many? Investment Desegregation in Private Equity', *The University of Chicago Law Review*, 2009, 56 ff.

Furthermore, the parties will typically accept that certain issues or grants of new securities should not trigger the anti-dilution provision and these will be expressly excluded from the definition of new securities. These grants and issues will usually include, for instance, the grant of options under an employee share scheme, an executive management incentive scheme or other incentive scheme that has been approved by the investor, or the issue of shares to satisfy the exercise of such options. Venture capital investors acknowledge that some form of option pool is necessary to give management and employees incentives, and usually agree a maximum number of shares for allocation under such schemes. In any event, the existing investor will already have accounted for dilution arising from the exercise of such options by agreeing the share capitalisation of the company following the investment and will therefore agree that options or shares issued in these circumstances will not trigger the anti-dilution provision. In addition, there may be other cases not contemplated by the investment documents where the existing investor is ready to accept dilution as the lesser of two evils when, for instance, the company is in financial distress and the only alternative is liquidation. In such a situation, the articles of association should expressly exclude such issues from the definition of new securities or provide that, where the existing investor agrees, the firm can issue new securities at less than the subscription price paid by the protected investor without triggering the anti-dilution provisions. Eventually, it has become increasingly common for the anti-dilution provision to compensate the protected investor for the dilution suffered by the issue of new securities in a down round by issuing additional bonus shares. If the existing investor has paid a premium for their shares, the issue of the anti-dilution bonus shares fully paid up to nominal value will itself trigger the anti-dilution provisions. This would not be reasonable and such issues should be expressly excluded from the definition of new securities. Shares issued in connection with lease finance arrangements, banking facilities and other financing up to an agreed amount may also be excluded from the definition of new securities.[453]

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[453] See British Venture Capital Association (BVCA) drafting notes of articles of association at http://admin.bvca.co.uk/library/documents/Articles_of_Association_-_Drafting_Notes.pdf

6.2.2.1. Price-based methods of anti-dilution

There are two methods commonly used for providing the existing investor with anti-dilution protection: the issue of additional shares and the adjustment of the conversion rate. The method of compensating an investor for the dilutive effect of a down round is for the company to issue additional shares to the existing investor. The company can compensate the investor by way of a bonus issue of shares if it fulfils all the requirements set out in the Companies Act 2006.[454] A bonus issue to holders of convertible securities does not differ from a bonus issue to all the existing shareholders. In order for a company to make a bonus issue to holders of convertible securities, it must have authority to make such an issue under its articles of association: usually this will be expressly provided for in the articles adopted when the existing investor invests. Depending upon the charter of the company, only certain classes of shares may be entitled to bonus issues, or may be entitled to bonus issues in preference to other classes. Bonus issues made under the anti-dilution provisions are usually expressly excluded from any pre-emptive offers that have to be made to shareholders.[455] In addition, the Company Act 2006 expressly empowers the directors of a company, if authorised by an ordinary resolution, to capitalise certain profits or reserves in paying up in full un-issued shares in the company.[456] Since there is now no "authorised capital" limit, a company's changes to issued capital must be notified to the Registrar at Companies House each time a new allotment is made.[457]

Critically, the company must have sufficient distributable profits, non-distributable reserves or other reserves such as a share premium account or capital redemption reserve at the relevant time to capitalise and apply for paying up the additional shares in full. The anti-dilution provision should normally state that if the company is unable to make a bonus issue, then the protected investor could subscribe to the additional shares at nominal value. The protected investor, therefore, will need

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[454] Let us assume that a convertible bond gives the bondholders the right to convert one bond into one share of the company. If the company decides to carry out a stock split and allocate three new shares for each old share, then the anti-dilution provision will provide the bondholder converting its securities with one share plus two additional new shares to compensate its dilution.

[455] s. 570 of the CA 2006.

[456] s. 551 of the CA 2006.

[457] s. 555 of the CA 2006.

to ensure that the nominal value of any additional shares is low enough that they do not have to pay a significant amount to exercise their rights. The additional shares can be preferred shares or ordinary shares.[458]

The second method of compensating an investor for the dilutive effect is the conversion rate method, which involves the mechanism used to calculate the number of ordinary shares into which the convertible securities convert. This amount is usually calculated by multiplying the number of convertible bonds held by the investor by the applicable conversion rate. The conversion rate will start at an initial rate of one for one and every time a down round occurs triggering the anti-dilution protection, the conversion rate is adjusted to more than one for one to account for the dilutive effect of the down round.[459] Regardless of whether the conversion rate or the additional share method is used, the anti-dilution provision often provides for adjustments to be made to the share capital following a down round, which, in the absence of manifest error, are normally then binding on all shareholders. This avoids any disagreement as to what the adjustment under the anti-dilution provision should be.[460]

6.2.2.2. Full ratchet and weighted average ratchet anti-dilution provisions

While the founders and management of a start-up firm usually accept that anti-dilution protection is unavoidable in order to raise further finance for the company, there is usually some debate as to the level of protection afforded to the protected investor. The most draconian adjustment is for the protected investor to receive full anti-dilution protection if there is an issue of new securities at less than the price paid by such investor. A full ratchet adjustment will compensate the protected investor

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[458] The “bonus issue” is the most common anti-dilution mechanic in the UK. A set out standards of it can be found in the BVCA Model Documents at http://www.bvca.co.uk/PEVCExplained/StandardIndustryDocuments (accessed January 2011).

[459] Let us assume that a convertible bond gives the bondholders the right to convert into shares at a conversion rate of one to one and each share has a nominal value of £15. If the company decides to carry out a stock split replacing each share of £15 with five new shares of £3, the terms of the anti-dilution provision will normally provide to adjust the conversion rate consequently into five shares to one bond. See other examples in Broadwin D.A., ‘An Introduction to Anti-dilution Provisions (Part 1)’, *Prac. Law.*, June 2004, 29.

[460] Bratton W.W., ‘The Economics and Jurisprudence of Convertible Bonds’, 1984 *Wis. L. Rev.*, 681-689, in particular at 687; See some US cases: Bratton W., *Corporate Finance, Cases and Materials* (5th ed., New York, 2003) 421-437; Kaplan S.N., ‘Piercing the Corporate Boilerplate: Anti-Dilution Clauses in Convertible Securities’, 33 *Univ. of Chicago L. Rev.*, 1965, 18; Kaplan S.N., ‘Some Further Comments on Anti-Dilution Clauses’, 23 *Bus. Law.*, 1968, 893; Ratner D.L., ‘Dilution and Anti-Dilution: A Reply to Professor Kaplan’, 33 *Univ. Of Chicago L. Rev.*, 1966, 494, 496-497.

reducing the conversion price to the exact price per share paid in the dilutive issuance, in effect allowing the holder of the convertible security to receive stock at that lower price.[461]

Theoretically, this approach fully protects the investor against economic dilution from the initial investment; after the adjustment, the securities receivable upon conversion will have the same aggregate value as the initial investment. Some scholars view full ratchet anti-dilution protection as unfair because of, among other things, the potential for substantial dilution to common shareholders, regardless of the size of the dilutive issuance.[462] Therefore, this approach is used almost exclusively in venture capital deals, where the common stockholders tend to be founders and managers. Because the parties in these transactions agree on a price based on numerous assumptions, significant valuation gaps can exist. Venture capitalists argue that if a subsequent round of financing is raised at a lower valuation, the assumptions underlying the original valuation were by definition incorrect and the investor should be fully protected. Not surprisingly, entrepreneurs often feel that, because a decrease in valuation may be caused by many factors, for example, a fall in the general market, the impact of a drop in valuation should be shared and therefore a different method of adjustment is more appropriate. Not surprisingly, even in venture transactions, use of full ratchet anti-dilution protection is rare. This type of protection is used most often in riskier transactions or in periods of economic turmoil.[463]

The amount of equity issued in the down round as anti-dilution provision should be considered in the context of the company's overall share structure. This is achieved by averaging the price across the different rounds of financing, taking into account the issued (and sometimes to be issued) share capital of the company. As the weighted average ratchet method looks at the actual effect of the issue of new

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[461] See Katzin J.S., 'Financial and Legal Problems in the use of Convertible Securities', *Business Lawyer*, January 1969, 365; Kaplan S.N., 1965, note above, 7.

[462] Woronoff M.A. and J.A. Rosen, 'Understanding Anti-Dilution Provisions in Convertible Securities', *Fordham Law Review*, 2005, 118-119; Broadwin D.A., 'An Introduction to Anti-dilution Provisions (Part 1)', *Prac. Law.*, June 2004, 36: "[A] full ratchet provision can have a draconian effect on the common stock. This effect is exacerbated by the fact that the full ratchet provision does not take into account the number of shares issued at the low price."

[463] *See* Broadwin D.A., 'An Introduction to Anti-dilution Provisions (Part 1)', *Prac. Law.*, June 2004, 34; Woronoff M.A. and J.A. Rosen, 'Understanding Anti-Dilution Provisions in Convertible Securities', *Fordham Law Review*, 2005, 117-119.

securities across the company's share capital, it is much more equitable to the non-investor shareholders compared to the full ratchet. For example, under the full ratchet method, if only one down round share is issued, the protected investor would still get an adjustment in respect of all their shares, resulting in the non-investor shareholders being severely affected. Weighted average ratchet can be "broad based", meaning that they look at the dilutive effect of the issue of new securities on all the company's share capital plus all securities that would be issued on the exercise of all outstanding options, warrants and other convertible securities. On the other hand, a "narrow-based" ratchet only looks at the effect of the down round issue on the issued share capital of the company. Therefore, with a narrow-based ratchet, the protected investor will receive a greater adjustment than is the case with a broad-based ratchet.[464]

When calculating the protected investor's position after the operation of an anti-dilution provision, both the method and the type of protection must be considered. Different formulae have been devised to calculate the full ratchet and weighted average ratchet (both broad and narrow) anti-dilution protection using both the bonus issue method and the conversion rate method with different results for every formula. There are advantages and disadvantages to both the (bonus issue and conversion rate) methods. With the bonus issue method, the benefit to the protected investor can be seen immediately. The additional shares are issued at the time of the down round, meaning the protected investor knows exactly how many shares they have got and the capitalisation of the company is clear. With the conversion rate method, the shareholders will not be able to see the effects of the anti-dilution provisions until the preferred shares are converted into ordinary shares. From the investor's perspective, where the conversion rate method is used, the rights of the convertible securities should be expressed to be "on an as converted basis", that is, as the convertible securities at the applicable conversion rate at the relevant time. So on a poll vote "on an as converted basis", on a return of capital, winding up or liquidation, the remaining assets of the company would be distributed to the

[464] Broadwin D.A., 'An Introduction to Anti-dilution Provisions (Part 1)', *Prac. Law.*, June 2004, 35; Woronoff and Rosen, 2005, note above, 119-121.

convertible security-holders "on an as converted basis"; dividends, if declared, would be allocated to the shareholders "on as converted basis".[465]

However, the transparency of the bonus issue method is also its downfall. As the additional shares are issued simultaneously with the down round, the entrepreneur/shareholder can immediately see the dilutive effect of the shares being subscribed to by the new investors in the down round, together with the additional shares issued to compensate the protected investor, which does little for motivation levels. Under the conversion rate method, the protected investor does not get their additional shares until conversion into ordinary shares, so the immediate effects of the dilution caused by the operation of the anti-dilution provisions are not so obvious (although if the rights are adjusted "on an as converted basis", then the impact is the same). If the company has entered into a series of down rounds, it may be difficult to keep track of the exact adjustments to be made under the conversion rate method. With the bonus issue method, shares are issued simultaneously with the down round.

The grant of any options falling within the definition of new securities exercisable at a down round price will trigger an adjustment under the anti-dilution provision. However, if the options are never exercised and lapse, the non-protected shareholders will argue that a readjustment needs to be made to ensure that the protected investor is in the same economic position he would have been in had the options never been granted. If the conversion rate method is used, then this is easily remedied, as the option grant can be ignored when calculating the rate for the conversion of the protected investor's shares into ordinary shares. However, making such a readjustment is difficult where the bonus issue method has been used as shares have already been issued to compensate the protected investor. One solution to this problem may be to convert some of the additional shares into economically valueless deferred shares on the lapse of such options. This would add to the complexity of drafting and require the rights attaching to such deferred shares to be included in the articles of association.

For this reason, it is also quite common to use a market-price formula, which is designed to protect the holder of a convertible security against economic dilution from current share market value. Therefore, the market-price formula provides for

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[465] Katzin J.S., 'Financial and Legal Problems in the use of Convertible Securities', *Business Lawyer*, January 1969, 366.

adjustments when additional shares of common stock are sold at a price below their current market value. This formula assumes there is no harm to holders of convertible securities when additional shares of common stock are issued at or above the prevailing market price, even if below the conversion price. This is based upon a presumption that the original conversion price was set by fully informed parties. This presumption is most likely to be true in the public company context, and as would therefore be expected, the market-price formula is found almost exclusively in anti-dilution provisions of convertible securities issued by public companies.[466]

Smaller public companies with less liquid trading markets for their common stock raise different issues. Their trading market is less liquid and more volatile. In addition, information barriers are more likely to exist, increasing the probability of a disparity between the initial conversion price and the fair market value on the date the convertible security is issued. Therefore, holders of convertible securities in small public companies often treat these issuers like private companies and seek price protection through a conversion-price formula.[467]

Although there may be some anti-dilution provisions included by the parties in their contracts, it is arguable whether convertible bondholders always need that protection. Ideally, a proper formula should discriminate between subsequent sales that truly dilute the convertible securities and those that merely reflect market information about the issuer. So, sales at or above market price should never trigger adjustments even if they fall below the original conversion price. This is the reason why large publicly traded companies often avoid any anti-dilution provision in their convertible issues. If the market fully values their securities, including the risk of dilutive events, sub-market-value issuance is very rare, and investors can rely on hedging techniques to limit the risks.[468]

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[466] Ratner D.L., 'Dilution and Anti-Dilution: A Reply to Professor Kaplan', 33 *Univ. Of Chicago L. Rev.*, 1966, 498-499.

[467] Broadwin D.A., 'An Introduction to Anti-dilution Provisions (Part 1)', *Prac. Law.*, June 2004, 27.

[468] Woronoff M.A. and J.A. Rosen, 'Understanding Anti-Dilution Provisions in Convertible Securities', *Fordham Law Review*, 2005, 123 ff.

6.3. The majority-minority conflict in venture capital financing: the investor's claim dilution

The reduction in the current price of a stock due to the increase in the number of shares is not the only dilution suffered by a non-subscriber member. An issuance of new shares decided by the majority shareholders may result in the shifting of fundamental positions of the stock, like ownership percentage and voting control, other than earnings per share and the value of individual shares. Therefore, the dilution can be costly for two reasons: the economic loss of value of the investment and the dilution of the investor's ownership interest and control rights in the company. This is exactly the case in a down round financing in venture capital recapitalisations. A down round is a stage of financing when fortunes for the start-up have declined because of economic downturn periods or because the milestones for the subsequent instalments are not achieved.[469]

A new start-up business normally requires a large amount of funds to grow and expand. During the company's life, more than one investment fund or financier will probably contribute finance to the business because when new finance is needed, investors who purchased securities in earlier stages of financing may be more limited in their ability to support the company or may prefer to wait for an acceptable exit event.[470] The staging of investments in private equity and venture capital financing ensures that a company's investors will hold different amounts of the company's capital, issued at different prices at each stage of financing and with different cash-flow and liquidation rights. These differences may encourage the venture capital investors to develop conflicting interests concerning the price at which they should sell their participation through a company exit event, or the price at which the company should issue new securities in the future.[471]

Although shareholders as a category risk dilution from new equity, minority shareholders including preference shareholders, who are holders of non-voting

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[469] Birdthistle W.A. and Henderson M.T., One Hat Too Many? Investment Desegregation in Private Equity, *The University of Chicago Law Review*, 2009, 56 ff.

[470] Fried J.M. and Ganor M., 'Agency Costs of Venture Capitalist Control in Startups', 81 *New York University L. Rev.*, 2006, 993 ff.

[471] Bartlett R.P., 'The Agency Costs of Venture Capital', 54 *UCLA L. Rev.*, 2006, 64 ff.; Bartlett R.P., 'Understanding Price-Based Antidilution Protection: Five Principles to Apply When Negotiating a Down-Round Financing', 59 *Bus. Law.*, 2003, 23 and 24-25; Woronoff M.A. and J.A. Rosen, 'Understanding Anti-Dilution Provisions in Convertible Securities', *Fordham Law Review*, 2005, 112 ff.

shares, face the largest risk, because they are typically not protected by shareholder decision rights. While the law facilitates creditor self-help in contracting for special anti-dilution provisions, it protects minority shareholders with specific norms, rules and standards.[472]

6.3.1. Existing legal remedies in the UK and US

Since 1980, UK legislation implementing the Second EC Directive has provided a statutory pre-emption right.[473] According to this, the new issues of "equity securities"[474] must be offered first to ordinary shareholders on a pre-emptive basis excluding the company itself as holder of treasury shares. However, while pre-emptive rights are a default option for public companies in all European jurisdictions, the UK grants them as the statutory default for closely-held companies. If shareholders are to receive pre-emptive rights, a company's articles of incorporation must provide for them. In addition, where the issuer is a company registered in England and Wales, ss. 549-551 of the Company Act 2006[475] limits this possibility of abuse by providing as a general rule that it is a criminal offence for directors knowingly involved[476] to allot shares or grant options to subscribe to shares or issue securities convertible into shares ("relevant securities") without the authority of the members given either in the articles or by ordinary resolution.[477]

Unfortunately, this set of rules, norms and standards does not apply to preference shareholders but only to the ordinary shareholders, namely shareholders other than shareholders that with respect to dividends and capital carry a right to

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[472] Davies P.L., *Gower and Davies' Principles of Modern Company Law* (Sweet and Maxwell, 8th ed. 2009) 837 ff.

[473] The relevant provisions are in CA 2006 ss. 560-577 introduced by the Company Act 1985 implementing the Council Directive 77/91/EEC (Art. 29). See in the Stock Exchange: *Listing Rules*, Ch. 13, para. 13.8. For an overview of the operation of pre-emption rights in France, Germany, Italy, the Netherlands and Spain, see Myners P., *The Impact of Shareholders' Pre-Emption Rights on a Public Company's Ability to Raise New Capital* (London, DTI, 2004), annex B.

[474] The definition of "equity securities" includes securities that have the right to subscribe for or convert into a company's ordinary shares. See, s. 560 CA 2006.

[475] Previously s. 80 of the 1985 Act to which the 1989 Act added s. 80A.

[476] s. 549(3) and 549(4) CA 2006. However, such failure does not affect the validity of the allotment. See s. 549(6).

[477] This may help to explain in part why the "shareholder rights plan" or "poison pill" against takeovers is rare in the UK, for the effectiveness of the plan depends heavily upon the directors being able to adopt it without shareholder approval.

participate only to a specified extent in a distribution.[478] Therefore, preferred stockholders will have to bargain with the company, where possible, for their protection. The decision of the law not to intervene on behalf of the preference shareholders has to be counterbalanced with the cost of having pre-emptive rights as a device for protection.[479] Pre-emptive rights can hinder a company's capacity to raise new funds, by forcing companies to solicit their own shareholders before turning to the market and limiting the directors' ability to issue blocks of shares with significant voting power. These constraints may also explain why public companies in the US have practically abandoned pre-emptive rights,[480] while they seem more popular in closely-held corporations.[481] For the same reasons, rights issues came to the foreground of policy concern in Europe in mid 2008 because of severe difficulties encountered by several banks that found themselves under credit-crunch-engendered pressure to shore up their balance sheets by raising new equity.[482]

Another remedy available in the UK for the minorities' protection is provided by s. 994 of the CA 2006 that allows minority shareholders, including preferred shareholders, to file a petition alleging that their minority shareholding has been "unfairly prejudiced" by the behaviour of the majority and seeking a right to be bought out at a fair price.[483] The courts will focus on the 'conduct of the company' and on the 'unfairness of the prejudice complained' and will apply an objective test in order to filter the suitable cases for resolution by way of an unfair prejudice petition. Accordingly, they will consider whether the conduct of the company, in its broader connotation, namely any action taken by, or on behalf of the company, by

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[478] s. 560(1) CA 2006.

[479] See, recently Ferran E., *Company Law and Corporate finance* (Oxford University Press, 2008) 525-528; DTI, *Pre-emption Rights: Final Report*, February 2005 (URN 05/679).

[480] In US jurisdictions, the statutory default is a rule of no pre-emptive rights for public as well as close companies.

[481] See Clark R.C., *Corporate Law* (Boston: Little, Brown & Co., 1986) 719; Hamilton R., *The Law of Corporations in the Nutshell* (West. 5th ed., 2000) 196.

[482] Under the *London Stock Exchange's Admission and Disclosure Standards* the minimum period for which an open offer has to remain open is 15 days (Para 3.9.), compared to the minimum of 21 days that is stipulated in the Companies Act 2006, while the FSA recently reduced the minimum rights issue offer period under the *Listing Rules* from 21 days to 10 business days (LR 9.5.6). The recent EC Directive 2007/36/EC of the European Parliament and the Council of 11 July 2007, [2007] OJ L184/17 has recently settled on 14 days as the minimum period for the exercise of certain rights of shareholders in listed companies.

[483] See s. 994 CA 2006 (re-enacting s.459 of the CA 1985).

any company's organs, but not only[484], is prejudicial to the interests of the members of the company. The unfair prejudice remedy addresses corporate conduct that affects the interests of a person only as a member and in a commercial sense, not the personal interests of the member. However, a member interests extends beyond their formal legal rights to all its 'legitimate expectations'.[485]

Only once the court has established that the conduct complained of is prejudicial to the interests of the members, it will consider whether the prejudice complained of is unfair. Traditionally, the courts have not interfered with how directors manage their corporate business affairs. Therefore, they will not intervene in any technical or trivial breach of fiduciary duty by the directors. Such conduct must be shown to be unfair for a petition to succeed. The definition of what constitutes an "unfairly prejudicial" conduct has been explored and redefined in case law.[486]

If the court accepts that the petitioner's interests have been unfairly prejudiced by the conduct of the company's affairs, the court has a wide discretion to order a variety of reliefs. The most common remedy is the buy-out of the minority shareholder's shares by the other "unfair" members of the company or by the company itself, at a fair price.[487] Accordingly, the court will ask for expert valuation evidence in order to determine a "fair price" for the shares, unless the parties can

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[484] Re Phoneer Ltd [2002] 2 BCLC 241; Re Citybranch Group Ltd v Rackind [2004] 4 All ER 735. See also Nicholas v Soundcraft Electronics Ltd [1993] BCLC 360.

[485] *Re Saul D Harrison & Sons Ltd* [1995] 1 BCLC 14. For a discussion see Kershaw D., Company Law in Context: Text and Materials (OUP 2009), 625-630.

[486] For example, *O'Neill-v-Phillips* [1999] 1WLR 1092; *O'Neill v Phillips* [1992] 2 All ER 961; *Re Marchday Group* [1998] BCC 800; *Re BSB Holdings Limited (No: 2)* [1996] 1 BCLC 155; *Re Saul D Harrison & Sons plc* [1995] 1 BCLC 14. Similarly, *Hawks-v-Cuddy* [2007] EWHC 2999 & [2009] EWCA Civ 291; *Re a Company* (No: 00709 of 1992) [1997] 2 BCLC 739; *Re Alchemea Ltd* [1998] BCC 964. Furthermore, where a member's participation was diluted by a proposed or actual decision of the company to allot further shares to other parties only to reduce the member's influence in the company. For selective or otherwise improper share issues, see *In the matter of Sunrise Radio Ltd* [2009] EWHC 2893; *In the matter of Gate of India (Tynemouth) Ltd* [2008] EWHC 959; *Re a Company* (No: 0026712 of 1984) [1985] BCLC 80; *Re a Company* (No: 007623 of 1984) [1986] 2 BCC 99,191. For unfair calls on shares, see *Re a Company* (No: 008126 of 1989) [1992] BCC 542; *Re D.R. Chemicals Ltd* [1989] 5 BCC 39; *Randall-v-S & F (Quarries) Ltd* (unreported) 12 October 1994; *Re Regional Airports Ltd* [1999] 2 BCLC 30; *Dalby-v-Bodilly* [2004] EWCA 307. Finally, any corporate action or decision that damages the different classes of shareholders and involves breaches of duty by directors, see *Re BSB Holdings Ltd (No: 2)* [1996] 1 BCLC 155. See also *Re Sunrise Radio Ltd; Kohli v Lit and others* - [2010] 1 BCLC 367 [2010] 1 BCLC 367.

[487] *Sudhir Sethi-v-(1) Patel & (2) Scitec Group Ltd* [2010] EWHC 1830; *Re Nuneaton Borough AFC Ltd (No: 2)* [1991] BCC 44; *Re Nuneaton Borough AFC Ltd* [1989] 5 BCC 792; *Re D. R. Chemicals Ltd* [1989] 5 BCC 39.

agree the price to be paid. The courts will examine the level of involvement of the petitioner in the company's business at the time the petition was presented and, if of minor importance, will discount the value of the shares to reflect the minority status of the petitioner.[488] Despite its efficacy, the unfair prejudice remedy produces cases often lengthy and fact-intensive while time is crucial for a start-up business in high-technology sector.[489]

6.3.2. Loan covenants, veto rights and pay-to-play clauses

When a company is in financial distress and the existing investor does not have the capacity or the willingness to support further stages of financing, two sorts of problems may concretise. The existing investors, who are unable to subscribe a new round of financing, could suffer from an "expropriation" of value if another investor shows up and contributes new finance. Prior venture capital funds sometimes cannot even recover the amount initially invested, to the advantage of a new venture capital investor. At the same time, investors, who are willing to risk additional capital, expect their co-investors to share the risk. A troublesome issue in the anti-dilution area is the "free rider" problem, occurring when a start-up firm, facing a down round, obtains the support of only some of the existing venture capital investors, while the others enjoy the benefits of that support because of the automatic operation of the anti-dilution provisions, without putting up any additional capital. Neither a price-based anti-dilution provision nor existing mandatory legal strategies are sometimes enough to protect the entrepreneur and the investors from possible opportunistic behaviours such as free riding and expropriation of value respectively. These kinds of abuses are better dealt with the contractual bargain of the parties involved.

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[488] *Re Sunrise Radio Ltd* [2010] IBCLC 367; *Fowler v Gruber* [2010] IBCLC 563; *Re McCarthy Surfacing Ltd* [2008] EWHC 2279; *Re Campbell Irvine (Holdings) Ltd (No:2)* [2006] EWHC 583; *Strahan-v-Wilcock* [2006] EWCA Civ 13; *Phoenix Office Supplies Ltd-v-Larvin* [2002] EWCA Civ 1740; *Re Jayflex Construction Ltd* [2003] EWHC 2008; *CVC Opportunity Equity Partners Ltd-v-Demarco Almeida* [2002] 2 BCLC 108; *Re Planet Organic Ltd* [2000] 1 BCLC 366; *Re Elgindata Ltd* [1991] BCLC 959; *Howie-v-Crawford* [1990] BCC 330.

[489] See *Re Unisoft Ltd (No 2)* [1994] BCC 766 where the judge noted that 994 petitions 'have become notorious to the judges of this court for their length, their unpredictability of management and for the enormous and appalling costs …'.

It is almost common practice for the investor in venture capital financing to obtain special covenants to protect its investment against claim dilution. These covenants vary in their intensity ranging from provisions that regulate the incurrence of new debt, allowing it when justified by the firm's financial condition to severe control rights that in certain particular circumstances assign to the investor a real right to veto a firm's decision such as a debt restructuring. Standard covenants dealing with claim dilution may achieve their finality obliging, for example, a company to seek new equity capital for new ventures that the firm wants to pursue.[490] In fact, if the venture were to be financed by additional borrowed funds with preferential rights or priority in liquidation, this would dilute the value of each prior investor's claim in the event of failure putting the company's solvency at risk, but investors would not reap the benefits of success since they do not share in capital growth.[491] In addition, an over-reliance on debt can result in companies rejecting potentially profitable opportunities because substantial benefits from those opportunities will accrue to lenders rather than to shareholders. In this way, covenants restricting borrowing may reduce the incentive to over-invest or shift risk.[492]

Conversely, control rights such as appraisal rights or veto rights give the investor a right to veto a particular company's decisions that may jeopardise their claim regardless of the level of control they possess as a result of their equity holdings. These veto rights provide a way to restore their bargaining power.[493] The British reluctance to adopt these *techniques* on a widespread basis contrasts with the laws in the US, where it is currently common to provide appraisal rights "in

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[490] These restrictions are normally expressed in fixed debt-equity ratio, net worth minimum, current ratio, working capital minimum and a ratio of interest:dividend payable to net profit, which means a restriction on making payments of dividends on shares and/or payments of interest and repayments of principal on the junior debt. See Nash R., J. Netter and A. Poulsen, 'Determinants of Contractual Relations between Shareholders and Bondholders: Investment Opportunities and Restrictive Covenants, 9 *J. Corp. Fin.*, 2003, 201 and 215; Bratton W.W., 'Bond Covenants and Creditor Protection: Economics and Law, Theory and Practice, Substance and Process', 7 *EBOR*, 2006, 39.

[491] Fischel D.R., 'The Economics of Lender Liability', 99 *Yale Law Journal*, 1989, 131.

[492] Myers S.C. , 'Determinants of Corporate Borrowing', 5 *Journal of Financial Economics*, 1977, 147; Sappideen R., 'Fiduciary Obligations to Corporate Creditors', *JBL*, 1991, 365; Smith C.W. and J.B. Warner, 'On Financial Contracting: An Analysis of Bond Covenants', 7 *Journal of Financial Economics*, 1979, 117 and 124.

[493] Bratton W., 'Venture Capital on the Downside: Preferred Stock and Corporate Control', 100 *Mich. L. Rev.,* 2002, 895; Bartlett R.P., 'The Agency Costs of Venture Capital', 54 *UCLA L. Rev.,* 2006, 74 and 75.

connection with mergers, sales and exchanges of substantially all assets of the corporation, and charter amendments that materially and adversely affect the right of the dissenting shareholder".[494] However for public companies in the UK, just as the City Code on Takeovers and Mergers provides affiliation rights for shareholders as a class, it also provides an exit right for minority shareholders through its mandatory bid rule.[495]

The appraisal rights or veto rights, however, do not come without disadvantages. An analysis of the practical problems with preference shares with veto rights shows that they cause a misalignment of the interests and objectives of different classes of shareholders or investors in a variety of situations and this can block the company's ability to act in its own best interest.[496] The venture capital fund holding control rights may have economic interests that differ from other investors owing to the capital-time investment constraint and investment return incentives. Consequently, the possibility exists that these veto rights may be used in a manner that adversely affects the wealth of a particular group of investors in much the same way that a manager may use his or her discretionary decision-making power to adversely affect the wealth of all stockholders. It goes without saying that it poses a constraint to the company's capacity to raise new funds. If the initial investor can veto any attempt to restructure with the justification of this being against their interests, or impose stricter conditions for potentially interested investors, it is likely that the management's negotiation for attracting new investors will be a harder task.[497]

However, in the US where the investors only rely on *ex post* legal remedies for protection, the Courts seem to avail the company's interests above everything at the expense of the single investor.[498] Therefore, investors have a strong incentive in contracting for their rights and expectations with particular care. Especially in

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[494] Clark R.C., *Corporate Law* (Boston: Little, Brown & Co., 1986) 443.

[495] City Code, rule 9 that requires a person who has acquired control over 30 per cent or more of the voting shares in a company to offer to buy out the remaining shareholders at the highest price paid for the shares in the controlling block.

[496] Bartlett R.P., 'The Agency Costs of Venture Capital', 54 *UCLA L. Rev.,* 2006, 78.

[497] Maynard O. and W. Bains, 'Shares and Entrepreneurship in Biotechnology', 8 *JCLS*, 2008, part I, 8-9; Fried J.M. and Ganor M., 'Agency Costs of Venture Capitalist Control in Startups', 81 *New York University L. Rev.*, 2006, 1003.

[498] *Re: Benchmark Capital Partners IV, L.P. v. Vague, et al.,* CA. No. Civ.A. 19719 (Del. Ch. July 15, 2002).

distressed situations, the technicality in the contract can be decisive for the efficacy of the provision. Veto rights, as well as any other preferential right and limits of preferred stock, have to be "expressly and clearly stated" and will not be "presumed or implied".[499] The parties who negotiate the charter are presumed to have full knowledge of the law and to recognise that all preferred shareholder rights must be set forth explicitly.[500]

In order to avoid the "free rider" problem and encourage existing investors to support a company, especially in down rounds, legal practitioners have designed the so-called "pay-to-play" provisions. These clauses require the investors of a company in financial distress to make an additional investment in the company or suffer the consequences of a dilution of their rights. In particular, if a protected investor does not take up a pre-defined percentage of their entitlement to the new securities under the pre-emption provisions (a non-participating investor), they lose some or all of their anti-dilution protections.[501]

The provision can take a variety of forms. Typically, the existing preference shares or convertible securities of the investors failing to participate in a dilutive financing are converted into a new series of preference shares, often referred to as the "shadow series". The shadow series is usually identical to the existing series of preference shares in terms of the preferential rights to income, capital and dividends, except it may have no pre-emption rights (pay to play class). The adverse consequences of non-participation may include the loss of the liquidation preference or voting rights held by the non-participating preferred stockholders, less anti-dilution protection such as weighted average-price instead of full ratchet protection. In more extreme cases, the non-player's existing securities are converted into common shares and they lose the company board seats associated with the earlier round preferred stock, or some combination of the foregoing advantages.[502]

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[499] See the Delaware Supreme Court's decision in *Elliot Associates L.P. v. Avatex Corp*. 715 A.2d 843 (Del. 1998), see also *Telecom-SNI Investors,* L.L.C. *v. Sorrento Networks, Inc.,* No. Civ.A. 19038-NC, 2001 WL 1117505 (Del. Ch. Sept. 7, 2001).

[500] Since in the Elliot case, the parties failed to provide for the possibility of a merger in the language of the original charter, the court applied the typical rules for a merger authorisation vote: a merger was authorised by a simple majority vote of all outstanding classes of stock.

[501] Bartlett R.P., 'The Agency Costs of Venture Capital', 54 *UCLA L. Rev.,* 2006, 57; Maynard O. and W. Bains, 'Shares and Entrepreneurship in Biotechnology', 8 *JCLS*, 2008, part I, 8-9.

[502] Bartlett J.W., *Equity Finance: Venture Capital, Buyouts, Restructurings and Reorganizations*, (Aspen Publishers, 1995) 209; Gompers P.A. and Lerner J., *The Venture Capital Cycle* (Cambridge,

The justification for pay-to-play provisions is that when the company is in financial distress such provisions are necessary to raise capital and, in some cases, avoid bankruptcy. If a pay-to-play provision is incorporated into the articles of association, advisers must ensure that, as regards class rights, the pay-to-play class and the original preferred shares are treated as a single class. This stops a non-participating investor, who may well be the sole shareholder of the pay-to-play class, being able to use their class rights to veto, for example, a subsequent financing of the company. Conversely, the holders of convertible obligations are in a different position because they are not stockholders and have no pre-emptive right to subscribe to new stock, although the issuance of new stock might also dilute or destroy the value of their conversion privilege.

6.4. An evaluation of the rationale and protections for hybrids

Convertible bonds and convertible preference shares are indeed an optimal tool for refinancing a firm or raising some funds for a project. The study of their peculiar features emphasises their capacity to reduce the shareholder's opportunism without depriving the investors – at least in the case of convertible bonds – of the advantage of having a contractual right against the company. As far as convertible instruments are concerned, the conflict of objectives revolves around the conversion privilege. It is common, especially in private equity and venture capital transactions where the finance is supplied through subsequent instalments conditional on the achievement of certain milestones, to have new tranches of finance offered at a discounted price to the previous rounds: the so-called down rounds. The down rounds cause dilution and give the opportunity to the new entries to capture most of the benefits at the expense of previous investors. Convertible bonds are an articulated and consolidated standardised practice to protect investors' rights from these problems: the anti-dilution clauses. However, not all the issuances of new shares are a cause of value dilution. For instance, when a new investor subscribes at a price equal to, or more

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Mass.: MIT Press, 2nd eds. 2004) 171 ff. For some judgements of the US courts see *WatchMark Corp. v. ARGO Global Capital, LLC, et. Al,* Del. Supr. 2004; *Benchmark Capital Partners IV, L.P. v. Vague,* Del. Ch. 2002. The courts upheld in their judgments the applicable "pay-to-play" provisions by focusing on procedural fairness and strict contract construction principles, rejecting equitable arguments rooted in the notion of substantive unfairness, and rejected the notion that a fiduciary duty was owed to the early round minority stockholders to not impair their rights.

than, the price paid by the existing investor, the anti-dilution provision will not operate, as the existing investor is happy to accept dilution on this basis. Similarly, a proper formula should distinguish between subsequent sales that truly dilute the convertible securities and those that merely reflect market information about the issuer. For instance, sales at or above the market price should never trigger adjustments even if they fall below the original conversion price. This is also why large publicly traded companies often avoid any anti-dilution clauses in their issues. If the risk of dilution is already discounted in the market, that sub-market-value issuance is very unlikely to happen.

Nevertheless, investors may suffer from ownership dilution that is the pro rata dilution of their voting and control powers. The UK law limits the possibility of abuse by providing as a general rule pre-emptive rights for shareholders. However, these norms and standards only refer to ordinary shareholders and do not apply for preference shareholders. Moreover, pre-emption rights are optional for private companies and can also be opted out of in public companies' charters. US and UK jurisdictions rely on a standards strategy: the duty of loyalty or the fiduciary duties in general. Therefore, a preferred shareholder may file a petition alleging that their minority shareholding has been unfairly prejudiced by the behaviour of the majority. This approach allows the courts to leave directors the discretion to manage the affairs of the company without interfering excessively. This *ex post* legal strategy seems robust. However, in the case of private equity and venture capital, it may not be enough, as demonstrated by the veto rights and appraisal rights attached to preference shares in the US market. These severe control rights given to the investor can be counterbalanced by special provisions such as pay-to-play clauses that are targeted to avoid the opposite opportunistic behaviour namely the free rider problem. The equilibrium must be found by the parties in the bargain, because only the parties are able to identify their risks and contract for protection. Again, since all the preferred rights must be explicitly stated in the contracts, the parties negotiating the charter require a very careful drafting.

Chapter 7. Control Transactions

In this chapter, I discuss the legal remedies and strategies available to preference shareholders for addressing the principal-agent problems that arise when a person – the acquirer – attempts, through offers to the company's shareholders, to acquire sufficient voting shares in a company to gain control of the company. These agency issues refer to the shareholder-board conflict in companies with dispersed shareholdings and the majority-minority conflict in firm in which there is a controlling shareholder or shareholding group. The difference between control transactions and mergers and acquisitions is that while a merger involves corporate

decisions, control transactions are effected by private contract between the acquirer and the shareholders individually.[503]

The usefulness of hybrids in private equity and venture capital is most evident in control transactions, where the parties must design the firm's capital structure not only to align *ex ante* the right incentives to achieve the target, but also to resolve distributional conflicts and make use of the right to sell control in the event of a future sale of the firm. IPO and sale of the start-up firm are two of the main exit mechanisms adopted by private equity and venture capital investors. However, since this kind of businesses is developed in high uncertainty, these events may occur prematurely or in bad economic conditions, when least desired. As a result it is possible that a hostile takeover bidder will approach the firm with the sole aim of expropriating wealth from the parties involved. For this reason, it is essential that whoever has the power to sell makes the decision that is most efficient for all the parties. This is possible with hybrid instruments, because they provide an asset-specific governance system that allows an optimal allocation of control rights and financial rights in the firm. Contractual design through the use of hybrids also seems the most efficient way of protecting investors' rights in private equity financing and in start-up businesses, which have great unexploited potential and very uncertain conditions. The issues discussed in this chapter are discussed in a UK and US context, since certain particular clauses have international application.

7.1. The agency conflict in control transactions

The shareholders of the target company, both as a class and as non-controlling shareholders, mainly suffer from agency and co-ordination costs. Consequently, with respect to the acquirer, they face significant co-ordination problems, because the decision to accept or reject the bid is normally made by the shareholders individually, rather than by way of a collective decision that binds everyone. With respect to the target management, the shareholders still face agency issues, since the board's recommendation to them, for or against the offer, may not be disinterested. In particular for the preference shareholders, who are a non-voting class of

[503] Of course, the acquirer often has a free choice regarding whether to structure the bid as a contractual offer or as a merger proposal. In the UK, the rules for control shifts can be applied to acquisitions through statutory mergers on the grounds that many of the principles are applicable for both control shifts and statutory mergers.

shareholders, the overwhelming problems are related to price: a preference shareholder as well as a minority shareholder can miss the opportunity to sell shares at a high price or can be forced to sell at too low a price.[504]

The co-ordination problems of shareholders may be mitigated to some degree through the board's negotiations with the potential acquirer. The agency costs may be reduced by the mandatory bid rule introduced by the EU Takeover Directive,[505] which obliges the acquirer of shares to make a general offer to the other shareholders once it has acquired sufficient shares by private contract, whether on or off market, to obtain control of the target.[506] In fact, although the acquirer's offer may be value-increasing for the target company's shareholders as a whole, the non-controlling shareholders may not obtain their pro rata share of that value in the future. However, the mandatory bid rule, by prohibiting partial offers for the acquisition of control over the whole of the company's assets, constitutes a pre-emptive strike at majority oppression of minority shareholders.[507] By extension, the law requires comparable offers to be made for all classes of equity shares in the target, whether those classes carry voting rights or not.[508]

In closely held companies, however, the application of the mandatory bid rule is questioned as it can result in high costs for minority shareholders. It is arguable whether this rule should be applied to a transfer of a controlling position, so as to require the acquirer to make a public offer, where they would otherwise not wish to do so, and on the same terms as those accepted by the controlling seller.[509] Indeed,

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[504] For an analysis of these costs and the related legal strategies, see Davies P. and K. Hopt, 'Control Transactions' in Kraakman R. et al. (eds) *The Anatomy of Corporate Law: A Comparative and Functional Approach* (OUP 2009, 2nd ed.) 225-273.

[505] EU Takeover Directive 2004/25/EC.

[506] See art. 5 of the Takeover Directive. The Directive leaves the triggering threshold to be decided by the member states, most of which, including the UK, put the triggering percentage near 30 per cent, while Latvia, Malta and Poland put it at 50 per cent or higher.

[507] One argument in favour of the mandatory bid rule is that it may force the buyer to end up with a larger block of shares, producing a greater incentive alignment between the buyer and the remaining dispersed shareholders. This would result in a smaller extraction of private benefits. See Gromb D., M. Burkart, and F. Panunzi, 'Agency conflicts in public and negotiated transfers of corporate control', 55 *Journal of Finance,* 2000, 647-677.

[508] The City Code contains both such rules. See Rules 14 (offers where more than one class of equity share) and 36 (partial offers).

[509] The Directive leaves the member states with scope for specific exceptions. Some, but by no means all, takeover regimes have responded to these concerns, either in the formulation of the rules relating to the fixing of the price for the general offer or by extending the list of exceptions to the rule.

some privately negotiated trades may occur because the buyer expects to extract more private benefits than the seller does in spite of the fact that the firm is expected to be worth less under the control of the buyer. Such transactions would not occur under the mandatory bid rule because the dispersed shareholders would have to be paid the same as the seller, which is more than their shares were worth before the trade. However, the rule may deter value-increasing takeovers because the takeover price fails to compensate the block owner for their private benefits.[510]

Since it is very difficult to establish *ex ante* whether the minority shareholders will be disadvantaged by the sale of the controlling block, the regulatory choice hesitates between reliance on general corporate law to protect the minority against unfairness in the future and giving the minority an exit right at the time of the control shift.[511] Nevertheless, mandatory exit rights and mandatory sharing of bid premiums for minority shareholders are a strong disincentive for any controlling shareholder to sell the control stake if the private benefits of control are high. In fact, the acquirer will have to bid for the whole share capital and will generally be reluctant to offer the transferor any premium for control if he or she does not want to overpay for the share capital taken as a whole. Accordingly, some systems do allow variations between the price offered to the minority and that paid for the controlling shares, or permit partial bids in certain cases. The UK City Code is unusual in applying the mandatory bid rule to any acquisition of voting shares by a shareholder holding between 30 and 50 per cent of the voting shares.[512]

These problems are particularly enhanced in venture capital control transactions. When an outside competitor – the acquirer – who possesses both adequate capital and knowledge, appears and takes over the firm, considerable majority/minority distributional conflicts can arise, generated by the inefficient allocation of the private benefits of control in the firm.[513] Two main agency conflicts

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[510] Bebchuk L., 'Efficient and Inefficient Sales of Corporate Control', 109 *Quarterly Journal of Economics,* 1994, 957-993. See also Dyck A. and L. Zingales, 'Private benefits of control: An international comparison', 59 *Journal of Finance,* 2004, 537-599 where the Authors extricate the private benefits of control from the increase in the share value due to the change in control, in order to perform an empirical evaluation of the costs and benefits of the mandatory bid rule

[511] See Davies P. and K. Hopt, 'Control Transactions' in Kraakman R. et al. (eds) *The Anatomy of Corporate Law: A Comparative and Functional Approach* (OUP 2009, 2nd ed.) 256-263.

[512] See Commission of European Communities, *Report on the Implementation of the Directive on Takeover Bids*, SEC (2007) 268, February 2007, at 6.

[513] Berglof E., 'A control Theory of Venture Capital Finance', 10 *Journal of Law Economics and Organization*, 1994, 248.

can be identified in this case: the expropriation of managerial quasi-rents, also known as the entrepreneur's private benefits of control and asset stripping, which is a potential abuse by the controlling parties of the non-controlling parties. For instance, the acquirer may be more efficient in running the firm, but may also fire management without compensation and dilute firm value by transferring assets to themselves in connection with liquidation.[514] Furthermore, even if the parties – investor and entrepreneur - agree *ex ante* to allow for a future sale of the business, they may disagree *ex post*. Therefore, there is a trade-off between, on the one hand, the wish of the initial contracting parties to benefit from potential efficiency improvements performed by a potential future competitor who buys the firm and, on the other hand, their desire to protect themselves against dilution. These problems are related to two generic state-contingent conflicts in entrepreneurial finance: one relates to private benefits in *good* "state of nature" and the other involves the value of the firm in *bad* states.[515]

It seems that since the sale of the firm is a verifiable event, contracts could be made contingent on a sale. However, because the parties' willingness to sell may be affected by the "state of nature", that is how the company is performing and the type of buyer, just making the contract contingent on the event of a sale is not sufficient.[516] This is also why the allocation of control rights and incentives should not be separated. When private benefits are an important part of managerial compensation schemes, state-contingent conflicts may arise and this separation may not hold. In order to mitigate these conflicts the decision to trade should be given to the party most vulnerable to dilution, namely the residual claimants.[517]

7.1.1. The exit event in venture capital start-up firms

Young growth-oriented firms, particularly in high-technology industries, frequently require substantial capital to develop and deploy their ideas. Several factors limit their access to capital: uncertainty, asymmetric information, the nature of firm assets and conditions in the relevant financial and product markets. As the firm develops

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[514] Jensen M.C., 'The Takeover Controversy: Analysis and Evidence', *The Midland Corporate Finance Journal*, 1986, 12.

[515] Asset stripping is more likely when a firm's assets are worth more in alternative uses outside the firm.

[516] Aghion P. and P. Bolton, 'An "Incomplete contract" Approach to Financial Contracting', 59 *Review of Economic Studies*, 1992, 476; Berglof E., 'A control Theory of Venture Capital Finance', 10 *Journal of Law Economics and Organization*, 1994, 249.

[517] Berglof, 1994, note above, 256.

and growths over time, these factors can change in rapid and anticipated ways. Thus, the ability to change dynamically is an essential skill to remain competitive in the market, but also a major problem for those contributing the finance. Careful designing of financial contracts and firm strategies can alleviate many potential obstacles. Therefore, the manner in which firms are financed is important; each source and type of investor may be appropriate for a firm at different points in its life. But the form of financing is crucial to reducing conflicts. As long as the endeavour progresses well, entrepreneurs are well-positioned to make the decisions. Control rights remain largely vested in them and their management teams. The venture capital fund is content with a minority of the board. If during the stages of financing the entrepreneur faces situations of financial distress, they can always decide to dilute their control, letting the venture capital fund convert some of its securities to equity or to subscribe to new rounds.[518]

However, a control 'flip' should be provided as and when the company gets in trouble, meaning that the venture capital fund gains outright control of the board in such cases, leaving the entrepreneur with a great incentive to operate for the company's success. For instance, control flips can occur when certain standards are not met or because certain negative covenants in a stock purchase agreement have been violated. The optimal allocation of control between inside and outside shareholders is determined by the trade-off between protecting the private benefits of the entrepreneur and the free-riding of the venture capital fund.[519] The parties to venture capital arrangements must design the firm's capital structure to resolve distributional conflicts and make use of the right to sell control, which is itself a fundamental property right influencing compensation to the initial contracting parties in the event of a future sale of the firm.[520]

In economic terms, no problems arise if trading with the acquirer can improve the situation for both initial contracting parties or, vice versa, if both parties are made worse off by trading with the acquirer and they will not trade in that case. However, when there are constraints on the *ex post* side contracting, the acquirer may collude

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[518] Aghion P. and P. Bolton, 'An "Incomplete contract" Approach to Financial Contracting', 59 *Review of Economic Studies*, 1992, 473-494.

[519] Grossman S. and O. Hart, 'One-Share One-Vote and the Market for Corporate Control', 20 *Journal of Financial Economics*, 1988, 175-202; Zingales L., 'Insider Ownership and the Decision to go Public', (1995) 62 *Rev. Econ. Stud.*, 425-448.

[520] Alchian A. and H. Demsetz, 'Production, Information Costs and Economic Organization', 62 *American Economic Review*, 1972, 777-795.

with one of the initial contracting parties to extract surplus from the other. For example, an outside investor could take over a firm that is performing well and fire its entrepreneur if he does not have the right to sell control of the firm without compensating him for his private benefits. Alternatively, a new owner could acquire a firm which is performing badly or is insolvent for a small price and take out assets from the firm without paying their full market value, thus harming the interests of the venture capital fund if its financial rights are not protected contractually or it does not control the firm. Furthermore, in the absence of adequate investment protections when ownership and management are transferred, venture capital funds will hardly contribute new finance or at will least demand much higher shares of revenue.[521]

The solution would be to write a perfectly contingent contract. Such a contract would ensure that the proper action is taken by allocating decision-making authority to the person with the right incentives, depending on the "state of nature". The difficulties involved in writing such comprehensive contracts include the verifiability of the state of nature, which is normally only observable and not verifiable.[522] Furthermore, a company's state of nature can be extremely difficult to describe. It really is just a general sense of how the company is doing, and many variables encompass such an evaluation. As a result, the contract cannot link a specified decision-maker to the appropriate state of nature and contracting parties can only avoid costly *ex post* bargaining by allocating control over strategic decisions to one of the parties.[523]

Alternatively, the return of the parties will increase if they can make this allocation contingent on some verifiable variables correlated with the state of nature, designing the financial structure so as to extract more from a potential buyer.[524] For example, the parties could agree in advance to allocate control power to the financier or the entrepreneur depending on certain signals reflecting the company's states of

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[521] See the importance of control allocation in Berglof E., 'A control Theory of Venture Capital Finance', 10 *Journal of Law Economics and Organization*, 1994, 249.

[522] For a discussion of verifiability of state of nature by public court see Tirole J., *Hierarchies and Bureaucracies: On the Role of Collusion in Organizations,* 2 Journal of Law, Economics and Organization, 1986, at 181-214. See also Hart O., *Firms, Contracts and Financial Structures* (Oxford University Press, 1995) 38 and 73; Scott R.E. and G.G. Triantis, Anticipating Litigation in Contract Design, 115 *The Yale Law Journal*, 2006, 814-879; Scott R.E. and G.G. Triantis, 'Incomplete Contracts and the Theory of Contract Design', University of Virginia John M. Olin Program in Law and Economics, 2005, Working Paper Series n. 23.

[523] Grossman S. and O. Hart, 'The Cost and Benefits of Ownership: A Theory of Vertical and Lateral Integration', 94 *Journal of Political Economy*, 1986, 691-719.

[524] Aghion P. and P. Bolton, 'An "Incomplete contract" Approach to Financial Contracting', 59 *Review of Economic Studies*, 1992, 473-494.

nature. If the signals are correct, contingent control may be preferable to unilateral control of one of the parties.[525] As we will discuss, hybrid financial instruments as convertible non-voting securities can guarantee an efficient allocation of control rights.[526]

7.1.2. The use of convertible instruments as a device to allocate control

Different control and revenue allocations can be achieved by the parties through the use of the standard financial contracts debt and equity. Equity ensures the entrepreneur compensation for his private benefits by giving him the right to sell control and allowing the external investor to benefit as a free rider from efficiency improvements brought about by a rival management team, but only when the firm is performing well. Conversely, debt protects external investors in times of financial distress by transferring the right to sell control to them when debt repayments are not met or negative covenants are missed. The basic mechanisms for control transfer associated with equity and debt, namely takeover and insolvency, complement each other. Under the assumption of perfect markets, takeover optimises between outsiders and insiders while bankruptcy does so among shareholders and debt-holders.[527] Given that convertible preference shares or bonds can be made state-contingent, they are the most suitable to achieve the optimal allocation of control rights, and protect the initial contracting parties as much as possible against dilution.[528]

This is easy to demonstrate. When only equity capital is issued in a start-up firm, the control power is allocated independently by the state of nature. One party holds or both parties share – in case of joint ownership – control in all states of nature. In such a context, whether the entrepreneur issues voting or non-voting shares to the venture capital fund, the conflicts of interest remain. If he issues non-

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[525] Gordon Smith D., "The Exit Structure of Venture Capital", 53 *UCLA L. Rev.*, (Dec.) 2005, 322; Aghion and Bolton, 1992, note above, 486.

[526] See Kaplan S.N. and P. Strömberg, 'Financial contracting meets the real world: an empirical analysis of venture capital contracts', 70 *Review of Economic Studies*, 2003, 281 and 283 footnote 5.

[527] Davies P.L., 'Shareholder Value, Company Law and Security Markets Law: A British View', in E. Wymeersch and K. Hopt (edn), Company Law and Financial Markets (Oxford: OUP, 2002) 261-288.

[528] Berglof E., 'A control Theory of Venture Capital Finance', 10 *Journal of Law Economics and Organization*, 1994, 253. The author examines six venture capital contracts: non-voting or minority equity, equity, voting or majority equity, joint ownership, standard debt and convertible debt or a combination of debt and non-voting equity. See also Sahlman W.A., 'The Structure and Governance of Venture Capital Organizations', 27 *J. Fin. Econ.,* 1990, 473-521; Bratton W., 'Venture Capital on the Downside: Preferred Stock and Corporate Control', 100 *Mich. L. Rev.,* 2002, 891, 900-901.

voting equity, he will be compensated in case of a takeover, because he enjoys his private benefits of control as well as the venture capital fund, which will be able to enjoy the benefits of efficiency improvement, but only if the company is performing well. By contrast, in a time of the company's financial distress, the private benefits of the entrepreneur are non-existent and the venture capitalist may be subject to costs of asset stripping. The situation is even worse if the entrepreneur issues voting shares to the venture capital fund.[529] In fact, the venture capital fund, which is in control of the firm, will sell it as long as the price is higher or equivalent to what it would get in the absence of a buyer. The entrepreneur loses his job but he retains his equity holdings. Consequently, he can share in potential value-increasing actions but his private benefits of control are expropriated if the firm is performing well and, in addition, assets are siphoned off when the firm is in financial distress.[530]

In joint ownership, the venture capital fund can extract some of the value of the private benefits from the entrepreneur before consenting to a sale. However, since the entrepreneur initially has great bargaining power, the possibility to extract private benefits in case of a sale merely leads the entrepreneur to offer the venture capital fund a power share of verifiable revenues. In conclusion, not all equity financing may be optimal. A possible solution has come from strategies of governance that part of the doctrine has defined as "shared control".[531] In a shared control situation, for example, the venture capitalist owns a majority of the voting stock of the portfolio company, as long as he does not control a majority of the board of directors. Such a situation, although unusual in the market,[532] would facilitate the transfer of control among the parties in certain cases in which there is no reliable signal that could trigger the shift in control.[533]

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[529] Fried J.M. and Ganor M., 'Agency Costs of Venture Capitalist Control in Startups', 81 *New York University L. Rev.*, 2006, 994 ff.

[530] To ensure that the entrepreneur is properly compensated for his private benefits, voting equity could be combined with a payout triggered by a sale of the firm (a golden parachute). Such a clause would extract more from the buyer. However, the entrepreneur should not be compensated in bad states of nature, where he enjoys no private benefits. For this reason compensation would have to be contingent on the state of nature, which is assumed not to be verifiable. See Berglof E., 'A control Theory of Venture Capital Finance', 10 *Journal of Law Economics and Organization*, 1994, 256.

[531] The key feature of Bratton's interpretation of the model is the notion of "shared control" – an "open-ended balance of power in the boardroom [where the] venture capitalist... gets no unilateral power to control the assets and terminate the entrepreneur on the downside". See Bratton W., 'Venture Capital on the Downside: Preferred Stock and Corporate Control', 100 *Mich. L. Rev.,* 2002, 895.

[532] Kaplan S.N. and P. Strömberg, 'Financial contracting meets the real world: an empirical analysis of venture capital contracts', 70 *Review of Economic Studies*, 2003, 287.

[533] See Bratton, 2002, note 634 above at 893 and 912 where the author is interested in "downside" protection, which he says consists of two powers: (1) the "power to replace the firm's managers (or

Assuming it is possible to stipulate a recognisable signal, since the two agency conflicts occur in different states of nature and between different parties, the parties may be able to extract more from a buyer by making the allocation of control contingent on the state of nature through debt financing. Therefore, the entrepreneur should hold all the voting rights and the venture capital fund should participate as debt-holder. In so doing, when the firm is performing well and a bid offer appears, the entrepreneur, who is the person vulnerable to expropriation of private benefits, is fully protected. Conversely, if the potential buyer shows up following the realisation of a state of insolvency, control shifts to the venture capital fund, which cares most about firm value. The problem, however, is that while control is optimally allocated, the allocation of rights to revenues is such that the initial contracting parties do not benefit from efficiency improvements brought about by a buyer when the firm is growing well.[534] If, for example, the buyer were less efficient than the entrepreneur, joint ownership would extract more from the buyer.[535]

The optimum would be to combine the protection against asset stripping offered by the contractual rights of a debt loan with the possibility of enjoying the benefits of a bid offer through issuing equity. The solution is to assign convertible preference shares or convertible bonds to the venture capital fund.[536] Convertible securities protect the venture capital fund against dilution when the firm is performing poorly by ensuring the liquidation value of the firm under the original entrepreneur. If the firm is performing well, asset stripping is not a problem, and debt is converted into (better if non-voting) equity and the venture capital fund can fully benefit from efficiency improvements as well as the entrepreneur. In addition,

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alternatively, to force premature sale or liquidation of the firm)" and (2) the "power to protect the venture [capital] contract itself from opportunistic amendment".

[534] The venture capitalist shares with the entrepreneur expectations of equity holders independently of the securities held, see Kaplan S.N. and P. Strömberg, 'Financial contracting meets the real world: an empirical analysis of venture capital contracts', 70 *Review of Economic Studies*, 2003, 281 and 306-308.

[535] Of course there may be considerable costs associated with unconstrained *ex post* bargaining, in which case all-debt financing is more attractive.

[536] See, for example, Admati A.R. and Pfeiderer P., 'Robust Financial Contracting and the Role of Venture Capitalists', 49(2) *Journal of Finance*, 1994, 371 on the anoptimal use of "fixed-fraction contracts" to resolve agency problems in venture capital transactions; Bergemann D. and U. Hege, 'Venture Capital Financing, Moral Hazard, and Learning', 22 *J. Bank. & Fin.*, 1998, 703 on the optimal mix of debt and equity to address moral hazard risks posed by entrepreneurs; Berglof E., 'A control Theory of Venture Capital Finance', 10 *Journal of Law Economics and Organization*, 1994, 247 on the optimal contract design to reduce conflicts of interest between the financier and the entrepreneur; Hellmann T., *The Allocation of* Control Rights in *Venture* Capital Contracts, 29 Rand J. Econ., 1998, at 57 on the optimal use of control rights; Schmidt K., 'Convertible securities and venture capital finance', 58 *J. FIN.*, 2003, 1139 on the optimal use of convertibles to induce efficient investment by entrepreneurs and investors; Black B. and R. Gilson, Venture Capital and the Structure of Capital Markets: Bank versus Stock Markets, 47 *J. Fin. Econ.,* 1998, 243, 253; Sahlman W.A., 'The Structure and Governance of Venture Capital Organizations', 27 *J. Fin. Econ.,* 1990, 473.

the conversion privilege of convertible debt allows the parties to contract on non-verifiable but observable information, which is the signal related to a state of nature. The main focus of exit theory, both in legal and economic literature, has been the trade-off between "liquidity" and "control".[537] The right levels of liquidity and control in each stage of a start-up firm can be adjusted through contractual rights. In designing an optimal financial contract, investors and entrepreneurs strive to provide incentives for efficient monitoring while allowing investors to obtain the maximum level of liquidity consistent with such monitoring.[538] In fact, the allocation of voting control, decision rights and financial rights generated by convertibles recognises the importance of both residual cash flow rights[539] as well as asset control rights[540] in resolving information asymmetry and agency conflicts among deal participants.

7.2. Existing legal strategies for preference shareholders protection

7.2.1. The UK Takeover Panel and the City Code on Takeovers and Mergers

In the absence of home-grown takeover remedies the Takeover Panel is the arbitrator and referee of mergers and acquisitions in the UK. The Panel normally prohibits a target company from taking legal action that would have the effect of frustrating an offer, unless shareholder permission is obtained. The Takeover Panel consists of representatives from the London Stock Exchange, the Bank of England, major merchant banks and institutional investors. Its task is to administer a set of rules known as the City Code on Takeovers and Mergers (the Takeover Code). It also operates to ensure that takeovers are conducted in a timely and efficient manner and that target companies are not subject to speculative and prolonged takeover bids. It is

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[537] See, for example, Coffee J.C. Jr., 'Liquidity versus control: The institutional investor voice', 91 *Columbia Law Review,* 1991, 1277; Faure-Grimaud A. and D. Gromb, 'Public Trading and Private Incentives', 17 *Rev. Fin. Stud.*, 2004, 985; Kahan M. and A. Winton, 'Ownership Structure, Speculation, and Shareholder Intervention', 53 *J. Fin.,* 1998, 99; Maug E., 'Large Shareholders as Monitors: Is There a Trade-Off Between Liquidity and Control?', 53 *J. Fin.*, 1998, 65; Roe M.J., 'Political and Legal Restraints on Ownership and Control of Public Companies', 27 *J. Fin. Econ.*, 1990, 7.

[538] Aghion, P. and Bolton, P. and Tirole, J., 'Exit options in corporate finance: liquidity versus incentives', 8(3) *European Finance Review*, 2004, 7.

[539] Jensen M. and W. Meckling, 'Theory of the Firm: Managerial Behavior, Agency costs and Ownership Structure', 3 *Journal of Financial Economics*, 1976, 307.

[540] The Property Rights Theory see Grossman S. and O. Hart, 'The Cost and Benefits of Ownership: A Theory of Vertical and Lateral Integration', 94 *Journal of Political Economy*, 1986, 691-719.

not, however, concerned with the "financial or commercial advantages [or disadvantages] of a takeover".[541]

The Takeover Panel's supervision differs significantly from the US framework for regulating takeovers with regards to several aspects: the time, the type and the flexibility of the intervention.[542] The Panel imposes little or no delay on the takeover effort, addressing takeover issues in real time. Furthermore, it operates a pro-active and flexible regulatory approach, which falls outside of the courts, allowing it to adjust to the regulatory requirements of a changing business environment. As a consequence, lawyers play little role in the Takeover Panel, which is staffed predominately by financial groups. The Panel is more business focused than legal and, in contrast to the US, tactical litigation as a takeover defence is virtually ruled out of the takeover process. Instead all objections and appeals are heard directly by the Panel to which Courts has recognised full jurisdiction.[543]

The Takeover Code also provides protection for the minority shareholders, including preference shareholders, from possible abuses by stating: "where a company has more than one class of equity share capital, a comparable offer must be made for each class whether such capital carries voting rights or not".[544] A comparable offer need not necessarily be an identical offer.[545] A bid offer either via private treaty with a small number of important shareholders or via purchases of shares on the market, or by way of a general and public offer to all the shareholders of the target company is clearly facilitated if the target's shares are traded on a public market. If this is the case and the offer concerns two or more classes of equity share capital, "the ratio of the offer values should normally be equal to the average of the ratios of the middle market quotations over the course of the six months preceding the commencement of the offer period".[546] Any other ratio adopted by the parties has

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[541] The Takeover Panel, Code Committee, Consultation on aspects of the takeover code, 2010/6.

[542] Armour J. and D.A. Skeel, "Who Write the Rules for Hostile Takeovers, and Why? – The Peculiar Divergence of U.S. and U.K. Takeover Regulation", 95 *Geo. L.J.*, 2007, 1744.

[543] *R v. Panel on Takeovers and Mergers ex parte Datafin* [1987] 2 WLR 699. See also *Regina v. Panel on Takeovers and Mergers, ex parte Guinness Plc.* [1990] 1 Q.B. 146; Idem, [1990] BCLC 255.

[544] See Rule 14.1 of the "Blue Book" (Takeover Code).

[545] See Rule 14.2 of the "Blue Book": "where an offer is made for more than one class of share, separate offers must be made for each class".

[546] See Rule 14.1 of the "Blue Book" comparability of the offer.

to be fully justified. Similarly, if one or more of the classes of equity share capital are not listed, the ratio of the offer values must be justified to the Panel in advance.[547]

When an offer for non-voting shares only is being made, comparable offers for voting classes are not required. In addition, "an offer for non-voting equity share capital should not be made conditional on any particular level of acceptances with respect to that class, or on the approval of that class, unless the offer for the voting equity share capital is also conditional on the success of the offer for the non-voting equity share capital".[548] In any case, it is always better to consult the Panel in advance, because the Panel, for the purpose of this Rule, may disregard as equity share capital certain classes of shares recognised as such by the Companies Act 2006 but holding in practice very limited equity rights.

The possible abuse by the acquirer in offering an undervalued price for special categories of preferred shares may be limited to a certain extent by the market arbitrage effect when the shares are listed on the stock market. When the undervalued class of shares is listed in a stock market and any information regarding the firm is disclosed, the arbitrage effect, although not without cost, will equalise the difference between the classes of shares. Every time the price offered for a preferred class of shares, largely in a takeover transaction, undervalues those shares in the market, qualified investors as private equity or hedge funds, if the profits offset the costs, might always buy those shares. They would thus acquire consistent ownership interest and control power in the class of share to oppose the unfair transaction, taking legal action against the company.[549]

However, if the shares are not listed on a public market their evaluation may be more arbitrary and difficult to oppose. In cases where preference shares are not included in the relevant securities category and therefore do not receive an offer, their shareholders may be left with no other remedy to avoid the wealth expropriation conducted by the majority shareholders. A possible means of tackling

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[547] See "Blue Book" notes on Rule 14.1.

[548] See Rule 14.1 of the "Blue Book".

[549] This is the case of Elliott Associates LP. They took on Cincinnati-based P&G in 2003, after the world's biggest consumer products company bid for Wella AG, a German hair care products company. Procter & Gamble offered the founding family and Wella management, which held all of the voting stock, 92.50 Euros ($133.40) a share, or $6.9 billion, to acquire the company. The offer was 42 per cent more than the 65 Euros offered to holders of nonvoting, preferred shares.

this problem could be to petition the court for relief on the grounds that the conduct of the company has been or is prejudicial to the interests of some part of its members or an actual or proposed act or omission of the company is or would be so prejudicial.[550] The issue of a petition may amount to an abuse of process, even though there has been unfair prejudice, if it is clear that the petitioner will have to sell his shares to the respondent and the petitioner has unreasonably rejected a reasonable offer to purchase his shares at a fair price.[551] However, over the years not many cases have arisen, and although the courts have always had jurisdiction to review the panel's decision,[552] there have been no grounds for interfering and the courts have declined to intervene.[553]

7.2.2. The standard strategy: the duty of loyalty in a UK-US comparative perspective

In common law countries a further protection comes from the fiduciary standards. In the UK, for instance, a director must "act in a way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole".[554] The common law obligation already compels directors to behave in the best interests of the shareholders as a whole, but s. 172 potentially departs from that position by requiring that, in promoting the success of the company, the director must have regard to a number of other stakeholder interests, such as the company's

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[550] See s. 994 of the CA 2006 "unfair prejudice" petition. Davies P.L., *Gower and Davies' Principles of Modern Company Law* (Sweet and Maxwell, 8th ed. 2008) 681-704.

[551] *Re a Company* (No: 003843 of 1986) [1987] 3BCC 624; *Re a Company* (No: 003096 of 1987) [1988] 4 BCC 80; *O'Neill-v-Phillips* [1999] 1 WLR 1092; *North Holdings Ltd-v-Southern Tropics Ltd* [1999] BCC 746; *West-v-Blanchet* [2000] 1 BCLC 795; *Wyatt-v-Frank Wyatt & Son Ltd* [2003] EWHC 520; *Isaacs-v-Belfield Furnishings Ltd* [2006] All ER (D) 216.

[552] Although the Takeover Panel purports to be part of a system of self-regulation and to derive its power solely from the consent of those whom its decisions affect, it is in fact operating as an integral part of a governmental framework for the regulation of financial activity in the City of London, is supported by a periphery of statutory powers and penalties, and is under a duty to exercise what amounts to public powers to act judicially.

[553] *R v. Panel on Takeovers and Mergers ex parte Datafin* [1987] 2 WLR 699. See also *Regina v. Panel on Takeovers and Mergers, ex parte Guinness Plc.* – [1990] 1 Q.B. 146; Idem, [1990] BCLC 255;

[554] s. 172 of the Companies Act 2006. For a fuller discussion compare Davies P.L., *Gower and Davies' Principles of Modern Company Law* (Sweet and Maxwell, 8th ed. 2009) 479 f. and 495 ff.; Kershaw D., *Company Law in Context: Text and Materials* (OUP, 2009) 299 ff.

employees, suppliers, customers and others.[555] Despite this, the preferable analysis of s. 172 is that it requires directors to have regard to the long-term interests of the shareholders. It may happen that directors may have to take account of other stakeholder groups but only in order to support the long-term growth of the company.[556] Thus, in a solvent company, it is the interests of the shareholders that remain the dominant concern. In fact, although lenders contribute significantly to corporate governance by monitoring the directors in accordance with their own interests, they are well protected by contract and by capital maintenance regime.

In the US, the duty of loyalty is used to monitor transfer of control in closely held companies as well as in publicly traded ones. These duties may impose an obligation upon the controlling seller either to compensate the remaining shareholders for foreseeable harm caused by the transfer[557] or to share the premium with the non-controlling shareholders when the transfer can be identified as involving the alienation of something belonging to all shareholders.[558] However, these cases do not state the general rule. US courts have not adopted a general equality principle, which might have led them to generate an unqualified right for non-controlling shareholders to share in the control premium.[559] A controlling shareholder can dispose of voting right securities for a price that is not made proportionally available to other shareholders, but is subject to a requirement for fair dealing. Providing self-dealing is effectively controlled, permitting sales at a premium price gives both seller and acquirer an appropriate regard for their extra monitoring costs.[560]

As in the UK, the main US doctrine has excluded bondholders from the protection of these duties, because no agency or trust relationship exists between

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[555] See *Re Smith and Fawcett Ltd* [1942] Ch 304, 306 per Lord Greene MR. Directors do not owe duties to individual shareholders. However, they may do so in specific factual circumstances: *Peskin v Anderson* [2001] 1 BCC 874.

[556] Kershaw D., *Company Law in Context: Text and Materials* (OUP, 2009) 349-351.

[557] See, *Gerdes v. Reynolds* 28 New York Supplement Reporter 2nd Series 622 (1941).

[558] *Perlman v. Feldman* 219 Federal Reporter 2nd Series 173 (1955); *Brown v. Halbert*, 76 California Reporter 781 (1969).

[559] See Clark R.C., *Corporate Law* (Boston: Little, Brown & Co., 1986) 478-98.

[560] Gilson R. and J. Gordon, 'Controlling Controlling Shareholders', 152 *University of Pennsylvania Law Review*, 2003, 811-816.

them in law.[561] The contrast between the rights of debt-holders and the simple expectations of equity holders, who are protected by fiduciary duties, has also been noted by the US courts of Delaware in several cases,[562] where they declined the imposition of a fiduciary duty in the absence of an equity interest.[563]

However, in past years, especially in the US, a pluralistic approach of the maximisation of the company as a whole has been developed at least at a doctrinal level, together with the conviction that directors' fiduciary duties are owed to the company.[564] In this line of reasoning, the doctrine has tried to relax the strict legal definition of the fiduciary relationship, adopting instead an economic concept of it. This study extracts generally applicable concepts of the essential fiduciary obligation from its particularised manifestation in agency and trust relationships, to replace them with a flexible definition of the fiduciary obligation as the "exercise of judgment on behalf of another".[565] This definition permits the identification of numerous interrelating fiduciary obligations in corporate structures and consequently obligations arising from contractual relationships as fiduciary. Furthermore, if, on the one hand, as long as the corporate debtor remains able to repay the debt, creditors' interests have not been impaired sufficiently to justify legal restraints on the corporation's self-interested actions, on the other, a different judgement is made regarding the insolvent corporate debtor when the insolvency jeopardises the

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[561] For an analysis of the main case law on this matter see Fraidin S. and F. Stevelman, "Duties to Bondholders in Recapitalizations and Restructurings", Corporate Law and Practice Course Handbook Series, 754 PLI/Corp 277, accessible at http://www.nyls.edu/user_files/1/3/4/30/31/32/PLIDuties.pdf

[562] See *Harff v. Kerkorian,* 324 A.2d 215 (Del. Ch. 1974), aff'd in part and rev'd in part, 347 A.2d 133 (Del. Supr. 1975); *In re Will Of Miguel,* 71 Misc.2d 640, 336 N.Y.S.2d 376, 379 (Sup. Ct. 1972).

[563] Based on the decision in *Harff* and *In re Will of Miguel,* the court in *Simons v. Cogan,* 549 A.2d 300 (Del. Supr. 1988) concluded: "In sum, a convertible debenture represents a contractual entitlement to the repayment of a debt and does not represent an equitable interest in the issuing corporation necessary for the imposition of a trust relationship with concomitant fiduciary duties"; 549 A.2d at 303.

[564] Parkinson J., *Corporate Power and Responsibility* (Clarendon Press, Oxford. 1993), 21-41; Kelly G. and J. Parkinson, 'The Conceptual Foundations of the Company: A Pluralist Approach', 2 *Company Financial and Insolvency Law Review,* 1998, 174; Mitchell L.E., The Fairness Rights of Corporate Bondholders, 65 *N.Y.U. L. Rev.*, 1990, 1165; Millon D., 'Theories of the Corporation', *Duke Law Journal,* 1990, 201; Llewellyn K.N., 'What Price contract? An Essay in Perspective', 40 *Yale L. J.*, 1931, 721. Also see Leung W., 'The Inadequacy of Shareholder Primacy: A Proposed Corporate Regime that Recognizes Non-Shareholder Interests', 30 *Columbia Journal of Law and Social Problems*, 1997, 589; Worthington S., 'Shares and shareholders: property, power and entitlements (Part 1 and 2)', 22(9) *The Company Lawyer*, 2001, 258 *et seq.*

[565] Jacobson, 'Capturing Fiduciary Obligation: Shepherd's Law of Fiduciaries', 3 *Cardozo L. Rev.*, 1982, 519 and 527; Frankel, 'Fiduciary Law', 71 *California L. Rev.*, 1983, 795 and 808-809.

repayment. In such a situation, the balance of interests shifts to favour the creditors, giving rise to creditor protection in law.[566]

The traditional analysis has challenged the idea of expanding the directors' fiduciary duties towards the creditors on the basis of the assumptions underlying the contract of corporation. Over the years there has been a weakening of the strong distinctions equity-debt, shareholder-bondholder and, consequently, a reclassification of their relationships into neat corporate and contract categories.[567] Corporate law used to tolerate only limited contractual alterations of the terms governing relationships between the corporation and its stockholders, but today, especially with respect to closely held corporations, as is suggested by the case of hybrid instruments, contractual arrangements between the stockholders may restrict the exercise of management discretion granted under the pure corporate model in much the same manner as negative covenants in bond contracts or veto rights in preference shares have done all along.[568]

For example, the convertible bond relationship presents an area of overlap between contract and fiduciary restraining principles. Outside the overlap, contract and fiduciary duties go off in different directions, with fiduciary duties focusing on the protection of the dependent party and contract duties focusing on the effectuation of the parties' allocation of risks. Generally fiduciary duties tend to impose a higher degree of selflessness than is imposed on contracting parties subject to the good faith duty. The fiduciary must put the beneficiary's interests ahead of his own even though the costs to the fiduciary exceed the benefits to the beneficiary. In contract, under a good faith approach the party under the duty need only give equal consideration to the other party's interests, placing them ahead of his own only where the balance of costs and benefits gives primacy to the other's interests.[569]

From another point of view, however, as some attentive doctrine has pointed out, the issuer fiduciary duty to bondholders is indistinguishable from the contract

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[566] Clark R., 'The Duties of Corporate Debtor to its Creditors', 90 *Harvard L. Rev.*, 1977, 510. See *Harff v. Kerkorian,* 324 A.2d 215 (Del. Ch. 1974), aff'd in part and rev'd in part, 347 A.2d 133 (Del. Supr. 1975).

[567] Kraakman R. and H. Hansmann, 'The Essential Role of Organizational Law', 110 *Yale Law Journal*, 2000, 387-440.

[568] Tung F., 'Leverage in the Board Room: The unsung influence of private lenders in corporate governance', 115 *UCLA Law Review*, 2009, 170-173; Hamer H. 'Corporate Control and the Need for Meaningful Board Accountability', 94 *Minnesota Law Review*, 2010, 541.

[569] Goetz and Scott, Principles of Relational Contracts, 67 *Va. L. Rev.*, 1981, 1128.

interpretation informed by a good faith duty.[570] While the duties in theory originate in different places – the contract law duty in the particular contract's bundles of promises and conditions, and the fiduciary duty in the issuer's exercise of judgement over the bondholders' investment – they become functionally identical as long as the bond contract is granted primacy over judicial fairness notions as the source of the relationship's rights and duties. Both duties justify bondholder protective filling in of contractual interstices and perhaps a generalised duty to disclose, but do nothing more.[571]

A court treating a contractual relationship too easily might be led to an erroneous avoidance of an unobjectionable contractual allocation of risk, by a rhetoric of selflessness that originated regarding very different fiduciary relationships.[572] The strain of bending fiduciary principles to fit the convertible bond context creates a risk of over-protecting bondholders. Since the results of the effort only duplicate results obtainable through contract law analysis, and since contract law provides a more precise set of analytical tools for resolving conflicts between issuers and bondholders, the courts have mostly abandoned this approach in fiduciary protection.[573]

Importantly, a justification key to the relative interests of stockholders and creditors only partially applies to hybrid securities like convertibles. The conversion privilege creates an additional bundle of bondholder interests to be thrown into the balance. One court, recognising this, hit upon the neat solution of extending management fiduciary duties to convertible bondholders only in cases where the "wrongs alleged [impinge] upon the equity aspects [of the bond]".[574]

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[570] Anderson A.G., 'Conflicts of Interest: Efficiency, Fairness and Corporate Structure', 25 *U.C.L.A. L. Rev.*, 1978, 759-760.

[571] On good faith and duties implied in law, compare with Bratton W., *Corporate Finance, Cases and Materials* (5th ed., New York, 2003) 438, 440-452.

[572] See *Zahn v. Transamerica Corp.*, 162 F.2d 36, 46 (3d Cir. 1947).

[573] Chirelstein M.A., 'Towards a Federal Fiduciary Standards Act', 30 *Clev. St. L. Rev.*, 1981, 210; Bratton W.W., 'The Economics and Jurisprudence of Convertible Bonds', 1984 *Wis. L. Rev.*, 730, 734 and 736-739; Benjamin J., *Financial Law* (Oxford University Press, 2007) 560-561.

[574] Green II, No. 76 Civ. 5433, slip op., at 17 (S.D.N.Y. July 13, 1981)

7.2.2.1. Do directors owe fiduciary duties to preference shareholders?

Regarding preference shareholders, the situation may be different considering that being part of the company's share capital, preference shares constitute an ownership interest in a corporation. Thus, it is certainly arguable to propose that the claim of a preference share could be a right shared equally by the common and preferred shareholders where fiduciary duties are owed. On the other side, as the previous historical analysis showed, it is true that the preference shares may hold a right to participate in the company's fortunes or misfortunes but more likely will have a fixed claim only subordinated to that of the creditors. To the extent that they enjoy fixed claims their interests may not be long-term as the ordinary shareholders' interests. However, English courts have not adopted the approach favoured by the High Court of Australia in *Gambotto v WCP Ltd*.[575] Instead, the English courts apply a subjective test[576] in order to understand whether the decision of the majority shareholders is bona fide in the interests of the company.[577] The burden of proof is on the claimant. This will leave a preference shareholder not many other alternatives other than a petition for unfair prejudice, but even on that ground the courts have held that if the offer of the majority to buy out the minority is fair any exclusion of the minority shareholder would not be unfair.[578] The rationale underlying it is the pre-eminent position of shareholders in a solvent company. The UK has adopted a shareholder-centred approach and the "enlightened shareholder value" recommendations of the Company Law Steering Group.[579]

Similarly in the US, the courts have basically recognised that the rights of preferred shareholders are "essentially contractual and the scope of the duty is appropriately defined by reference to the specific words evidencing that contract".[580]

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[575] (1995) 182 CLR 432, 447 (HC Aust). In this case, the majority shareholders altered the articles of the company in order to acquire compulsorily the shares of the minority shareholders. The High Court held the expropriation to be unlawful on the basis that it was oppressive to the minority shareholder although the price offered was more than its market value including the future possible cash flows.

[576] *Allen Gold Reefs of West Africa Ltd* [1900] 1 Ch 656.

[577] *Citco Banking Corp NV v Pusser's Ltd* [2007] UKPC 13; [2007] BCC 205, *Shuttleworth v Cox Brothers and Co (Maidenhead) Ltd* [1927] 2 KB 9, 23.

[578] *O'Neill v Phillips*, [1999] 1 WLR 1092.

[579] See DTI, Company Law Reform (Cm 6456, 2005), para 3.3.

[580] These are the words of the court in *Jedwab v. MGM Grand Hotels, Inc.,* 509 A.2d 584, 594 (Del. Ch. 1986) at 594; *Wood v. Coastal States Gas Corp.*, 401 A.2d 932 (Del. 1979). In the UK, see Lord Simonds in *Scottish Insurance Corp v. Wilson & Clyde Coal Co.* [1949] A.C. 462; 1949 S.C. (H.L.)

Because of this, they have generally assigned no claim for breach of fiduciary duties, when the shareholders' rights are specifically stated and governed by the articles of the company. In such cases, in fact, that device already protects the preference shareholders.[581] Therefore, it would seem that the contractual rights of preferred shareholders exist alongside but independently from the duties of care, loyalty and disclosure that are owed to all shareholders of a corporation.[582]

Generally, in corporate restructuring transactions such as mergers or reorganisations, directors cannot always overlook the fiduciary duties owed to preferred shareholders, particularly where the transaction involves an insider or an affiliate and benefits the common shareholders to the detriment of preferred shareholders.[583] However, as it has emerged in case law, the board of directors may sometimes encounter difficulties in owing fiduciary duties to the shareholders as a whole when the interests of the internal shareholder classes may diverge.[584] Thus, it could be argued that another key to interpreting the directors' fiduciary duties can be proposed. It could be assumed that preference shares are granted certain rights by statute and common law even where the corporation's organic documents are silent. In this way, where the contract is silent, preference shares should get the same pro rata voting and participation rights as common shares.[585]

90; 1949 S.L.T. 230; and Sir Raymond Evershed in *Re Isle of Thanet Electricity Supply Co.* [1950] Ch 161, CA.

581 *HB Korenvaes Invs., L.P. v. Marriott Corp.,* Civ. A. No. 12922, 1993 WL 205040* (Del. Ch. June 9, 1993)

582 According to the court in *Jedwab v. MGM Grand Hotels, Inc.,* 509 A.2d 584, 594 (Del. Ch. 1986) "when a right asserted is equally shared by preferred and common stockholders, the right and scope of the correlative duty may be measured by equitable as well as legal standards". Similarly, in *Eisenberg v. Chicago Milwaukee Corp.,* 537 A.2d 1051, 1062 (Del. Ch. 1987) recognised that a corporation's directors "are fiduciaries for the Preferred stockholders [sic], whose interests they have a duty to safeguard, consistent with the fiduciary duties owed by those directors to [the corporation's] other shareholders and to [the corporation] itself".

583 See *Jackson Nat.l Life Ins. Co. v. Kennedy,* 741 A.2d 377, 387 (Del. Ch. 1999); *Dalton v. American Inv. Co.,* 490 A.2d 574 (Del. Ch.) aff'd, 501 A.2d 1238 (1985); *Judah v. Delaware Trust Co.,* 378 A.2d 624, 628, 631 (Del. 1977); *Zahn v. Transamerica Corp.,* 162 F.2d 36, 42, 46.47 (3d Cir. 1947); *Dart v. Kohlberg, Kravis, Roberts & Co.,* 11 Del. J. Corp. L. 602, 1985 WL 11566 (Del. Ch. June 25, 1985); *Kimeldorf v. First Union Real Estate Equity and Mortgage Investments*, 309 A.2d 151, 754 N.Y.S.2d 73 (1st Dep't 2003); *Quadrangle Offshore (Cayman) LLC v. Kenetech Corp.,* 24 Del. J. Corp. L. 748, 1998 WL 778359 (Del. Ch. Oct. 21, 1998), appeal refused by *Kentech Corp. v. Quadrangle Offshore (Cayman) LLC*, 723 A.2d 839 (Del. Supr. 1998).

584 See the US court in Delaware In *Re: Trados Incorporated Shareholder Litigation*, No. 1512-CC (July 24, 2009).

585 As it is the case of *Jedwab v. MGM Grand Hotels, Inc.,* 509 A.2d 584, 594 (Del. Ch. 1986).

Although in theory this scenario is possible, the approach of extending the fiduciary duties does not really eliminate potential conflicts of interest between the holders of preferred and common stock when those interests clash.[586] After all, as the courts have made clear, the preferred shareholders are not entitled to an equal share in the merger consideration but only to a fair share.[587] The difficulties arise when the board has to decide what is fair *ex ante,* because although the board makes a good faith effort to set a fair price, the indeterminacy of valuation means that reasonable people could differ. Different is the case in which a prospective buyer that is a third person proposes the bid for common and preferred shares. In fact, the board would likely escape liability.[588]

A possible solution would be to assimilate the preference shares to the debt contracts. In contrast to preference shares, bond contract terms can be hundreds of pages long and generally deal with virtually every imaginable contingency. Therefore, the vacuum left by the preference share contract could be filled by the courts presuming, by analogy to the bond setting, an implied covenant of good faith rather than fiduciary duties. In the context of financial distress, where the company is unable to satisfy the expectations of all the constituencies, such a covenant would prevent the board from perpetrating opportunistic behaviour that deprives the preferred shareholders of the benefit of their bargain.[589] Alternatively, a special committee representing each of the different classes of stock could be created only during certain critical corporate transactions.[590]

Nevertheless, it is wrong to think that protection for preference shareholders is to be found only in the mandatory provision of company law. Provided that these

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[586] Compare "Fiduciary Duties and Preferred Stockholders", in Professor Bainbridge's Journal of Law, Politics and Culture, available at http://www.professorbainbridge.com/professorbainbridgecom/2009/08/fiduciary-duties-and-preferred-stockholders.html (accessed in January 2011); McEllin M.M., "Note: Rethinking Jedwab: A Revised Approach to Preferred Shareholders Rights", *Colum. Bus. L. Rev.*, 2010, 895; Sepe S., "Corporate Agency Problems and Dequity Contracts", 36 *J. Corp. L.*, 2010, 113.

[587] *Jedwab v. MGM Grand Hotels, Inc.,* 509 A.2d 584, 594 (Del. Ch. 1986).

[588] *In Re: Trados Incorporated Shareholder Litigation*, No. 1512-CC (July 24, 2009). The board could defend itself on causation grounds that is, whether or not the board breached its fiduciary duties, that breach was not the cause of plaintiff's injuries, see, for example, *Dalton v. Am. Inv. Co.,* 490 A.2d 574 (Del. Ch.), aff'd, 501 A.2d 1238 (Del. 1985).

[589] Bainbridge S.M., *Much Ado about Little? Directors' Fiduciary Duties in the Vicinity of Insolvency*, UCLA School of Law, Law-Econ Research Paper No. 05-26, at 26.

[590] See this and several proposed solutions in McEllin M.M., "Rethinking *Jedwab:* A Revised Approach To Preferred Shareholder Rights", *Colum. Bus. L. Rev.*, 2010, 919-933.

shareholders have sufficient bargaining power, they may be able to negotiate for special private protections. Surely no court or any third party is better positioned than the parties to design the arrangements best suited to govern their relationship. They know what types of investment have been made and the related risks they are facing and, therefore, only the parties, if they wish so, can design effective mechanisms to neutralise these risks.[591]

7.3. Financial contract design for controlling the board's power in exit events: veto rights, drag-along and tag-along clauses

The above analysis of the court's approach to the protection of preferred shareholders is a strong incentive to bargain for any rights contractually in order to avoid future surprises and misunderstandings. For this reason, to protect both the value and the liquidity of an investment in the event of any projected transaction involving its share capital or the composition of its shareholding, it is becoming common practice especially in venture capital financing to confer on the participants special rights to control, to a certain extent, how transfers of shares in the company shall occur.[592] These are also called the "drag-along" and "tag-along" clauses. These clauses present an alternative to the conversion feature attached to preference shares or subordinated debt. As suggested earlier, the founders, who control sufficient stock to block a corporate reorganisation, will often prefer to hold the firm as an independent vehicle in order to protect their employment or more frequently because their inflated expectations suggest that, in few more years, the investment may give a much higher return. On the other hand, given the time value of money, the venture capital funds may be impatient to realise on their investment.[593]

Tag-along and drag-along arrangements entitle one shareholder to participate in another's sale to a third party. These clauses are attempt to control two types of opportunistic behaviour both associated with underinvestment problems. On the one

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[591] See Sáez Lacave I. and N. Bermejo Gutiérrez, 'Specific Investments, Opportunism and Corporate Contracts: A Theory of Tag-along and Drag-along Clauses', (2010) 11 *EBOR*, 423-458.

[592] Robinson D.T. and T.E. Stuart Robinson, 'Financial Contracting in Biotech Strategic Alliances', (2002) Working Paper available at: <http://www.ssrn.com>, 21; Cumming, 'Contracts and Exit in Venture Capital Finance', 21(5) *Rev. Financ. Stud.*, 2008, 1975; Broughman B. and J. Fried, 'Renegotiation of Cash Flow Rights in the Sale of VC Backed Firms', (2010) 95 *J. Fin. Econ.,* 384-399.

[593] Gompers P.A. and Lerner J., *The Venture Capital Cycle* (Cambridge, Mass.: MIT Press, 2nd eds. 2004) 345 ff.

side, there is a risk of expropriation of the investment on the occasion of inefficient sales; on the other, there is a risk of extortion in efficient or productive sales, a problem also referred to as free riding.[594]

Drag-along rights give someone the right to drag someone else along in a deal. The provision would generally state that if a specified percentage of shareholders or perhaps only certain categories of shareholders accept an offer to sell, then on condition that the terms being offered to all parties are economically the same, those majority shareholders can force the minority shareholders to sell even when they may not wish to do so.[595] In particular, upon the occurrence of the triggering event, an agent for any dissenting shareholder will be appointed as a director of the board with authority to sign the stock transfer forms and any other necessary paperwork on their behalf.[596]

The ratio of the drag-along clauses lays in the attempt to prevent one of the shareholders from staying in the company to appropriate the added value generated by the third party newcomer. These clauses are commonly found in private equity investing in various forms. It is possible to identify the percentage of the group of investors or class of shareholders that is required to trigger the rights or to set a condition to a transaction as for instance a minimum price that can trigger those rights. Private equity investors often have these clauses included in a shareholders' agreement applicable to all shareholders who are a party to that agreement. In certain locked-in start-ups, where the shareholders commit to a specific investment, the company agrees not to issue additional shares of stock unless the purchaser becomes a party to the shareholders' agreement. The only limit remains whether this combination of defensive measures and deal protection terms becomes so rigid to preclude the ability of the directors to exercise their fiduciary duties and of the

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[594] See Aghion P., M. Dewatripont and P. Rey, 'Renegotiation Design with Unverifiable Information', (1994) 62 *Econometrica,* 257-282 and Chung T-Y., 'Incomplete Contracts, Specific Investments, and Risk Sharing', (1991) 58 *Rev. Econ. Stud.,* 1031-1042.

[595] Sáez Lacave I. and N. Bermejo Gutiérrez, note 591, 423-458; Cumming, 'Contracts and Exit in Venture Capital Finance', 21(5) *Rev. Financ. Stud.*, 2008, 1947-1982; Cumming D., 'Capital Structure in Venture Finance', (2005) 11 *J. Corp. Fin.*, 550–585; Zingales L., 'Insider Ownership and the Decision to go Public', (1995) 62 *Rev. Econ. Stud.*, 425-448; Smith, D.G., 'The Exit Structure of Venture Capital', 53 *UCLA Law Review,* 2005, 315-356.

[596] Bartlett J.W., *Equity Finance: Venture Capital, Buyouts, Restructurings and Reorganizations*, (Aspen Publishers, 1995) 233; Aghion P., P. Bolton and J. Tirole, 'Exit Options in Corporate Finance: Liquidity versus Incentives', (2004) 8 Review of Finance, 349.

shareholders to reject that transaction.[597] For this reason, a right to compel sale should be drafted with particular care to set out exactly the respective obligations of the parties.[598] The practice has known some special rights to petition for dissolution that can be included in a venture capital agreement.[599]

Conversely, tag-along rights address the concern of minority shareholders neutralising the effects of inefficient sales. Since these exit events fail to maximise the value of the company as a whole, they constitute expropriation. A majority shareholder could sell his holding to a third party under terms that would pay for him more than his share of the surplus due to him under the provisions of the agreement. Thanks to the use of a tag-along clause, if the majority sell their shares, the minority will have the right to have the offer extended at the same price.[600] In other words, the clause obliges the shareholders with selling power to give notice to the other shareholders and negotiate for them too.[601]

The tag-along clauses protect the investor exposed to an expropriation risk through a property rule designed *ad hoc* in the agreement.[602] Assuming a private

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[597] See, *Omnicare, Inc. v. NCS Healthcare, Inc.,* 818 A. 2d 914 - Del: Supreme Court 2003, where the Court nullified these provisions because they included an irrevocable agreement among the holders of 65 per cent of the target's outstanding stock to vote in favour of the deal; an agreement to put the merger to a vote of the target's shareholders even if the board of directors withdrew its recommendation for the deal and the lack of an effective "fiduciary out".

[598] For Delaware corporations at least, drag-along rights prevent some issues of fraud or duress would be enforced, see Del. Cod. Ann. Tit. 8, 202 (1983) and the case that has construed the sections of the Delaware statute enabling shareholders to enter agreements amongst themselves including an agreement respecting a forced sale: *Shields v. Shields*, 498 A.2d 161, 168 (Del. Ch. 1985). In US courts other than Delaware see also in favour *Gottschalk v. Avalon Realty Co.*, 23 N.W.2d 606 (Wis. 1946); contra *In re Bacon*, 287 N.Y. 1, 138 N.E.2d 105 (1941).

[599] One of the least complicated is the "shootout" or "Texas auction" arrangement, whereby one shareholder may compel a dissolution of the deadlock by fixing a price on his shares (or a formula for fixing the price) and the other party must elect either to sell or buy at that price.

[600] Beddow S., *The Equity Deal*, in C. HALE, *Private Equity: a Transactional Analysis* (Globe Business Publishing, 2007), 51: where a shareholder is selling a partial stake in the company, the other shareholders have the right to have a corresponding percentage of their holding of shares purchased at the same conditions.

[601] A similar employed device to accomplish the same aim in the US practice was to issue redeemable preference shares at the option of the holder. The expectation of such preferred shareholders is not necessarily that they will be able to exercise their right to put their shares of the company at some price formula at the end of the financing cycle, but rather the threat of such a put being exercised will be enough, when the time comes, to bring the founder into line. See, Bartlett J.W., *Equity Finance: Venture Capital, Buyouts, Restructurings and Reorganizations*, (Aspen Publishers, 1995) 231 where some cases are reported in fn. 52.

[602] Property rules are known to be the classic 'anti-expropriation' rules. See Calabresi G. and A.D. Melamed, 'Property Rules, Liability Rules, and Inalienability: One View of the Cathedral', (1972) 85 Harvard Law Review 1092-1093, 1105-1106.

equity fund holds a minority share in the company but the largest stake of hybrid capital. Therefore, it would suffer from an asset substitution problem when a third newcomer acquires the company from the majority shareholder and starts selling the assets piecemeal, the tag-along clause allows the investor to co-sell its stake when the entrepreneur decides to sell.[603]

Finally, other provisions commonly used in practice are: the demand rights or registration rights, the piggyback rights and the catch-up clauses. Demand rights allow the parties to force their partners to agree to take the firm public in an IPO while piggyback rights allow the parties to demand to be included in an IPO in proportion to their stakes in the firm. Finally, the catch-up clauses deny the parties holding a call option the ability to profit from exercising their call prior to a trade sale or an IPO.[604]

7.4. An evaluation of hybrid financial instruments' use and protection in the UK and US jurisdictions

The disputes arising from the opportunism of the parties in corporate agency relations are on the same footing as bad faith and a form of breach of contract: the breach of contract respecting shareholder exit and cash flow rights. If the parties agreed to certain distribution of common earnings, any *ex post* alteration by one of the parties to appropriate part of the gains due to the other is contrary to good faith requirements. The UK and US legal systems adopt *ex post* standards strategies to protect minorities. US law, which is more protective of the prerogatives of management, places the decision on the control transaction in the hands of the board and relies on fiduciary duties, which assuming shareholders' good faith afford protection through the judicial review of their unfair behaviour. The UK legal system of company law has instead always been shareholder-centred. The decision-making on control shifts is given wholly to the shareholders, and the protection of the minorities is left to the Takeover Panel, which acts as authority. Other ex post

[603] For an economic rationale for the use of these clauses see Chemla G., M.A. Habib and A. Ljungqvist, 'An Analysis of Shareholder Agreements', (2007) Journal of the European Economic Association, 93-94 and 101-113.

[604] Aghion, P. and Bolton, P. and Tirole, J., 'Exit options in corporate finance: liquidity versus incentives', 8(3) *European Finance Review*, 2004, 348; Chemla G., M.A. Habib and A. Ljungqvist, note above, 93-94.

remedies like the petition for unfair prejudice or for breach of fiduciary duties are also available.

The Takeover Panel offers some advantages compared to the US framework for regulating takeovers and protecting minority shareholders. In fact, it addresses takeover issues in real time, imposing little or no delay on the takeover effort. In the context of an active bid, the Panel's Executive requires participants to submit regular updates on compliance. The Panel evaluates on a case by case basis whether a class of preference shares should receive an offer according to the equity rights included in the shares and supervises the fairness of the offer. If one of the parties to a bid protests to the Takeover Panel, it will issue rulings as appropriate and, in contrast to the US courts, these decisions are virtually immediate and provide real-time decisions on takeovers. Furthermore, the Takeover Panel operates a pro-active and flexible regulatory approach, which falls outside of the courts, allowing it to adjust to the regulatory requirements of a changing business environment. Thus, in contrast to the US, tactical litigation as a takeover defence is virtually ruled out of the takeover process. The Takeover Panel normally prohibits a target company from taking legal action that would have the effect of frustrating an offer, unless shareholder permission is obtained. Instead objections and appeals are heard directly by the Takeover Panel and are dealt with outside of the courts.[605]

In addition, in EU countries, the Directive on takeovers introduced the mandatory bid rule that provides a very effective exit right for minorities. However, the use of the mandatory bid rule is questionable, especially for closely held companies. It has been argued that the application of this rule can cause high costs to minority shareholders and slow down corporate restructuring, because it makes the total price of the target firm more expensive for potential bidders. In so doing, the rule may deter value-increasing takeovers because the price fails to compensate the block owner for their private benefits.[606]

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[605] Armour J. and D.A. Skeel, "Who Write the Rules for Hostile Takeovers, and Why? – The Peculiar Divergence of U.S. and U.K. Takeover Regulation", 95 *Geo. L.J.*, 2007, 1744.

[606] However, the Directive leaves the countries a lot of scope for the implementation of this rule. Some systems do allow variations between the price offered to the minority and that paid for the controlling shares, or permit partial bids in certain cases. The UK City Code is unusual in applying the mandatory bid rule to any acquisition of voting shares by a shareholder holding between 30 and 50 per cent of the voting shares.

Despite this, no rule can replace the flexibility of the venture capital agreement in private equity control transactions. The problem is also that it is often difficult for third parties - courts - to verify a breach, and thus *ex post* defences fail to provide shareholders with satisfactory protection for their interests. Provided that these shareholders have sufficient bargaining power, they may be able to negotiate for special private protections. Surely no court or any third party is better positioned than the parties to design the arrangements best suited to govern their relationship. They know what type of investments has been made and the related risks they are facing and, therefore, only the parties, if they wish so, can design effective mechanisms to neutralise these risks.[607]

[607] See Sáez Lacave I. and N. Bermejo Gutiérrez, 'Specific Investments, Opportunism and Corporate Contracts: A Theory of Tag-along and Drag-along Clauses', 11 *European Business Organization Law Review*, 2010, 423-458.

CONCLUSIONS

Chapter 8. Conclusive Considerations

The analysis contained in this thesis has shown that the dichotomous legal distinction between equity and debt can be meaningless and the results of that categorisation misleading. The law has the necessity to classify financial and voting rights in the equity-debt continuum because it relies on classifications as a control over regulations. Several regulatory areas adopt different approaches to classifying hybrids driven by the purpose they are trying to achieve. However, none of these approaches is able to consistently deliver the "correct" results, even within the narrow boundaries of the respective discipline or regulatory aim. Hence, they often create incentives for regulatory arbitrage. The capacity of hybrids to replicate characteristics of equity or debt, depending on the situation, makes these securities largely adopted as tools for intra-group financing, driven by both tax and accounting regulations. Moreover, issuers can raise finance without fully having reflected their true financial positions in head-line financial metrics such as the debt-to-equity ratio.

From a company's perspective, opportunities for hybrid-driven arbitrage also exist in the field of corporate law. This is an area that has so far received only scarce attention in the legal literature. While deeply interwoven with accounting and insolvency law, corporate law also uses the distinction between debt and equity as a reference point when assigning roles within the organisational governance structure. While economic models typically regard shareholders' governance rights as a natural counterweight to their "residual claimant"-nature and their lack of fixed entitlements to the firm's assets, company law typically takes a very formalistic approach towards assigning such control rights. However, an issuer is always able to create an equity-like financial position which, from a corporate law perspective, does not make the holder of the instrument a shareholder. This is the case of the economic owner of firm who does not hold voting rights. This can also have important regulatory consequences affecting third parties, since creditors' protection rules such as the rules on share buy-backs can effectively be disapplied by the company. Likewise, shares can also be structured in a way that closely resembles debt instruments, conferring control rights on parties with no (real) residual claim. In other words, by using hybrid financial instruments, parts of the mandatory corporate law can

effectively be side-stepped, leading to a more flexible framework within which a company can reach a bargain with its investors than envisaged by the legislator.

While it is clear that regulatory arbitrage is currently the main driver behind the use of hybrids, the question remains whether such instruments can fulfil any useful economic function besides granting companies additional flexibility as to the applicable legal regime. As described in Part II, hybrids do indeed play an important function in areas such as private equity and venture capital where parties rely on complex allocation of financial rights and decision making rights and where plain vanilla debt and equity instruments are incapable of providing the economic exposures the different investors want to create. In order to assess the role of hybrids the thesis develops a functional approach that focuses on the economic logic of corporate law. Often hybrids have been analysed in relation to one or some of their features but never in context. Since economic theories have evolved with the development of the corporation, the analysis of corporate structure and in particular of its financial instruments must also be adjusted. The functional approach not only stresses the agency problems at the core of corporate law but also integrates the theories of the firm on transaction costs and property rights studies. Accordingly, it shows that hybrids can be written as compensation contracts to align the *ex ante* incentives of managers and investors and therefore reduce agency costs, while at the same time being stipulated as contingent to critical strategic events and to the achievement of the firm's objectives in order to provide investors with a flexible governance mechanism of *ex post* regulation or measurement during the life of the firm. The study deals with various typologies of preference shares and convertible bonds. The definition of hybrids also includes debt with covenants, which may constrain management discretion.

8.1. The rationale for hybrids and implications for corporate governance

The first conclusion derived from the analysis contained in this study highlights an important rationale for the use of hybrid instruments, that is the firm's need to allocate control and cash-flow rights in a way that diverges from the classic allocation resulting from equity and debt. This need is evident in private equity and venture capital transactions where hybrid financial instruments play an essential role in financing innovation. In particular, these advantages are observable in situations

of economic integration, when two firms, usually an established corporation and a small research-intensive firm or a start-up, consider an R&D alliance or develop a contract together. The small firm has the know-how but may not have the funds or the ability to commercialise the innovation itself. Hybrids can be stipulated as compensation contracts to align the incentives of managers and investors. Performance can be tied to several measures and compared to various benchmarks. It is possible to include commitments to contract for R&D on specific topics, milestone payments contingent on the achievement of technological and marketing objectives or renewal of the agreement and a royalty on the eventual sales generated by the product. In addition, hybrid instruments empower compensation schemes and give investors an incentive to get involved in the business and monitor the firm closely, because a specific allocation of the cash flow is linked to certain performance records. In this way, entrepreneur and investors ensure that appropriate decisions are taken and that suitable progress is being made.

There is a strong rationale for convertible instruments and debt with restrictive covenants in a firm's reorganisation and restructuring because they largely reduce the agency costs of debt, which are caused by the incentive of the directors to engage in transactions that lower the value of the firm but nevertheless increase shareholder wealth by shifting wealth from bondholders to shareholders.

However, these advantages do not come without costs. The fact that funds in private equity and venture capital are constrained with respect to time and capital creates costs of wealth expropriation. These costs result in dilution for the investors. On one hand stands the need of the founder investor (angel) not to be excessively diluted in terms of control and financial rights; on the other is the danger that an excess of veto rights could hinder the firm's capitalisation. In the case of firms raising finance through an issue of convertibles, where information disparities exist over issuance of these securities, it is reasonable to acknowledge the desirability of a conversion adjustment. Using price-based methods of anti-dilution is a common way to avoid the outright expropriation of value from the convertible-security holders to the common stockholders. However, a commonly used market-based adjustment may not always be the solution because it relies on an initial conversion price set with admittedly faulty information. In some situations conversion-adjustment formulas provide protection that is inferior to other alternatives. For instance, in young growth-oriented high-technology based firms, investors may suffer not only

from economic dilution, but also from the dilution of ownership interests. This dilution occurs in situations of financial distress when an entrepreneur-manager decides to raise additional finance that the existing investor is not able or willing to invest.

In fact, a new investor entering the firm's capital at that point may bargain and obtain better conditions and a discounted price. This dilution may also occur when an entrepreneur-manager, holding control of the board, decides to sell the company or its assets to a third party. If the entrepreneur has the power to sell the firm, they may accept a price that rewards their efforts but which may be at a loss for the investor who has contributed finance in several tranches. Since it is very difficult to establish *ex ante* whether minority shareholders such as preference shareholders will be disadvantaged by the sale of the controlling block, the regulatory choice hesitates between reliance on general corporate law to protect the minority against unfairness in the future and giving the minority an exit right at the time of the control shift through the use of the mandatory bid rule.

The usefulness of hybrids in private equity and venture capital is most evident in control transactions, where hybrid instruments present an optimal compromise to the firm's need of a bespoke capital structure able to allocate efficiently cash-flow rights and control power for exit decisions. In these situations, investors have to address the principal-agent problems that arise when a potential bidder attempts, through offers to the company's shareholders, to acquire sufficient voting shares to control the company. The acquirer may collude with one of the initial contracting parties to extract a surplus from the other. Two main types of opportunism are discussed – the expropriation of the entrepreneur's private benefits of control and asset-stripping at the expense of the existing (venture capital) investors. Accordingly, an outside investor could take over a firm, which is performing well and fire its entrepreneur if he does not have the right to sell control of the firm without compensating him for his private benefits. Alternatively, an outside investor could acquire a firm that is near insolvency or performing badly for a small price and take assets out of the firm without paying their full market value, therefore harming the interests of the existing investors, if their financial rights are not protected contractually or they do not control the firm. The parties have to resolve distributional conflicts and make use of the right to sell control in the event of a future sale of the firm. It is essential that whoever has the power to sell, takes the decision that is most efficient for all parties. This is possible with hybrid instruments,

because they provide an asset-specific governance system. In fact, financial contracting on observable, if not verifiable, events, milestones or objectives, allows an efficient allocation of propriety rights between the parties so that crucial decisions are always taken by the party that has the best incentive to maximise the firm's value. Critical control mechanisms, such as the right to approve or oppose important decisions for the firm, need to be effectively allocated in any relationship between an entrepreneur and investors. Thus, contract design of hybrid instruments anticipates the uncertainty existing in the business by preserving the flexibility to terminate the contract if input costs rise to the point where they exceed the output benefits. Hybrids' contractual features, which may either set performance obligations or define contingencies, reduce the *ex post* costs of litigation, facilitating the provision of efficient incentives and the signalling of private information at the time of contracting and renegotiation. Since most of the provisions included in hybrid instruments are performance-related or contingent to observable but not verifiable events, the parties will prefer to bargain for a solution that maximises the common benefits instead of supporting costs of litigation with uncertain results.

Transaction cost economics and property rights theory both focus on the role of ownership in supporting relationship-specific investments in a world of incomplete contracting and potential hold-up problems. The property rights approach put a strong accent on incentives driven by ownership when investigates how control rights should be allocated efficiently in a firm. The capital structure impacts the governance structure of the firm and it can thus be viewed as a mechanism for dealing with incentives and hold-up problems.

8.2. Legal strategies for protection: the need for regulation or more flexibility?

Another important aspect of this thesis is its focus on the analysis of investor protection in relation to holders of hybrid securities. Hybrids as a tool of corporate finance ought to offer to particular investors the certainty of entitlements, while at the same time allowing businesses a more flexible allocation of equity or debt like cash-flow rights as well as control rights. For example, through hybrid issues the firm can raise additional funds without diluting the voting rights or the amount of final surplus distributable in liquidation. At the same time, the firm does not necessarily incur the risk of insolvency if it fails to satisfy the financial entitlements

of its hybrid holders. This element features prominently in banking regulation, where the use of hybrids often primarily tries to achieve a more robust financial position without forcing institutions to raise traditional equity.

Conversely, investors subscribing to convertible bonds or preference shares accept a lesser degree of control and long-term commitment on the part of the issuer in exchange for more extensive financial entitlements. Although the nature of a preference share has never been declared by the courts, the rights attached to a particular class of shares have traditionally been considered contractual in nature. In some respects, this has made the status of a preference share more like that of a bond than an ordinary share. However, as emerges from the historical analysis in this thesis, the position of preference shareholders vis-à-vis the firm has often given rise to a number of grounds for dissatisfaction in the past. Companies in need of finance often raised funds in the forms of preference shares promising the investors higher returns that never materialised, because once the economic conditions became favourable again the law – and imperfect contracts – opened several avenues to opportunistic behaviour on the part of the issuer. Companies sometimes were able to effectively cancel dividends in arrears, freeze out preference shareholders when the economic outlook became rosier, or force them to surrender their class rights.

Nowadays, the UK courts seem to have reached a definitive canon of construction regarding the rights attached to preference shares. Shareholders in UK firms have a strong legal position vis-à-vis the firm regarding changes of a firm, including merger and major restructurings. This somewhat contrasts with the situation in the US, where preference shareholders are offered less protections as a separate class and it is still unclear whether or not directors owe them fiduciary duties. However, US law arguably provides stronger protection to minority shareholders in general – whether they hold ordinary shares or preference shares – by providing exit rights in the form of appraisal rights.

In UK law, minority shareholders, including preference shareholders, are protected by the regulation of class rights variations and the unfair prejudice provisions. In addition, the Companies Act confers a right on dissenting shareholders holding no less than an aggregate of 15 per cent of the issued shares of the class in question to petition the court for an annulment of changes to class rights. This remedy, however, shows important weaknesses, given the self-restraining approach taken by the courts when deciding what constitutes a variation of a class right. The

distinction between rights affected as a "matter of law" and as a "matter of business", and the notion that losses of the *enjoyment* of rights are not the same as losses of the *right itself* often lead to incomplete protection of preference shareholders' interests. This is particularly true in the area of private equity and venture capital, where changes affecting the enjoyment of a right as a matter of commercial reality may completely change the original bargain and severely modify the incentives.

Likewise, the UK law allows minority shareholders including preference shareholders, who believe their interests are being prejudiced by the behaviour of the majority shareholders, to file a petition for unfair prejudice. British courts have developed a technique for encouraging an agreed solution to unfair prejudice claims by allowing the minority to have their shares liquidated at a fair price. This approach allows the courts to leave directors with the discretion to manage the company's affairs without interfering excessively. However, this remedy has proved to be very time-consuming, burdensome and expensive. In the fast-moving world of the high-tech industry, where hybrid forms of financing are particularly prevalent, this remedy does not seem to constitute an adequate solution to the problems identified here. Moreover, determining the "fair price" of an immature business is a difficult – and sometimes impossible – task, which further questions the ability of the unfair prejudice remedy to resolve conflicts between hybrid holders and the controllers of the business.

Finally, both the UK and US legal systems rely on the judiciary to oversee transactions associated with structural changes to the corporation, particularly in relation to mergers. Two different doctrinal paths have emerged in these two legal systems. The US approach is more protective of the prerogatives of management and assigns to them the decision on the control transaction but gives to the target shareholders a veto over the transaction. Conversely, the UK scheme of arrangement regulation is more shareholder-centred and leaves to the shareholders the decision-making on control shifts with little use of appraisal rights and veto rights.

In relation to takeovers, the UK has effectively delegated the task of protecting shareholders to the Takeover Panel (whose jurisdiction also includes schemes of arrangements). Notably, the Takeover Panel takes a less formalistic or legalistic approach compared with the court-based protection of (preference) shareholders. It also addresses the issues arising from control transactions in real time, imposing

little or no delay on the transaction. This standards strategy does not impede a preferred shareholder from bargaining for additional protection in the form of contractual clauses. However, according to the equity- or debt-like nature of the hybrid contract the Takeover Panel retains the right to decide whether a class of preferred shares has to be included in the group of relevant "shares" for an offer. Doing this, the Panel adopts a far more *functional* approach to the classification exercise than we examined in other legal areas.

It is legitimate therefore to wonder whether the protection of preference shareholders, whose contribution fulfil much of the same function as traditional equity financing (they are subordinated to all creditors in liquidation as the ordinary shareholders and have no certainty of a periodic interest), should be a mandatory matter of company law outside the takeover context, too, or whether this should simply be left to the parties' freedom of bargaining.

This, in effect, is a question about the legislator's trust in the efficient functioning of the market. To the extent markets are efficient, and investors act rationally, the answer to any such concern could simply be that hybrid securities are priced in anticipation of future opportunism, and hence any materialisation of such anticipated opportunism does no harm to the investor.

If one doubts such a smooth functioning of the market, which arguably requires a sophisticated understanding of the intricacies of the law by (institutional) investors, the obvious question is whether hybrid holders are offered enough protection under the current law.

The findings described in this thesis are twofold. Holders of preference shares seem to be under-protected, creating some scope for opportunism on the part of the issuer. Both institutional investors and the London stock exchange discourage the use of preference shares, mainly because of this imperfect protection the law offers.[608] This in itself seems to partly rebut the "right price – no harm" argument made above. Where, in addition, institutional investors shy away from non-voting preference shares, and such instruments are primarily held by less sophisticated individual investors, the case for increased protection is further strengthened.

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[608] See Brennan, M. and Franks, J., 'Underpricing, Ownership and Control in Initial Public Offerings of Equity Securities in the U. K.' 45 Journal of Financial Economics, 1997, 391 (395).

Holders of convertible bonds, on the other hand, do not seem to lack relevant protection. The underlying conflicts here are essentially the same – opportunism by the issuer – but the problems naturally revolve around the conversion privilege. Corporations are not static. Their capital structure changes and the share of stock of today, while legally an identical unit with the share of yesterday, may represent an investment in an entirely different commercial entity tomorrow. Between the time of issuance of the convertible bond and the vesting of the conversion right shareholders – and managers – have an incentive to develop the business in a way that allocates a larger-than-expected part of the company's cash-flows to their current shareholders. A simple example would be a dividend payment, which essentially devalues the conversion right, while benefitting the issuer's current shareholders. While this case could relatively easily be dealt with in the bargain, many other corporate actions with an impact on the value of the conversion right are harder to anticipate. The problem can thus be seen as one of incomplete contracts.

However, rather than abandoning convertible securities because of these problems, practice has developed in a direction which can be regarded as over-protective. Lacking the ability to anticipate the exact avenues of future expropriation, convertible bond holders often bargain for extensive (negative) control rights to secure their position, arguably granting them a higher degree of influence over the issuer's business than would be justified based on their economic exposure. Technically, this (over-)protection is typically achieved through the use of restrictive covenants.

This is especially relevant in the realms of private equity and venture capital, where the business evolves in conditions of particular uncertainty. Here, the main concern is economic dilution. Convertible bondholders use a standardised set of anti-dilution clauses to protect their rights to address these problems. However, not all the issuances of new shares are a cause of value dilution and restrictions on the managers' discretion can come at a cost. Ideally, covenants would distinguish between truly dilutive issues and those that merely reflect market information about the issuer. However, any assessment of the dilutive effect of subsequent rounds of financing necessarily depend on the knowledge of (or agreement on) the company's fair value. As mentioned above, a consensus on the fair value will often be hard to achieve, particularly in relation to immature businesses or financially distressed companies in transitional phases trying to turn-around their fortunes.

The causes for disagreement between holders of ordinary and preference shares, as well as shareholders and convertible bond holders, do not always stem from opportunism. Often they can simply be found in a disagreement about the firm's strategy. While the parties may have agreed on a business strategy *ex ante*, this may change as the business develops and conditions change *ex post*. This adds to the disputes arising from the opportunism of the parties in corporate agency relations. In these situations, the protection of hybrid holders – originally developed to address concerns about opportunistic behaviour – suddenly has wider implications. Where certain hybrid holders are found to be over-protected, which as described is a strategy to resolve the problems created by incomplete contracts, the protective covenants may enable them to substantially influence the business decisions of a corporate venture, particularly where they effectively have a veto right in relation to *all* possible responses to changed economic conditions. This, in turn, may lead to opportunism on the part of the hybrid holders, who may have an incentive to only agree to transactions that distribute a disproportionate part of the possible gains to them. Hence, the risk of opportunism exists on both ends of the bargain.

Surely no court or any third party is better positioned than the parties to *design* the arrangements best suited to govern their relationship. This does not mean, however, that there is no role for courts to resolve conflicts arising from unexpected developments after the investment has been made. This is acknowledged by UK company law, where additional discretion is vested in the courts in the form of the unfair prejudice remedy and the procedure in s 633 CA 2006 regarding the variation of class rights.

In the UK and especially US, the contractual design in the practice of the markets has seen extensive use of drag-along and tag-along clause and even explicit veto rights, giving preference shareholders or convertible bond holders wide discretion in relation to corporate policy. Arguably, this development should be met by courts taking a more active role, even if this means that the traditional self-restraint of judges in relation to business decisions may suffer.

On this basis, it can also be discussed whether some common forms of hybrid financial instruments should be standardised. In my opinion, a less flexible regulatory framework could impede financial innovation and impose obstacles to the parties' incentives to devise the terms that will best protect their interests, suit their

circumstances and redesign governance mechanisms to reflect the changing economic environment. The contractual design of hybrid financial instruments is the optimal way to fill the vacuum voluntarily left by mandatory company law in favour of a major flexibility in the market and a more business-friendly legal system.

Standardisation may also take the form of default, rather than mandatory rules. Pure default rules would not, however, stifle innovation. In fact, they could reduce transaction costs and add to legal certainty by broadening the scope of application of court decisions dealing with standardised terms. With added legal certainty and a more balanced distribution of rights and financial entitlements, there is scope for hybrid financial instruments to play a more important role outside the realm of regulatory arbitrage, allowing market participants to fully realise the potential of a more flexible allocation of financial entitlements and governance rights.

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