LSE Research Online

THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

Sarah Paterson

The paradox of alignment: agency problems and debt restructuring

Article (Accepted version) (Refereed)

Original citation:
Paterson, Sarah (2016) The paradox of alignment: agency problems and debt restructuring. European Business Organization Law Review, 17 (4). pp. 497-521. ISSN 1566-7529

DOI: 10.1007/s40804-016-0056-9

© 2016 The Author

This version available at: http://eprints.lse.ac.uk/65327/

Available in LSE Research Online: November 2016

LSE has developed LSE Research Online so that users may access research output of the School. Copyright © and Moral Rights for the papers on this site are retained by the individual authors and/or other copyright owners. Users may download and/or print one copy of any article(s) in LSE Research Online to facilitate their private study or for non-commercial research. You may not engage in further distribution of the material or use it for any profit-making activities or any commercial gain. You may freely distribute the URL (http://eprints.lse.ac.uk) of the LSE Research Online website.

This document is the author's final accepted version of the journal article. There may be differences between this version and the published version. You are advised to consult the publisher's version if you wish to cite from it.

http://eprints.lse.ac.uk

Traditional agency theory predicts that when a large company is trading solvently shareholders will align their interests with those of the directors, but that this may also mean that when the company is financially distressed directors will prefer shareholder interests to those of the creditors (even if there is no residual value for the shareholders in the company). Both the law and the market respond to this problem, and to date the situation has been held in some sort of approximate balance. However, this article examines the consequences of alignment of shareholder and director interests when a large private equity company is in financial distress, in light of the debt restructuring which is likely to be in contemplation and the type of director who is often retained. It argues that in these cases directors may have an incentive to support creditors' debt restructuring plans and, paradoxically, the closer the alignment of their interests and those of the shareholders when the company is trading solvently, the greater this incentive to prefer creditors may be (even if there is still a residual interest for the shareholders in the company). The implications of this for the law and for the market are explored.

Keywords: Directors' duties; insolvency; debt restructuring; board composition; private equity; law and finance

1 Introduction

Considerable ink has been spilt, over a considerable period of time, on the question of whether, and the extent to which, the law should intervene to regulate the duties of directors. Part of this literature focuses on so-called agency problems in large and larger mid-cap companies. An agency problem may arise when a person (the principal) is reliant on another (the agent) to perform some role on its behalf and the interests of the principal and the agent diverge, so that the agent is not motivated to act in the principal's best interest. The literature on agency problems in large (ordinarily publicly traded) companies is itself divided into two distinct strands. First, the literature explores the problems which may arise if shareholder and directorial incentives are not aligned when a solvent company is trading, the costs which this may generate and the role which the law

can play in reducing these costs by aligning shareholder and director interests.[1] The second strand of the literature explores agency problems which can arise between shareholders and creditors when a company is in financial distress, the costs which can arise and the role which the law can play in reducing these costs by protecting creditor interests when there is a doubt that all claims will be repaid.[2]

Most of the literature analyses the relative merits of controlling directorial behaviour in distress on the assumption that shareholders will take steps to align their interests with those of the directors when the company is trading solvently, with the result that directors may prefer shareholder interests in financial distress. Indeed, in this view, the greater the alignment of shareholder and director interests in the good times, the greater the risk directors will prefer shareholder interests over creditor interests in financial distress, even when shareholders have no residual economic interest in the company. Although scholars disagree over the extent of the issue, the appropriate solutions to it, and whether other considerations prevail, [3] most seem to consider it the issue at hand.

This article reveals a more complex account in modern financial markets, and argues that, in certain cases, directorial incentives now militate against shareholder interests, in favour of creditor-led restructuring plans and creditor interests in financial distress. Moreover, and perhaps paradoxically, it argues that the greater the alignment of shareholder and director interests in the good times, the greater this preference for creditor-led restructuring plans in distress may be. Using the English market as an example, it develops a more nuanced account of agency problems and agency costs in modern debt restructuring, implicating not only shareholders, directors and creditors but also complex relationships between directors and shareholders, senior and junior financial creditors, and (perhaps intuitively unlikely) director/shareholder/creditor alliances.

[1] For an excellent overview and analysis see Enriques et al.(2009)
[2] For an excellent overview and analysis see Armour et al. (2009)
[3] In particular, as to whether the market mechanisms available to stakeholders to control for these agency problems offer sufficient protection, or whether legal intervention is also necessary. See, e.g., Keay (2003)

The article proceeds as follows. It begins with a review of the existing literature on the shareholder-director incentive problem in publicly traded companies, and the traditional English legal and market response. It explores how this relates to the so-called shareholder-creditor agency problem which arises when one of these companies is in financial distress, and the traditional response of English law and the market to this issue. It then examines the private equity model of share ownership, and analyses the impact of this model on directorial behaviour. It explores a more complex web of shareholder/creditor/director relationships and revisits the connection between the steps taken by shareholders to address agency problems in good times and directorial incentives in distress. Having considered the impact of both the new agency analysis and the new market environment on the traditional view, the article makes some recommendations for law and for the market. The article then concludes.

2 The Traditional View

2.1 The Shareholder-Director Agency Problem

In their seminal 1932 book, Berle and Means identified the wide spread dispersal of share ownership in US firms, and the separation of the owners from the managers who ran the businesses but had a negligible ownership interest in them.[4] This wide dispersal of share ownership occurs to a greater extent in some jurisdictions than in others, but it occurs in all developed economies to some extent.[5] Two problems present themselves. First, an agency problem may arise where shareholder and directorial incentives are not aligned. Shareholders seek wealth in the stock market, while directors seek utility in the labour market. Thus directors may have a preference for "perks" such as a fast car or lavish client entertainment, for leisure activities rather than hard work ("shirking"), for a lower level of risk than shareholders (because their human capital is all tied up in one firm) or for different time preferences than shareholders (short term rewards rather than long term return – although

[4] Berle and Means (1933)
[5] Wymeersch (2013), at p. 124

this last is controversial).[6] Secondly, if share ownership is dispersed, it gives rise to a problem of collective action in controlling the agent directors.[7] As soon as share ownership is spread amongst a wide group, different actors may have different preferences giving rise to a problem of coordination.

English company law offers a variety of mechanisms to deal with these agency problems.[8] For example, section 172(1) of the Companies Act 2006 provides that a director must act in the way he or she considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, having regard to the non-exhaustive list of factors set out in the section. The Companies Act also imposes other relevant duties on directors,[9] and enables a simple majority of shareholders to vote to remove a director.[10] These rules seek to incentivise directors to have regard for the interests of their principal (the shareholders) in two ways: first, by threatening court-imposed sanctions if shareholder interests are ignored and, secondly, by providing shareholders with the power to remove recalcitrant directors.

Nonetheless, in practice, the English courts have remained reluctant to interfere in commercial decision making on a number of grounds: that judges have neither sufficient experience nor knowledge to decide commercial matters;[11] that judicial interference will slow up the pace of commerce; that it is important for the commercial world to know that decisions which are reached will not be upset except in the clearest of cases; and that commercial decision making often requires a balancing exercise between competing considerations which the court should not interfere in.[12] Moreover, the *Charterbridge* test requires that in determining whether the director has acted in the best interests of the company the English court will ask itself whether the director acted in what the director, rather than the court, thought to be in the best interests of the company, and that the

[6] This list is taken from Molho (1997), at p. 120-121
[7] Olson (1971); Buchanan et al (2004)
[8] See Armour, Hansmann and Kraakman (2009)
[9] Companies Act 2006, s 171(b), s 172(1), s 173(1), s 174(1), s 175(1), s 176 and s 177
[10] Companies Act 2006, s 168
[11] *Lesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch); [2010] BCC 420, at [85]
[12] *Cobden Investments Limited v RWM Langport Ltd, Southern Counties Fresh Foods Limited, Romford Wholesale Meats Limited* [2008] EWHC 2810 (Ch), at [754]

question for the court to consider is whether the director honestly believed that his or her act or omission was in the best interests of the company. Only if the director failed to turn his mind to a relevant factor, or the court does not believe the director's assertions, will the court apply an objective standard.[13] Thus, often, "law stays at the margins of what boards are doing by focusing on formalities, process and liability",[14] so that there are limits to the effectiveness of English commercial law in eliminating agency problems. Exercise of shareholder powers such as removal, on the other hand, requires both coordination and observation of the behaviour complained of. Both of these may prove challenging.

As a result, shareholders in large corporates in England have not relied entirely on the law to control agency problems, but have developed their own mechanisms to influence directorial behaviour. Two of these are particularly relevant to our account. First, large listed companies do not necessarily seek directors based on particular industry expertise, but rather based on their skills in communicating with investors and the market.[15] Indeed, Dave Lewis, the current chief executive of the English supermarket chain, Tesco, proudly announced "I've never run a shop in my life" on his appointment.[16] Executive directors in large UK listed companies are often what we might call "professional" directors: directors who do not see their career progression in terms of a particular sector or business, but rather in terms of progressing through the ranks of listed companies. A small group of so-called institutional investors (mainly pension funds and insurance companies) has traditionally exerted substantial control over these listed company directors.[17] Although the mix of shareholders in listed corporate Britain is changing rapidly, already encompassing a far more diverse range of institutional shareholders, such as overseas investors, hedge funds, activist investors, sovereign wealth funds and others,[18] a core group of institutional domestic shareholders remains a

[13] *Charterbridge Corp. Ltd v Lloyds Bank Ltd* [1969] 3 WLR 122
[14] Winter and Van de Loo (2013), at p. 228
[15] Stapledon (1996), at p. 101-106 and p. 117-121
[16] Wood (2014)
[17] Stapledon (1996), at pp 33-53
[18] Office for National Statistics (2012)

regular investor in the market.[19] Directors of UK listed companies expect to have repeated interactions with these key players throughout their professional lives, and to focus on their reputation with this influential cohort.[20] Thus concern for reputation in the market for directors strongly incentivises the UK listed company executive director to focus on shareholder value.

UK listed companies also retain professional, non-executive directors (often referred to in the literature as "independent" or "outside" directors). These directors are appointed for the purpose of remaining independent of those involved in the management of the firm.[21] They will usually have a portfolio of interests, and will perform this role on each of the boards on which they sit. These non-executive directors are also highly motivated by concerns for their reputation with shareholders. They expect to rotate through a number of appointments as they vacate seats on boards at the end of their term, and are dependent on reputation for their ability to gain another appointment. In the listed company space, given that they are likely to be dependent on the Chairman and Chief Executive for an appointment,[22] a record of looking after shareholder interests is likely to be an essential qualification for recruitment. They are also likely to serve on other boards, and to be concerned with reputation insofar as it affects their other positions.

The second market control mechanism for the shareholder/director agency problem relevant to this account is close alignment of incentives through pay. There are two principal forms of incentive alignment through pay. The first is to continue to pay the director in cash, but to tie a percentage of the pay package to results (performance pay). The second is to give managers shares in the company in addition to salary and cash bonuses.[23] In this way, management's incentives are aligned closely with those of the shareholder body, and management is motivated to act in the shareholders' best interests. Although executive compensation generally, and equity compensation

[19] Wymeersch (2013), at p. 115

[20] Stapledon (1996), at pp 79-154 provides a detailed account of institutional shareholder involvement in the UK

[21] Hansmann et al. (2009), at p. 55

[22] Stapledon (1996), at p. 139 and p. 143

[23] Molho (1997), at p. 122, listing a system of bonuses, profit sharing, profit-related pay, payment by commission or linking pay to the company share price

schemes in particular, have been the subject of critical enquiry recently, and may create their own agency issues in healthy companies,[24] they remain an important plank in the bastion against directorial self-interest.[25] In their path finding work in the 1970s Jensen and Meckling described the sum of reputational bonding and monitoring expenditure, and the residual loss which arises to the extent that directorial self-interested behaviour is not completely eliminated, as "agency costs".[26]

2.2 The Shareholder-Creditor Agency Problem

Close alignment of shareholder and directorial interest through reputational bonding and incentive pay generates another agency problem, this time between shareholders and creditors, when a company is distressed.[27] When the company faces financial trouble, directors' alignment with shareholder interests may cause them to take ever more reckless action in an attempt to turn things around: action which may also be in the best interests of shareholders who will have no residual interest in the company if it becomes insolvent, but which will not be in the best interests of creditors. This excessively risky behaviour may impose costs on the company and its creditors if it is not eliminated.

English common law responds to this problem by imposing a shift in the duties of directors, when a company is financially distressed, from acting in the best interests of shareholders towards acting in the interests of creditors.[28] Whilst the comparatively recently codified duties of directors of a company incorporated in England and Wales require the directors to promote the success of the company for the benefit of its members, section 172(3) of the Companies Act 2006 preserves the

[24] Bebchuk et al. (2002), at pp. 751-846; Bebchuk and Fried (2004)
[25] Bozzi et al. (2013), at p. 298
[26] Jensen and Meckling (1976), at p.304
[27] Jensen and Meckling (1976), at p. 345
[28] See *Lonrho Ltd v Shell Petroleum Co Ltd* [1980] 1 W.L.R 627; *Re Horsley & Weight Ltd* [1982] 3 All E.R. 1045; *Winkworth v Edward Baron Development Ltd* [1986] 1 W.L.R 1512; *Brady v Brady* (1988) 3 B.C.C. 535; *Liquidator of West Mercia Safetywear v Dodd* (1988) 4 B.C.C 30; *Facia Footwear Ltd (in administration) v Hinchliffe* [1998] 1 B.C.L.C 218*; Re Pantone 485 Ltd* [2002] 1 B.C.L.C 266; *Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd* [2002] EWHC 2748 (Ch) ; [2003] 2 B.C.L.C 153*; MDA Investment Management Ltd* [2003] EWHC 2277 (Ch); [2005] B.C.C 783; *Bilta (UK) Ltd v Nzir* [2015] UKSC 23; [2015] 2 W.L.R. 1168 at [123]-[126]

common law requirements to consider the interests of creditors when the firm is distressed.[29] The English common law position is supported by statute, particularly section 214 of the Insolvency Act 1986 and the Company Directors Disqualification Act 1986. Section 214 of the Insolvency Act 1986, known as the wrongful trading test, provides that a director may be personally liable if he or she should have known that the company had arrived at the point at which there was no reasonable prospect it would avoid insolvent liquidation, and he or she did not then take every step with a view to minimising potential loss to creditors.[30] The standard prescribed is that of the reasonable director, enhanced by any particular knowledge, skill and experience of the director in question.[31] The disqualification regime threatens miscreant directors with disqualification from acting as a director for a period of between 2 and 15 years.[32]

Once again there are significant enforcement challenges. Insofar as the common law duties are concerned, the English courts have continued to be aware of the risk of intervention in commercial decision making, not only for all the reasons already identified but also, in this area, specifically because of the risk of hindsight bias. Thus they have commented that it is not the function of the court to second guess the decisions which businessmen take in the moment,[33] and have made clear that they will approach the duties of directors of a financially distressed company in the same way as the *Charterbridge* approach discussed above.[34] In other words, provided the director adduces evidence that he or she was acting in good faith, and turned his or her mind to the question of creditor interests, the decision will not be impugned. Moreover, it is not clear precisely

[29] Providing that the duty to promote the success of the company "has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company"
[30] Insolvency Act 1986 s. 214(2) and (3)
[31] Insolvency Act 1986 s. 214(4)
[32] Company Directors Disqualification Act 1986, s.6(4)
[33] *Re Sherborne Associates Ltd* [1995] B.C.C 40, at [54]
[34] *Re Regentcrest plc v Cohen* [2001] 2 B.C.L.C 80, at [120]

when the duty to creditors arises,[35] and, when it does arise, whether it supplants or joins the duty to shareholders.[36]

Furthermore, in the case of wrongful trading, it is challenging to establish when the duty to avoid wrongful trading arises, what it is that the directors should conclude and how the "reasonable prospect" test should be applied, so that in reality great weight will be put on the written record for the purposes of assessing liability under section 214 of the Insolvency Act 1986. Moreover, the general approach to contribution appears to be compensatory rather than penal and, until recently, claims were limited to only certain types of office holder (liquidators), who frequently faced practical difficulties in raising finance to bring a claim, so that the benefits of a claim might not easily be said to outweigh the risks.[37] Notwithstanding reform in the Small Business, Enterprise and Employment Act 2015, enabling other office holders (administrators) to bring wrongful trading claims as well as

[35] The cases have variously described the duty as arising when the company is of "doubtful solvency" (*Re Horsely & Weight Ltd* [1982] 3 All E.R. 1045 at [442]; *Brady v Brady* (1987) 3 BCC 535 at 552; *Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd* [2002] EWHC 2748 (Ch); [2003] 2 B.C.L.C 153, at [74]); "near-insolvent" (*The Liquidator of Wendy Fair (Heritage) Ltd v Hobday* [2006] EWHC 5803, at [66]); "on the verge of insolvency" (*Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd* [2002] EWHC 2748 (Ch); [2003] 2 B.C.L.C 153, at [74]);"bordering on insolvency" (*Bilta (UK) Ltd v Nazir* [2015] UKSC 23; [2015] 2 W.L.R. 1168, at [123]); in a "very dangerous financial position" or "parlous financial state" (*Facia Footwear (in administration) v Hinchcliffe* [1998] 1 B.C.L.C 218); or in a "precarious" financial position (*Re MDA Investment Management Ltd* [2003] EWHC 2277 (Ch);[2005] B.C.C 783, at [75])

[36] It appears that when the company is insolvent the creditors' interests override the interests of the shareholders, and even before the onset of insolvency, English law mandates a strong shift towards creditor interests. In *Re MDA Investment Management Ltd* [2003] EWHC 2277 (Ch);[2005] B.C.C 783, at [70], Mr Justice Park indicated that when a company is in financial difficulties, although not insolvent, "the duties which the directors owe to the company are extended so as to encompass the interests of the company's creditors as a whole, as well as those of the shareholders". Mr Justice Lewison took a similar approach in *Ultraframe (UK) Ltd v Fielding* [2005] EWHC 1638 (Ch), at [1304]. In *Bilta (UK) Ltd v Nazir* (n 28) in the Supreme Court, Lord Toulson and Lord Hodge rather ambiguously stated that when the company is insolvent or bordering on insolvency the directors must have "proper regard" for the interests of the company's creditors, and, later, that the interests of the company "are not to be treated as synonymous with those of the shareholders but rather embracing those of the creditors". But other cases have indicated that creditors' interests are "paramount", and not only when a company is insolvent but also when it is doubtfully solvent (*Colin Gwyer & Associates Ltd v. London Wharf (Limehouse) Ltd* [2002] EWHC 2748 (Ch); [2003] 2 B.C.L.C 153, at [74]; *Roberts v Frohlich* [2011] EWHC (Ch) 257; [2012] BCC 407 at [85] and [94]; *GHLM Trading Ltd v Maroo* [2012] EWHC 61, at [165]; *Re HLC Environmental Projects Ltd* [2013] EWHC 2876, at [92]), and at least one leading English Queen's Counsel has suggested that this best summarises the current position in English law (Arnold (2015), at p. 51)

[37] For a more detailed review of the enforcement challenges see, for e.g., Keay (2005)

liquidators and entitling office holders to sell wrongful trading claims, scholars wonder whether incentives to bring claims will be increased.[38]

We also find the disqualification regime beset with enforcement challenges. Disqualification is a state-enforced regime but the Secretary of State is reliant on information from office holders in deciding whether to act.[39] In their turn, office holders have limited incentives to be proactive given that no proceeds flow from a successful disqualification for the estate.[40] Judges have exhibited disqualification reticence in all but the most serious of cases (particularly where negligence is implicated),[41] and questions have been raised about Governmental resources to pursue disqualification cases.[42] Significant reforms to this regime are also being introduced through the Deregulation Act 2015 and the Small Business, Enterprise and Employment Act 2015,[43] although some of the underlying problems continue to subsist.

Nonetheless, whatever the odds of a successful claim, the professional executive or non-executive director in a UK listed company is unlikely to regard the risk of censure worth the putative benefit of excessively risky behaviour. Even judicial or state criticism is likely to have a significant impact on the ability for directors in this group to find work. Thus, whatever the enforcement weaknesses of the common law and statutory regime, the professional director is likely to take the regime seriously so that it will influence corporate governance in UK listed companies in the period of financial distress.[44] Listed company directors are also likely to be well-advised, and will thus be well-informed about the legal rules and their legal responsibilities. For all these reasons, directors of

[38] Williams (2015)
[39] Company Directors' Disqualification Act 1986, s. 7
[40] Finch (1992), at p. 194
[41] Finch (1990), at pp. 385-389
[42] Finch (1992), at p. 195 (discussing the role of the DTI; but the same criticisms have been made of the Insolvency Service, the executive branch of the Department for Business, Innovation and Skills, currently responsible for disqualification)
[43] Including Deregulation Act Schedule 6 Part 4 which provides the Secretary of State and the Official Receiver with the right to obtain information on director conduct from third parties, the Small Business, Enterprise and Employment Act 2015 s.106 inserting new factors to be considered in every disqualification case and the Small Business, Enterprise and Employment Act 2015 s.110 entitling the Secretary of State to apply to court for a compensation order or to obtain a compensation undertaking from a disqualified director
[44] Hicks (2001), at p. 442

UK listed companies are likely to be mindful of their legal obligations to creditors in financial distress, to some extent addressing shareholder-creditor agency problems.

Given, however, that English corporate law does not eliminate the shareholder-creditor agency problem completely, creditors have developed their own market mechanisms to reduce total agency cost. Jensen & Meckling highlighted the role of covenants imposed in the lending contract as a market control mechanism.[45] Through the covenants lenders can monitor firm performance and at an early sign of distress can bring management to the table, control their risk-taking behaviour and, if necessary, force the company into an insolvency process to realise the assets and distribute the proceeds. Thus creditors are able to strengthen their position through the lending contract. Following Jensen & Meckling, expenditure on negotiating covenants and monitoring, together with any residual loss to creditors to the extent excessively risk-taking behaviour is not eliminated completely, constitute the agency costs of debt. When the monitoring provisions of the lending contract are coupled with the shift towards creditor interests in English law they balance the strong incentives which UK listed company directors have to protect their reputation in the market for directors and to protect their equity value at risk, so that the benefit of these self-help steps in tackling risk-taking behaviour and reducing the residual loss to creditors makes it worth bearing the cost of taking them. Total agency costs are reduced and, overall, the system could be said to be in an approximate balance or equilibrium. But, as we shall see, new market changes may destabilise this delicate eco system.

3 Market Changes

3.1 Private equity

Thus far we have described only one type of large company with widely dispersed shareholders. However, since the 1990s the private equity industry has exploded onto the scene in the UK. The private equity firm regularly raises funds from widely dispersed shareholders. Each fund is invested

[45] Jensen and Meckling (1976), at pp. 337-339

in the private equity limited partnership (with the private equity firm providing the general partner). The limited partnership will acquire companies ("portfolio companies") either in public company takeovers or through auctions or private purchases, funding the purchase through comparatively small amounts of equity and significant amounts of debt (so that these purchases are known as leveraged buyouts or "LBOs"). The private equity firm then trades the business for a few years, with a view to selling it to a new buyer or re-listing it on the stock exchange, and returning a profit to the investors.[46] The private equity model thus transforms widely dispersed share ownership into a new form of concentrated share ownership.

The private equity director is often hired for his or her particular expertise in a given market.[47] There may not be a broad market for this director's skills, and attractive vacancies may emerge comparatively infrequently. His or her "payoff" may be highly dependent on the results of the particular firm in which the director invests time and effort, and the director may attach more weight to direct compensation than to reputation when compared with the professional director. Private equity houses are adept at aligning their interests and those of management in pursuing a clear business plan to achieve an exit from the investment in a relatively short period of time (often somewhere between 5 and 7 years after purchase),[48] and both parties are offered the prospect of a relatively quick but significant financial return.[49] Management in private equity situations are likely to have a significant proportion of their remuneration tied up in shares in the business, and often work with single minded focus toward the proposed exit. We might expect, therefore, to find the shareholder-creditor agency problem to be particularly acute when a private equity portfolio company is in financial distress. But, as we shall see, changes in restructuring practice produce new and perhaps intuitively surprising agency problems in these companies.

[46] Gullifer and Payne (2015), at p. 768
[47] Kaplan and Strömberg (2009), at p. 132
[48] Bratton (2008), 511
[49] Cheffins and Armour (2007), at pp. 7-9 and p. 27; Gilson and Whitehead (2008), at p. 235; Jensen (1989), at p. 69-70

3.2 Restructuring Practice

The traditional view of the shareholder-creditor agency problem in distress in widely-held public companies was developed at a time when a few large deposit taking or "clearing" banks provided the bulk of finance to corporate Britain.[50] Financial covenants in the lending agreement tested, on an ongoing basis or periodically, whether the borrower's financial health was being maintained (for example, by testing that balance sheet value was maintained at not less than a stated amount, or that the ratio of financial indebtedness to tangible net worth remained within prescribed levels).[51] If the testing process revealed that a financial covenant had been breached, the borrower and the lender(s) (ordinarily a single bank or a small group of banks) would meet to discuss what to do next. Typically, the banks would commission an accountancy firm to produce an independent business review (IBR) of the company's financial and operational position. The banks would then determine whether a restructuring was possible, or whether the company should be placed in a formal insolvency process and (ideally) its business and assets or (at least) its assets sold, and the proceeds distributed.[52]

Until comparatively recently, if a restructuring could be agreed in the UK it involved extension of repayment dates, relaxation of covenant levels or of other aspects of the testing regime and sales of non-core parts of the business in order to pay down some debt. Agreement would usually be reached out-of-court and by contract.[53] Where a restructuring could not be agreed, management failings were likely to be implicated in the collapse, for example because managers had expanded firms too quickly, had failed to recognise changed market conditions, had not demonstrated sufficient commitment to the business, or lacked knowledge or ability.[54] Directors knew that if measures could not be agreed, or were not successful, formal insolvency would follow,

[50] Armour et al.(2002), at pp. 1772-1773
[51] McKnight (2008), at pp.149-151
[52] Segal (1992), Ch. 8
[53] Armour and Frisby (2001), at p. 93
[54] Stein (1985), at p. 380

and they would lose their jobs and their equity in the company. Crucially, their currency in the market for directors would likely be depreciated, making it very difficult for them to secure another role. In other words, their incentives were closely aligned with those of the shareholders in preferring continuation of the company wherever possible, the shareholder-creditor agency problem was broadly as described in the first part of this article and the agency cost analysis holds good.

In the last decade private equity companies have raised more debt relative to the amount of equity which has been invested than a typical listed company.[55] Often this debt is divided into layers or "tranches", with some senior debt which commands a relatively low interest rate but which ranks first on an insolvency, and some debt ranking behind the senior debt on an insolvency (in other words, junior or subordinated to it) but commanding a higher interest rate.[56] During the recent recession many operationally sound companies struggled to meet large debt service bills, or found that they could not refinance at the same multiple of their earnings when their debt matured.[57] Whereas a traditional restructuring of a large corporate did not implicate a restructuring of its debt (other than, possibly, extending maturity dates or amending terms such as financial covenant testing ratios), in these highly leveraged situations the most obvious solution was often to swap some of the financial liabilities for equity. In this way, lenders retained a residual interest in the firm, and were able to capture any improvement in financial performance after the deleveraging, but the company was not saddled with ongoing debt liabilities which absorbed all of its free cash.

Moreover, a specialist market for investing in distressed situations is now well-established.[58] Distressed debt investors buy debt at a discount to the face value of the debt, with a view to profiting when a debt restructuring is in prospect or is implemented. As a result, if a traditional bank

[55] ABI Commission to Study Reform of Chapter 11 (2014), at p. 12. For more detail on the role of debt in private equity see Gullifer and Payne (2015), at pp. 788-790
[56] McKnight (2008), at pp. 882-884
[57] Takacs (2010), at p. 5-6
[58] Paterson (2014), at pp. 337-338

lender is not convinced by the case for a restructuring but the distressed debt investors are, the bank is able to sell its debt claim at a predictable loss rather than taking the risk of insolvency enforcement and sale. Once those who do not want to support the company have traded out, and those who see profit in a restructuring have traded in, the debt for equity swap can be implemented.[59] These distressed debt investors require timely and significant profit to meet the expectations of their own investors.[60] Some will sell quickly, once debt prices trade up on the prospect of a restructuring. Others will have a longer term plan to hold the equity and make significant profit by re-listing the company or selling it once the market or the business has recovered. But even these longer term investors will expect to achieve an exit in a comparatively small number of single digit years.

This new environment has several implications for the agency analysis. First, although the new environment brings new challenges (such as identifying who is holding the company's debt),[61] arguably the prospects for a successful rehabilitation of the business after a debt restructuring implemented via legal process are improved from the days when funding was provided exclusively by bank lenders and the only options were amendment of loan terms or a sale of the business and assets and distribution of the proceeds. Crucially, the debt-for-equity swap will immediately ease the company's liquidity pressures and will often free up cash for investment and growth. Directors may, therefore, see a debt restructuring as improving the company's prospects and, if they can retain their jobs, implicitly their own. Secondly, the cause of the financial difficulty is often an inappropriate capital structure imposed by the investors in the business and not the directors, so that the directors are not implicated in the company's problems.[62] Creditors may, therefore, be content for the directors to continue in post after the debt restructuring. Thirdly, it becomes necessary to value the business in order to determine how far down the capital structure equity

[59] Harner (2006), at pp. 70-119
[60] Harner (2006), at pp 103-104
[61] Howard and Hedger (2014), at p.298 para. 6.20
[62] Takacs (2010), at p. 24

should be distributed in the debt for equity swap, and in what proportions.[63] This valuation will be dependent on management's business plan and projections for the company,[64] and as we have seen, the English court pays deference to the commercial judgment of the directors. Finally, distressed debt investors will wish to align their interests with management in order to secure a successful exit, just as the original shareholders did before them. For all of these reasons, the directors may be offered a significant equity stake, ranking behind less debt, if the debt-for-equity swap is implemented.

Here is the nub of the matter. Whilst in the traditional analysis the director's only hope of making a recovery was to renegotiate the company's lending arrangements, retain his or her equity, ranking behind a significant amount of debt, and maintain his or her currency in the market for directors and thus the ability to be appointed to another listed company role, many modern debt-for-equity swap restructuring proposals may offer the industry-specialist director a more attractive solution. If the director takes the new equity on offer in the new restructuring, he or she will have a good stake in a deleveraged company ranking behind considerably less debt; possibly a once-in-a-lifetime opportunity to make a significant amount of money. English insolvency law does not prohibit this allocation of equity to the director, and the delicate balance maintained between shareholders and creditors in the listed company situation achieved through the incentive to retain equity and concern for reputation on one side of the scales and common law and statutory obligations to creditors on the other is fundamentally shifted. In many highly leveraged private equity situations, the director's equity stake is more likely to have value if the initial valuation of the business is as low as possible, so that as much debt (ranking ahead of the equity) as possible is written down.[65] There is little to incentivise a director to think about shareholders and/or junior creditors at all when market reemployment prospects might be low and his or her financial and career returns are best improved by backing the senior creditors' horse. This imposes new agency

[63] Clark (1981), at p.1252
[64] Paterson (2014), at p.353
[65] Howard and Hedger (2014), at pp.276-277 paras 5116-5.119

costs on the shareholders to the extent that the directors prefer the creditor-led restructuring plan and the low valuation which supports it, even where the shareholders may be able to argue for a residual economic interest in the company. In this situation, if the law mandates replacement of shareholder interests with creditor interests before the onset of insolvency, the scales are simply tipped more dramatically in favour of creditors. Paradoxically, the greater the extent to which shareholders have aligned their interests with those of the director through equity compensation when times are good, the greater the incentive the director will have to prefer a creditor-led restructuring plan (and a low valuation for the company) in distress.

We might expect that the private equity sponsor would rely on independent or nominee appointees to the portfolio company board to reduce total agency costs. As these directors rely on the private equity house for appointment and are unlikely to be offered compensation in a creditor-led debt restructuring they might be expected to favour the interests of the private equity sponsor over creditor interests, and to argue for a more optimistic business plan supporting a higher valuation for the company. However, in their survey Cornelli and Karakaş find evidence of few independent directors in private equity companies.[66] They cite Kaplan and Stromberg's suggestion that modern private equity firms "often hire professionals with operating backgrounds and an industry focus".[67] It is the case that sometimes the private equity sponsor will place its own nominee, or nominees, on the board of directors. However, Cornelli and Karakaş have shown that private equity firms will not always put a nominee on the board, because the private equity sponsor does not have limitless resource, and because there is a trade-off between the costs of making the appointment and the benefits of doing so.[68] Whether a nominee is appointed or not may depend, amongst other things, on the complexity of the case, the strategy for the investment and the approach to governance of the particular private equity house (Cornelli and Karakaş remind us that "it might be misleading to think about a private equity modus operandi with the assumption that all

[66] Cornelli and Karakaş (2012), at p. 12
[67] Kaplan and Strömberg (2009), at p. 32
[68] Cornelli and Karakaş (2012), at p. 20

private equity firms have the same approach").[69] Moreover, and significantly, Cornelli and Karakaş find a lower level of private equity sponsor nominees on boards where "leverage", or the ratio of debt to equity, is higher.[70] They tentatively conclude that these may be what they call "financial engineering deals": in other words, deals where success is dependent on the capital structure chosen for the acquisition, with high levels of debt at low rates of interest, rather than on bringing about operational change. Yet we also know that high leverage may increase the prospect that the company faces financial distress in the future.[71]

Significantly, Cornelli and Karakaş also show that where the sponsor does have a nominee on the board, management still tends to command more votes.[72] In other words, the private equity nominee does not control the board, and even if the private equity sponsor has appointed a nominee it is unlikely to eliminate the risk of self-interested decision-making by the majority of the board. If shareholders exercise their powers to remove directors once the company is distressed to address agency problems they risk prompting lenders to take action to accelerate their debt and seize control of the business through an administrator, notwithstanding that the covenant breach entitling the lenders to do so may fall far short of actual cash flow insolvency absent an actual acceleration. Moreover, nominee board members may become concerned about their personal liability in a legal architecture built around the concept of a shift in duty towards creditors, so that replacement nominees are likely to require expensive indemnities, if a candidate can be found at all.[73] And the shareholders expose themselves to arguments that they have acted as so-called shadow directors of the company and that they are also responsible for wrongful trading.[74] Overall, the cost of these steps to address the agency problem may be too high relative to the prospects of eliminating creditor bias in the board's decision-making process and, therefore, the anticipated

[69] Ibid., p. 3
[70] Ibid., p. 3
[71] Kaplan and Stein (1993), at p.347
[72] Ibid., p. 13
[73] Stapledon (1996), at pp. 125 -6
[74] Insolvency Act 1986, s 214(7)

reduction in the shareholders' residual loss.[75] As Easterbrook and Fischel explain, the "trick" is to hold total agency costs as low as possible.[76] If one agency cost does not reduce another which it is designed to tackle, or not by much, then it will not be worth taking.

New agency costs may also arise between different classes of financial creditor. Just as senior creditors, supported by the directors, may advance a low valuation for the company in order to grab the lion's share of the equity from the shareholders, so senior creditors and the directors may also argue that the valuation is such that the junior creditors no longer have an economic interest in the company. Junior creditors may not be able to control for this agency cost in their lending contract with the senior creditors at any price. This is because the senior creditors may only be willing to allow more debt to be raised on the basis that it is on subordinated terms, so it is likely that pursuant to the contact between the senior lenders and the junior creditors (known as the intercreditor agreement) the junior creditors will have passed to a specified majority of the senior lenders the power to control enforcement, until the senior creditors have been repaid in full, and, possibly, will have agreed that that the junior creditors will not enforce other rights (potentially even the right to receive interest) for a period of time.[77] This issue is exacerbated by the lack of authority around the meaning of "interests of creditors" in section 172(3) of the Insolvency Act 1986. Recent cases have conceptualised it as "creditors as a whole".[78] Yet the application of this standard is murky where more than one class of financial creditor is implicated, and leaves ample room for directors to justify a preference for senior creditor value as the first value at risk, where self-interest is in reality the motivating factor.

It is also worth mentioning in passing that the picture may be even more complicated than these two broad scenarios. In some cases the shareholder may regard its best chance of salvaging

[75] Stapledon (1996), at p.127 (discussing other types of intervention, but making the same point about risk and reward)
[76] Easterbrook and Fischel (1996), p.10
[77] Howard and Hedger (2014), at p.56 para 2.106, p.347 para 6.212 and pp.354-356 para 6.237
[78] *Re Pantone 485 Ltd* [2002] 1 BCLC 266

something from the situation to lie in injecting new liquidity into the business in the form of a new equity subscription.[79] As this will be equity in the newly deleveraged company, the shareholder hopes to profit alongside the distressed debt investors and the directors when the company is listed, sold or another exit strategy pursued. Yet this can lead to quite byzantine negotiations. Where the senior lenders are leading the restructuring plan, supported by the directors, the shareholders may seek to align themselves with this group, excluding the junior creditors. Indeed, ideally the shareholder whose strategy is to make a return through a new equity injection would prefer its equity to rank behind as little debt as possible, and would prefer a deep debt-for-equity swap. In this case, a complex shareholder and senior creditor – junior creditor agency problem may arise, with the former group capturing directorial support for their plan and then advancing a low value for the company supported by the directors' business plan whilst the junior creditors maintain that they have a continuing economic interest. But in other cases it is possible that the junior creditors will have a good case for an equity allocation in the debt-for-equity swap so that the shareholders need to obtain their support for the liquidity injection. Thus all sorts of strategies may be in play, and it is difficult to make generalisations about how stakeholders will interact as the analysis becomes highly case specific.

3.3 Some Empirical Support

One of the challenges with research in this area is the difficulty of investigating behavioural differences, still less quantifying them. Yet there is a risk that without any empirical research the assumptions about transactions will remain a matter of anecdote and hypothesis. In order to go some small way to addressing this issue, a hand-picked data set of restructurings of large and larger mid-cap English groups between 2008 and 2013 was built, using a variety of sources, particularly the restructuring deal lists published by Debtwire (an online provider of information on corporate debt situations), press reports, announcements from participants in the transaction and details of certain

[79] Takacs (2010), 15

of the transactions in the *European Debt Restructuring Handbook*.[80] In all 52 cases were included in the data set. The cases were then examined to establish whether they resulted in a debt-for-equity swap, a formal insolvency process or some other outcome. Where a formal insolvency process (such as a pre-packaged administration) was used to transfer equity ownership of the business to the lenders, the transaction was classified as a debt-for-equity swap, and not an insolvency proceeding.[81] Where a debt-for-equity swap, or a transaction which produced a functionally equivalent outcome, was identified, sources were reviewed to establish whether management received an equity allocation or not, or whether that was unknown. Where possible, the size of any management equity allocation was noted. Some data was cross-checked with information available on the English Companies House's new, free Beta Service but it often proved difficult to identify the ultimate parent company in a corporate group, and in many cases where it was identified, the ultimate parent was not incorporated in England and Wales and so did not file accounts or annual returns here. Specialist finance structures such as structured investment vehicles (SIVs), and collateralised mortgage backed securities (CMBS), were not included in the list. Where research indicated a formal insolvency process (other than those used to implement a transaction which was functionally equivalent to a debt-for-equity swap), management were assumed to have made no return. The purpose was not to undertake a full-scale empirical study, but rather to provide just enough empirical fact to ground the discussion in this article, and the results are set out in the table below.

Company Type	Outcome			Management equity allocation?			Size of Management equity allocation		
	Debt-for-	Insolvency	Other	Yes	No	Unknown	5-10%	10.1 – 20%	Unknown

[80] Asimacopoulos and Bickle (2013)

[81] This is because, whilst the transaction is substantively an insolvency, functionally it produces a debt-for-equity swap in which some lenders emerge holding equity in a new holding company for the business

	equity swap								
Listed	5	9	5	2	10	7	1	1	
PE	22	2	2	9	2	15	5	1	4
Other	1	4	2		4	3			

Notwithstanding their limitations, several things are striking about the data. First, in many listed company cases the company entered a formal insolvency process. A range of other outcomes was identified, including takeovers at a low price; rescue rights issues; and refinancing, but the data set included only two cases in which the directors appear to have supported a creditor-led debt-for-equity swap in a listed company. In the first of these, shareholders were offered the chance to vote to accept the transaction at a value which would have seen them recover 1 English penny per share. The shareholders voted against the deal, but it was implemented via a pre-packaged administration sale of the business and assets to a new company owned by the lenders, with management reported to have acquired a 20% stake in the post-restructuring equity.

The second case concerned Hibu, a yellow pages directories business in the UK. In 2013 it announced a debt-for-equity swap implemented via an insolvency sale pursuant to which large fund investors would take control, and its shareholders would be wiped out. The Hibu shareholders formed an action group and wrote an open letter in which they explained that they would be asking the board to demonstrate that they had acted in shareholders' best interests throughout the process. The letter stated:

… we note that [the directors] have paid themselves bonuses from shareholder funds and appear to have negotiated themselves new contracts with the creditor group. We will need comfort that throughout this process it was shareholders' interests and not self interest that was uppermost in their minds.

A newspaper report in September 2013 listed the shareholder grievances, including that allowing the executive directors to remain in position after the shares were suspended seemed "too cosy".[82] Hibu's Chairman and its Chief Executive resigned following completion of the financial restructuring. There is evidence here both of reluctance by professional listed company directors to attract shareholder ire, and of coordinated shareholder action.

When we come to the private equity cases the situation is very different. The overwhelming majority of cases proceeded by way of debt-for-equity swap, and in many it has been possible positively to identify a management equity allocation. In most of the cases it was challenging to determine the size of the equity allocation, although of those cases where it could be identified 5 were in the 5%-10% range (most around 10%) and 1 was in a higher range. Once again, this is only a very partial picture, and the claims made for the data are not great. For example, the data does not identify when the directors were appointed to the board, their individual characteristics, the amount of debt on the balance sheet pre and post restructuring and the valuation for the company, whether the post-restructuring equity was divided into different classes of share, or the economics attaching to management's stake. Nonetheless, notwithstanding the need to approach the data with an awareness of their limitations, they are interesting in supporting the picture that debt-for-equity swaps with an allocation of equity to management have become a regular feature of leveraged buyout restructurings. Notably, the number of formal insolvencies in this group is very low. Only two cases were identified in which the company successfully refinanced, and in one of these cases lenders were provided with some control rights.

4 Impact of Market Changes on the Traditional View

This leads us to the question of whether English corporate law should seek to reduce the agency costs of restructuring by reducing the risk of creditor bias in the board's decision-making process. The risk that mangers may be incentivised to support creditors when the firm is financially distressed

[82] Spanier (2013)

if they are to receive equity in the restructured business has been identified in the English cases. In *Re Bluebrook* (also known as *IMO Carwash*), the junior creditors argued that a debt restructuring in which only senior creditors would receive equity was unfair because the value of the group's assets was greater than the value of the senior debt.[83] Mr Justice Mann specifically noted that a majority of the board was transferring to the new group (which was to be owned by the senior lenders), with a bonus plan.[84] However, he fell back on a device commonly used to defend against agency problems: the independent director. Two of the directors were not transferring to the new group but had approved the deal.

It has been increasingly common in recent times for creditors to request that an individual with experience of financial distress is appointed to the board of a troubled company to provide advice to the other directors. But the creditors are likely to have influence in the identity of the appointee, and the specialist manager taking a board appointment in a period of distress is likely to be conscious of the need for repeated interaction with the creditor body .[85] Like the professional non-executive director, they are likely to place great currency on their reputation in the market for turnaround directors, but in this case on their reputation with the creditors rather than with the shareholders. We might, therefore, expect this group to put more weight on reputation than some of the other groups, but reputation for delivering an acceptable result for the major creditors. Even as between creditor interests an independent turnaround director may not deliver the protection which the appointment might be seen to promise. It would be a particularly courageous individual who would stand in the way of a debt restructuring which commands sufficient senior creditor and board support to be implemented, and who would advance the interests of a weaker constituency who lacked the bargaining power to protect themselves. Indeed, a turnaround director who adopted this course would be wise to worry about his future employment prospects.

[83] *Re Bluebrook Ltd* [2010] B.C.C 209
[84] Ibid., at [63]
[85] Baird (2006), at p. 1235

In *Re Bluebrook* the junior lenders argued (although apparently tentatively) that the board should have considered alternative transactions which would have produced a return for the senior and the junior creditors. Mr Justice Mann expressed concern with the practical realities of the situation which appears, in turn, to have forced Counsel for the junior lenders into arguing for a negotiating position based on the fact that the senior lenders would never have contemplated an insolvency sale, so that the board could simply have refused to take any action unless some value was attributed to the junior lenders.[86] Put in these terms the argument looks rather stark, and Mr Justice Mann concluded:

This is not to say that the board had no negotiating position at all. It did not have to do whatever the senior lenders wanted. But it was not in a position to bargain for some return to other creditors if the senior lenders resisted that.[87]

Yet even if the valuation evidence in Bluebrook could not sustain a challenge, the junior lenders' arguments do reveal some of the difficulties with which this article is concerned. First, it is not possible to arrive at a single assumption about the way in which directors will behave when a company is financially distressed to which the law responds. Instead, what is needed is a flexible approach which can adapt to the particular circumstances of the case. Secondly, one scenario is that in a modern restructuring case the directors may have their own reasons for preferring creditors over shareholders, or certain creditor interests over others, even when shareholders or junior creditors, or both, have some economic interest in the company, so that legal rules which entitle directors to give primacy to senior creditor interests may exacerbate, rather than address, emerging agency costs. And finally self-help measures to control the total agency costs of restructuring may be too expensive relative to their benefit or not practically available at all, so that there is a good case for corporate law to respond.

[86] *Re Bluebrook Ltd* [2010] B.C.C 209 at [59]
[87] Ibid., at [61]

In another context, Andrew Keay has made a persuasive theoretical case for an entity maximisation and sustainability approach to directors' duties in English law, or "EMS".[88] EMS does not require directors to attempt to identify and focus on particular stakeholders in determining how to balance different options or considerations, but rather mandates a single objective of maximising the long-run value of the company. However, in doing so directors must also have regard to "sustainability", used here in the purely financial sense in which Keay uses it, involving, "*both* the survival of the company, namely the company does not fall into an insolvent position from which it cannot escape, and the continuing development of the financial strength of the company".[89] EMS would seem to offer a promising standard against which to judge directors' decision-making in a debt restructuring.

First, where we are considering a large debt restructuring, either by way of a debt-for-equity swap or a rescue rights issue or distressed takeover of a listed company, we do want the directors to consider whether the restructuring is the best transaction for the company as a whole, or whether there is another transaction which will maximise the value of the company for a greater number of stakeholders, but which is also feasible and sustainable. In *Re Bluebrook* Mr Justice Mann was sceptical that there was such a role for the directors, given the valuation evidence that was before the Board and the fact that the junior lenders were well-organised and arguing for themselves.[90] However, with respect, this does not provide a complete answer.

The Board is the guardian of the business plan which will be fundamental to the valuation exercise. Given the evidence of this article, we should be mindful about the range of incentives which operates on directors in a modern case. We should incentivise directors, in setting the business plan, not to be so cautious that those who are rolled into the restructuring transaction

[88] Keay (2005); Keay (2008)
[89] Keay (2008), at p.691
[90] *Re Bluebrook Ltd* [2009] EWHC 2114 (Ch);[2010] B.C.C. 209 at [56]

receive "too good a deal",[91] but at the same time not to be so optimistic that those low in the capital structure get a chance to make a recovery at the expense of the claims of those higher up, or that shareholders are persuaded to invest in a rescue rights issue when in reality there is no real equity story for the business. The entity maximisation and sustainability approach works well as a test here: in setting the business plan the directors should attempt to maximise the value of the company for all its stakeholders, but not in an excessively risky fashion. It provides directors with a clear way to think about their obligations in producing the company's strategic plan. Crucially, at a time when it may be very difficult to identify who has an economic interest and who does not, EMS does not require directors to satisfy particular stakeholder interests where there are other, sustainable, solutions to create value for a larger number of stakeholders. It therefore also goes some way to removing directors' preferences from the decision-making process: a defensive response that directors' behaviour is justified in (senior) creditors' best interests is replaced with a test which assesses "principled decision making independent of the personal preferences of managers and directors" in reviewing the basis on which the directors arrived at the forecasts in the business plan.[92] Moreover, the test should work reasonably well whatever the particular incentives of the directors. This means that it is also more future-proof as the mix of shareholders in publicly traded companies in the UK continues to diversify, and some of the reputational bonding mechanisms explored in the article come under pressure in that context.

However, merely adopting a new standard without adopting a new standard of judicial scrutiny is unlikely to have any significant effect on the agency costs of restructuring. In *Re Bluebrook*, Mr Justice Mann expressed frustration at how late the case against the directors was put, and how weakly it was articulated.[93] Yet we have already seen that a successful challenge is likely to require the claimant to adduce evidence that the directors acted in bad faith, and thus to challenge their honesty. This is obviously a serious allegation, which in England implicates professional

[91] Ibid., at [49]
[92] Jensen (2010), at p.17
[93] Ibid., at [54]-[55]

conduct standards for Counsel advancing it, and appears to have resulted in allegations being made against directors in vague and half-hearted terms. It is suggested that the solution to this problem lies in the English court adopting an enhanced level of scrutiny, in lieu of the *Charterbridge* test, in assessing debt restructuring transactions where a majority of the board is to receive an equity allocation in the debt restructuring. Something might usefully be learnt here from the approach of the Delaware courts in the field of takeovers, where directors may also be acting out of self-interest in defending a hostile bid, or in promoting the interests of one bidder over another. Time and space do not permit a full review here, but the point with which we are particularly concerned is the court's approach to its review. Where the circumstances are enough to suggest that director self-interest might be a motivating factor, in certain cases the Delaware courts have not required the claimant to prove, as a threshold condition, that the directors were acting in bad faith.[94] Instead, the courts have conducted an initial enquiry to establish whether the usual deference to the board's decision making in US law should apply. This is achieved by placing the initial burden of proof on the directors to show that they complied with their duties. Applying this to a debt restructuring in which the directors are to receive an equity allocation, the English courts would require the directors to establish that they pursued an EMS approach in preparing the business plan. Notwithstanding concerns about judicial intervention,[95] we are concerned here with the production of a business plan and the selection of a particular transaction, rather than second-guessing commercial decisions made in the course of business with the benefit of hindsight. In other words, it is suggested that the worst concerns with judicial scrutiny would not apply if, where a debt-for-equity swap is proposed in which the directors are to receive an equity allocation, the directors' obligation to prepare a business plan in a way which maximises the value of the company and is sustainable were accompanied by an enhanced level of judicial scrutiny of their decision-making.

[94] *Unocal Copr. V Mesa Petroleum Co* 493 A.2d 946 (Del. 1985); *Revlon Inc v MacAndrews & Forbes Holdings Inc.* 506 A.2d 173 (Del. 1986), discussed in Bainbridge (2013)
[95] Belcredi and Ferrarini (2013), at p. 17

It is also suggested that shareholders should think about corporate governance issues not only for the good times, but also to protect themselves against a flight of loyalty if the business becomes distressed. Paradoxically, the more closely shareholders align compensation incentives when the company is trading profitably, the more the director may be incentivised to switch allegiance if the company becomes financially distressed. Thus the very mechanism by which shareholders reinforce loyalty in good times may hasten a switch of loyalty in bad times, at least in certain types of company. As we have seen, there will be a cost/benefit analysis to be undertaken in determining the composition of the board, so that it will not always be feasible or desirable to add independent or nominee directors to a board; and, in any event, as we have seen, unless the independent and nominee directors constitute a majority of the board they are unlikely to significantly reduce total agency costs of restructuring.

It is suggested here that soft action in terms of "relationship building" may provide part of the answer. The risk shifting incentive arises because of the powerful single-minded focus of management on their payoff from equity incentive schemes and, it has been suggested, is greatest for industry experts for whom the exit opportunity offers perhaps a once-in-a-lifetime chance for significant financial reward. Whilst this single-minded focus can be highly effective, it is suggested here that there is also a need for shareholders to build a relationship of trust and loyalty with directors who see a long term future with them, and are thus incentivised to protect shareholder interest if the firm is wounded, but not fatally so. It is suggested that detailed governance considerations will become increasingly important for private equity firms, and for those who invest in them. It is also something which the more heterogeneous shareholder body in listed companies will need to get to grips with.

5 Conclusion

In a publicly traded company, shareholders face a series of agency problems because their incentives may not be the same as the incentives of the directors. English commercial law provides a range of solutions to agency problems, particularly by imposing duties on directors. However, in practice the English courts are reluctant to second-guess directorial decision-making and so the market has also developed solutions to the agency problem. A classic solution is to reinforce reputational concerns and to align shareholder and director interests through compensation. The traditional analysis shows how this close alignment of shareholder and director interests may give rise to another agency problem in financial distress: the shareholder-creditor agency problem. Put shortly, the more shareholder and director interests are aligned when the company is solvent, the greater the incentive for directors to prefer shareholder interests when the company is financially distressed (and even if the shareholders have no residual economic value in the company). English law responds to this problem by imposing obligations on directors to consider creditor interests. Once again, though, there are limitations to the solutions offered by the law, and so creditors also respond to the issue by imposing covenants in the lending contract. Together, the shift in duty at law and the contractual protections balance the incentives for directors to prefer shareholder interests.

Modern cases introduce new, and complicated, dynamics. The growth of the private equity industry means that many large companies are now privately owned by private equity sponsors, and have raised significant amounts of debt relative to equity. Private equity sponsors may also have a preference for industry specialist directors. Together these mean that both the type of director and the type of transaction which is contemplated in financial distress are likely to be different. Crucially, the restructuring plan may very well offer directors the prospect of an equity allocation ranking behind less debt, so that industry-specialist directors with few prospects for alternative employment may be incentivised to support it in circumstances where there is a still a residual interest for other financial creditors or shareholders. Paradoxically, this incentive may be greater the more closely directorial compensation incentives are aligned with those of the shareholders. Moreover, complex relationships between directors, shareholders and different classes of creditor

may emerge. A limited amount of empirical evidence from English cases goes some way to supporting the thesis, although there is undoubtedly considerable further research which could usefully be done, for example, in a detailed comparison of the returns to management and the returns to different classes of creditors and to the shareholders.

Once we understand how directors may behave in a modern restructuring case, and the range of different behaviours, we may wish to revisit our approach to the duties at law of directors when a financially distressed company is undertaking a restructuring transaction. This article has suggested that we should replace tests which assume creditor interests supplant shareholder interests, or which impose a vague obligation to act in the interests of "creditors as a whole", with a test (modelled on the US test) of whether the directors have sought to maximise the value of the company for all the stakeholders in preparing the business plan and projections on which the debt restructuring is based and pursuing the particular transaction before the court. This does not require the directors to be excessively cautious or excessively ambitious; a middle ground is required. Perhaps more significantly, this article has suggested a heightened level of judicial scrutiny when director self-interest is in prospect in a debt restructuring and, crucially, that directors' decision-making in this area should be capable of being impugned without demonstrating bad faith or a lack of honesty. It has suggested that the worst concerns with judicial review of commercial decision-making do not arise here, because we are not focused on second-guessing business decisions with the benefit of hindsight but rather on a contemporaneous review of the business plan and projections, and the decision to pursue one transaction rather than a different one. But it has also suggested that the review of directorial incentives holds lessons for all institutional shareholders, particularly in how they approach board composition, and their relationships with the board.

References

ABI Commission to Study Reform of Chapter 11 (2014) Final Report

Adams RB, Hermalin BE and Weisbach MS (2010) The role of boards of directors in corporate governance: a conceptual framework and survey. Journal of Economic Literature 48.1: 58

Armour J, Cheffins BR and Skeel DA Jr. (2002) Corporate ownership structure and the evolution of bankruptcy law: lessons from the United Kingdom. Vanderbilt Law Review 55.6:1699

Armour J and Frisby S (2001) Rethinking receivership. O.J.L.S 21.1: 73

Armour J, Hansmann H and Kraakman R (2009) Agency problems and legal strategies. In: Kraakman R, Armour J, Davies, P, Enriques L, Hansmann H, Hertzig G, Hopt K, Kanda H and Rock E The anatomy of corporate law: a comparative and functional approach, 2nd edn. Oxford University Press, Oxford

Armour J, Hertig G and Kanda H (2009) Transactions with creditors. In: Kraakman R, Armour J, Davies, P, Enriques L, Hansmann H, Hertzig G, Hopt K, Kanda H and Rock E The anatomy of corporate law: a comparative and functional approach, 2nd edn. Oxford University Press, Oxford

Arnold M and Haywood M (2013) Duty to promote the success of the company. In S. Mortimore QC (ed.) Company Directors Duties, Liabilities and Remedies Oxford University Press, Oxford

Arnold M (2015) Directors duties in the zone of insolvency: recent developments South Square Digest February: 46. Available at http://www.southsquare.com/files/SSD%2026elec_Layout%201.pdf. Accessed 9 October 2015.

Asimacopoulos K and Bickle J (eds.) (2013) European Debt Restructuring Handbook. Globe Law and Business, London

Bainbridge SM (2012) The geography of Revlon-land. Fordham Law Review 81:3277

Baird DG (2006) Private debt and the missing lever of corporate governance. University of Pennsylvania Law Review 154.5:1209

Bank of England (2015) Trends in lending April 2015. Available at http://www.bankofengland.co.uk/publications/Pages/other/monetary/trendsinlending.aspx. Accessed 9 October 2015.

Bebchuk LA and Fried J (2004) Pay Without Performance: The Unfulfilled Promise of Executive Compensation. Harvard University Press, Cambridge, Mass. and London

Bebchuk LA, Fried J and Walker D (2002) Managerial power and rent extraction in the design of executive compensation. University of Chicago Law Review 69.3: 751

Belcredi M and Ferrarini G (2013) Boards, incentive pay, shareholder activism. In: Ferrarini G, Belcredi M (eds) and Emittenti Titoli SpA (sponsoring body) Boards and shareholders in european listed companies Cambridge University Press, UK

Berle A and Means G (1993) The modern corporation and private property. Macmillan, New York

Bozzi S, Barontini R, Ferraarini G and Ungureanu MC (2013) Directors' remuneration before and after the crisis: measuring the impact of reforms in europe. In: Ferrarini G, Belcredi M (eds) and Emittenti

Titoli SpA (sponsoring body) Boards and shareholders in european listed companies Cambridge University Press, UK

Bratton W (2008) Private equity's three lessons for agency theory. European Business Organization Law Review 9:509

Buchanan J, Tullock G and Rowley CK (2004) The calculus of consent: logical foundations of constitutional democracy. Indianapolis. Ind., UK

Cheffins BR and Armour J (2007) The eclipse of private equity. Working Paper, ESRC Centre for Business Research, no. 339

Clark RC (1981) The interdisciplinary study of legal evolution. Yale Law Journal 90:1238

Committee on the Financial Aspects of Corporate Governance (1992) Report with Code of Best Practice

Cornelli F and Karakaş O (2012) Corporate governance of LBOs: the role of boards. Available at SSRN: http://ssrn.com/abstract=1875649. Accessed 9 October 2015.

Enriques L, Hansmann H and Kraakman R (2009) The basic governance structure: the interests of shareholders as a class. In: Kraakman R, Armour J, Davies, P, Enriques L, Hansmann H, Hertzig G, Hopt K, Kanda H and Rock E The anatomy of corporate law: a comparative and functional approach, 2nd edn. Oxford University Press, Oxford

Easterbrook FH and Fischel DR (1996) The economic structure of corporate law, paperback edn. Harvard University Press, Cambridge, Mass. and London

Finch V (1990) Disqualification: a plea for competence. Modern Law Review 53.3: 385

Finch V (1992) Company directors: who cares about skill and care? Modern Law Review 55.2:179

Gilson RJ and Whitehead CK (2008) Deconstructing equity: public ownership, agency costs, and complete capital markets. Columbia Law Review 108.1: 231

Grant Thornton (2014) Capital for commerce: fuelling growth through non-bank lending. Available at http://www.grant-thornton.co.uk/en/Thinking/FD-Intelligence/Issues/Future-finance--the-rise-of-non-bank-lenders-/. Accessed 9 October 2015.

Gullifer L and Payne J (2015) Corporate finance law: principles and policy. Hart Publishing, Oxford and Portland, Oregon

Hansmann H, Kraakman R and Enriques L (2009) The basic governance structure: the interests of shareholders as a class. In: Kraakman R, Armour J, Davies, P, Enriques L, Hansmann H, Hertzig G, Hopt K, Kanda H and Rock E The anatomy of corporate law: a comparative and functional approach, 2nd edn. Oxford University Press, Oxford

Harner M (2006) Trends in distressed debt investing: an empirical study of investors' objectives. 16 American Bankruptcy Institute Law Review 16:69

Harner MM (reporter) (2014) Final Report of the ABI Commission to Study Reform of Chapter 11

Hicks A (2001) Director disqualification: can it deliver? The Journal of Business Law 433

Howard C and Hedger B (2014) Restructuring Law and Practice. LexisNexis, London

Jensen MC and Meckling WH (1976) Theory of the firm: managerial behavior, agency costs and ownership structure. J. Fin. Econ 3:305

Jensen MC (1989) The eclipse of the public corporation. Harvard Business Review 67.5: 61

Jensen MC (2010) Value maximisation, stakeholder theory and the corporate objective function. Journal of Applied Corporate Finance 22.1:32

Kaplan SN and Strömberg P (2009) Leveraged buyouts and private equity. Journal of Economic Perspectives 23:121

Kaplan SN and Stein JC (1993) The evolution of buyout pricing and financial structure in the 1980s. The Quarterly Journal of Economics 108.2: 313

Keay A (2003) Directors' duties to creditors: contractarian concerns relating to efficiency and over-protection of creditors. Modern Law Review 66: 665

Keay A (2005) Wrongful trading and the liability of company directors: a theoretical perspective. Legal Studies 25.3:431

Keay A (2005) Formulating a framework for directors duties to creditors: an entity maximisation approach. The Cambridge Law Journal 64.3: 614

Keay A (2008) Ascertaining the corporate objective: an entity maximisation and sustainability model. Modern Law Review 71.5: 663

McKnight A (2008) The Law of International Finance. Oxford University Press, Oxford

Molho I (1997) The economics of information: lying and cheating in markets and organizations. John Wiley & Sons, UK

Office for National Statistics Statistical Bulletin (2012) Ownership of UK quoted shares, 2012

Olson M (1971) The logic of collective action: public goods and the theory of groups. Harvard University Press, Cambridge, Mass.; London

Paterson S (2014) Bargaining in financial restructuring: market norms, legal rights and regulatory standards. Journal of Corporate Law Studies 14.2:333

Segal N (1992) Approaches other than formal insolvency procedures. In: R. Cranston (ed.) Banks and Remedies. Lloyds of London Press, London

Spanier G (2013) Yellow Pages investors accuse board of dereliction of duty. The Independent 11 September.

Stapledon GP (1996) Institutional shareholders and corporate governance. Clarendon Press, Oxford

Stein JH (1985) Rescue operations in business crises. In: Hopt KJ and Teubner G (eds.) Corporate Governance and Directors Liabilities. W. de Gruyter, Berlin

Takacs A (2010) European Restructuring Report: Default, Restructuring and Recoveries in 2008-2010. Debtwire Europe, UK

Williams R (2015) What can we expect to gain from reforming the wrongful trading remedy? Modern Law Review 78:55

Winter J and Van de Loo E (2013) Board on task: developing a comprehensive understanding of the performance of boards. In: Ferrarini G, Belcredi M (eds) and Emittenti Titoli SpA (sponsoring body) Boards and shareholders in european listed companies. Cambridge University Press, UK

Wood Z (2014) Tesco's new boss promises to bring a fresh perspective. Guardian 1 September

Wymeersch E (2013) European corporate governance codes and their effectiveness. In: Ferrarini G, Belcredi M (eds) and Emittenti Titoli SpA (sponsoring body) Boards and shareholders in european listed companies. Cambridge University Press, UK