Shareholder Primacy and the Trajectory of UK Corporate Governance

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Abstract
Core institutions of UK corporate governance, in particular those relating to takeovers, board structure and directors' duties, are strongly orientated towards a norm of shareholder primacy. Beyond the core, in particular at the intersection of insolvency and employment law, stakeholder interests are better represented, thanks to European Community influence. Moreover, institutional shareholders are redirecting their investment strategies away from a focus on short-term returns, in such a way as to favour stakeholder-inclusive practices. We therefore suggest that the UK system is currently in a state of flux and that the debate over shareholder primacy has not been concluded.

JEL Codes: D23, G32, G33, G34, K22, K31

Key Words: corporate governance, stakeholding, hostile takeovers, company law, insolvency, employee representation, shareholder activism

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1. Introduction

It is widely believed that the United Kingdom's system of corporate governance, in common with that of the United States but in contrast to those of mainland Europe and Japan, places the interests of shareholders above those of other corporate stakeholders, such as employees and creditors. We examine this claim through a close study of corporate governance institutions in the UK. Our focus is on the rules and practices governing restructuring in large corporations with external shareholders, an area where potential inter-stakeholder conflicts are particularly intense. We suggest that certain core institutions – takeover regulations, corporate governance codes, and the law relating to directors' fiduciary duties – are indeed highly shareholder orientated (section 2). However, in other areas, particularly in the interplay between insolvency law and statutory employee representation, there is considerable scope for the exercise of voice by non-shareholder constituencies (section 3). In addition, institutional shareholders are beginning to play a more active role in promoting stakeholder-inclusive practices by the companies in which they invest (section 4). On this basis we conclude that the system, rather than stabilizing around a norm of shareholder primacy, is currently in a state of flux.

Our analysis is designed to cast light on the active debate which has taken place in the UK over the past decade about the merits of a stakeholder-based approach to corporate governance. Notwithstanding the claims made by adherents of this approach (Hutton, 1995; Kay and Silberston, 1995), calls for a more explicit recognition of the role of non-shareholder constituencies have not so far led to significant legal or institutional change. The Company Law Review, while making some concessions to stakeholder concerns in the form of new reporting requirements for companies, rejected calls for changes to the law governing directors' duties (Company Law Review Steering Group, 2001, 2002; see Williamson, 2002). The reaction to the corporate scandals of 2001-2 was telling. In the United States, the Sarbanes-Oxley Act, rushed into place by Congress in the summer of 2002 largely as a response to the Enron affair, completely ignored stakeholder claims in favour of further entrenching accountability to shareholders (Deakin and Konzelmann, 2003). In the UK, the Higgs review of the role of non-executive directors (Higgs, 2003), while milder than Sarbanes-Oxley in terms of the requirements that it would impose upon companies, shared its philosophy of shareholder primacy. Meanwhile there are signs that the shareholder value norm is exerting a growing influence on other systems, in particular Germany (Lane, 2003). It is therefore not surprising that leading corporate governance scholars should have argued that the fundamental issues of corporate ownership and control have now been settled in favour of the shareholder value model (Hansmann and Kraakman, 2001).

On the basis of the analysis of institutions that we present below, we reject this claim as far as the UK is concerned. Corporate governance in the UK has not reached the 'end of history'. The shareholder value model is less deeply rooted than is generally supposed. The institutions which support it – above all, the City Code on Takeovers and Mergers and the corporate governance codes – are of recent origin. From an historical perspective, the extent of shareholder pre-eminence achieved in the 1980s and 1990s, far from being a normal state of affairs, is an anomaly (Davies, 2002). Today, the exclusion of stakeholder voice from corporate decision making is far from uncontested. But just as there is no straightforward way back to a time before the rise of the hostile takeover bid and the assertion of institutional investor power, so there is little prospect of the UK model converging on mainland European or Japanese practices, not least because these are undergoing changes of their own. What we are likely to see instead is a period of uncertainty as the corporate governance actors struggle to come to terms with the inevitable contradictions and tensions of the shareholder primacy norm.

2. The core institutions of UK corporate governance

Corporate governance systems around the world have been categorised in a range of different ways. Perhaps the most helpful of these distinguishes between outsider/arm's length, and insider/control-oriented, systems (Berglöf, 1997; Cheffins, 2002). The 'insider/outsider' distinction refers to the degree of concentration of share ownership, and the arm's length/control-oriented dichotomy relates to the degree of activity exhibited by shareholders in matters related to corporate governance. Dispersed ownership is associated with shareholder passivity because, where each shareholder has only a small amount at stake, they have little incentive to intervene in the running of the firm. In contrast, concentrated share ownership is associated with shareholder activity, as the owners of large blocks of shares will reap much of the benefit of their interventions. Dispersed share ownership is the norm in the UK, where over 85% of listed firms lack a shareholder with 25% or more of voting rights (Crespi-Cladera and Renneboog, 2000: 4). This is similar to the US, but contrasts dramatically with the position in other developed countries, which have insider/control-oriented systems (Gospel and Pendleton, 2003).

Fashions in corporate governance (in the sense of both practice and scholarship) have changed over the years. However, the currently dominant paradigm in outsider/arm's length systems is for corporate governance mechanisms to be understood as a set of responses to the separation of ownership and control, that

is, the familiar agency problem arising from the opportunities provided to managers to further their own personal goals at the expense of the shareholders (see Shleifer and Vishny, 1997). This view, which is variously characterised as the shareholder value or shareholder primacy approach, accepts that in a system of dispersed ownership, shareholder passivity is inevitable and perhaps even desirable (in the sense that it is not necessarily in the best interests of the firm for ownership to be concentrated in the hands of a dominant group of investors who can then extract private benefits of control). As a result, mechanisms other than those based on direct intervention are required in order to keep managers' actions aligned with the interests of shareholders. Much energy has been devoted in the past twenty years to facilitating governance mechanisms of this type. These include the law relating to directors' duties, supervision via non-executive directors, executive compensation agreements, managerial labour markets that respond to past performance, the market for corporate control, discipline exercised by creditors, and competitive product markets.

What is striking about the UK framework is just how focused on the shareholder value model it appears to be. This can be seen through an examination of several core governance mechanisms: hostile takeovers, directors' duties, and board structure. But it is also the case that shareholder primacy has not gone unchallenged, and that the internal contradictions of the shareholder value approach are increasingly reflected in the current policy debate.

2.1 Hostile takeovers

Within the framework of the shareholder value model, the hostile takeover is a key mechanism for aligning managers' interests with those of shareholders. The extent to which the hostile takeover can work as a disciplinary device in this way is largely a function of the legal and regulatory regime. In particular, the extent to which incumbents may employ defensive tactics, such as the use of 'poison pills' – pre-commitments to engage in some activity or restructuring if a hostile bid succeeds that will destroy any value the bidder would obtain from the firm – will affect the level of hostile bid activity. The regime in the UK is highly restrictive of the use of defensive tactics (Deakin and Slinger, 1997). Takeovers of public companies are regulated by the City Code on Takeovers and Mergers (Takeover Panel, 2002). This is a self-regulatory framework dating from the late 1960s, adherence to which is overseen by the Panel on Takeovers and Mergers, a group of specialists drawn from practice and from regulatory organisations in the City of London. Although the Code does not itself have the force of law, it may be enforced by regulatory bodies exercising statutory powers, including by the Financial Services Authority (see FSA, 2001).

General Principle 7 and Rule 21 of the City Code proscribe managerial actions which might frustrate a bid. General Principle 7 states:

> At no time after a bona fide offer has been communicated to the board of the offeree company, or after the board of the offeree company has reason to believe that a bona fide offer might be imminent, may any action be taken by the board of the offeree company in relation to the affairs of the company, without the approval of the shareholders in general meeting, which could effectively result in any bona fide offer being frustrated or in the shareholders being denied an opportunity to decide on its merits.

Rule 21, which fleshes out General Principle 7, provides that from the point in time at which the incumbents believe that an offer might be imminent, the board of directors may not issue shares, options, or convertible securities, agree to sell, dispose of or acquire assets of a material amount, or to enter into any contract otherwise than in the ordinary course of business. Together, these rule out defensive tactics by the incumbents once a bid is on the horizon, otherwise than in accordance with the wishes of shareholders.

The Code does not apply to actions taken when there is no threat of a bid. It might be thought therefore that a board could unobtrusively commit the company to a poison pill, so as to protect it from any bid which might subsequently materialise. It is clear that in at least a small minority of cases, pre-bid defensive tactics such as poison pills are employed (Paul, 1991: 142). However, the structure of shareholder rights means that a board is hard pressed to commit the company to something sufficiently 'poisonous' to deter a bidder, without the prior approval of the shareholders. In particular, issues of new shares, repurchases of existing shares, and significant transactions with related parties all require the consent of a majority of shareholders. Moreover, directors who attempt to create a 'poison pill' may be found to have breached their fiduciary duties by exercising their powers for an improper purpose, namely the protection of their own position, as opposed to the furtherance of the company's business.

Senior managers are likely to be replaced following a UK takeover regardless of whether or how the firm is under-performing. This leads Franks and Mayer (1996) to conclude that takeovers represent a poorly focused disciplinary mechanism. Studies of the accounting performance of the targets of successful UK hostile takeovers have shown, on average, small—but statistically significant—improvements after the bid (Franks and Mayer, 1996; Cosh and Guest, 2001), although these were not inversely related to pre-bid

underperformance. Again, this tends to contradict the idea that managers are being disciplined. However, the evidence is consistent with the idea that management teams face takeovers if their *future* strategy is not as good as it might be: what Stapledon (1996) refers to as '*ex ante* discipline'.

Firms may be acquired for reasons other than underperformance by managers (see Romano, 1992 and Shleifer and Vishny, 1997, for a full discussion). Other common objectives include the realisation of synergy gains, the pursuit of monopolistic practices, empire-building by bidder management, and most importantly for current purposes, the expropriation of employees and other non-shareholders constituencies. When such expropriation occurs, a bidder may pay a premium for a company's shares not because of managerial underperformance, but because, through breaching implicit contracts with employees, quasi-rents which were being paid to this group can instead be diverted to shareholders (Shleifer and Summers, 1988). Thus a focus on takeover bids highlights one of the fundamental tensions of the shareholder value model: the more the hostile takeover is facilitated as a disciplinary device, the more difficult it may become for firms to make credible commitments to their employees that implicit contracts to share quasi-rents will not be breached. In turn, this will make employees less willing to make firm-specific investments *ex ante*, and can result in loss of value for all participants.

The normative case for regulatory facilitation of takeover bids therefore depends on the extent to which they have value-enhancing, as opposed to merely redistributive, effects. This is a question for empirical research, but measuring the welfare effects of takeovers on all stakeholders, as opposed to the impact on shareholders' interests as expressed through stock price movements or corporate profitability, is extremely difficult. Conyon *et al*. (2002) found evidence that hostile takeovers in the UK between 1987 and 1996 were associated with significant falls in both employment and output for the firms concerned, and concluded that the overall effect of such mergers was, after controlling for the change in output, to enhance the efficiency with which labour was utilized at firm level. On this basis the authors claimed that 'the results are generally supportive of the view that merger activity, particularly related and hostile merger activity, promotes efficiency'. However, they also accepted that 'if the observed employment reductions constitute a reneging on the implicit terms of the labour contract, in the sense of Shleifer and Summers (1988), there may be associated costs generated through the subsequent reductions in firm-specific human capital investment by employees. These will be manifested in lower output levels but any such changes would be very hard to identify' (Conyon *et al*., 2002: 40).

Deakin *et al.* (2003) conducted case studies of some of the most prominent of the takeover bids of the mid-1990s' wave in the UK, including the contests which involved Glaxo and Wellcome, Granada and Forte, and the restructuring of the electricity industry following its privatization. On the basis of interviews with bid participants including directors, investment bankers, legal advisers and employee representatives, they found that the regime of the City Code was perceived as having a considerable impact on both the conduct and outcome of bids. During bids, directors of bid targets reported that they focused on the concerns of target shareholders to the exclusion of other stakeholder groups. A review of the case studies five years on from the initial interviews found that, almost without exception, mergers had led to large-scale job losses and asset disposals. However, analysis of the discussion of these mergers in the financial press over the period in question showed that after an initially favourable response from the City, almost none of the mergers (including those initiated by Glaxo and Granada respectively) were considered by the financial community, at the end of the period, to have generated a surplus for shareholders.

The evidence on the overall welfare effects of hostile takeovers is unclear. What can be said with some confidence is that the City Code sets up a regime that focuses director attention in the conduct of a bid on the immediate question of whether it is in the shareholders' best interests to accept a tender offer. In principle, this could impose a constraint on the capacity of UK managers to engage in a strategy of building long-term relations with stakeholders. The existence of this possible constraint was noted by the Company Law Review (Company Law Review Steering Committee, 2000: paras. 3.162-3.168; Company Law Review Steering Committee, 2001: paras. 6.19-6.21). While the Steering Committee concluded that 'there was no clear case made out for inhibiting the takeover market' (Company Law Review Steering Committee, 2001: 140), it nevertheless proposed to the UK Listing Authority that the Listing Rules be strengthened so that a wider range of transactions would be referred to shareholders in the bidder company for their prior approval, and that parties to takeovers should issue stakeholder-related information at the time an offer is made (Company Law Review Steering Committee, 2001: 140-141). Thus the argument that, as the Steering Committee put it, 'synergies [from takeovers] were often exaggerated and… employment and productive capacity were often destroyed by such deals, without economic benefit' (Company Law Review Steering Committee, 2001: 140), did not fall on completely deaf ears.

2.2 Directors' duties and responsibilities to stakeholders

While the Takeover Code strongly prioritises shareholder interests, general company law observes the legal principle that directors must act in good faith in the interests of the company, rather than those of the shareholders alone (see Parkinson, 2003). How much leeway this gives boards is a matter of dispute. Boards are permitted to take a view based on what the Company Law Review Steering Group (1999: 37) called 'enlightened shareholder value', that is, striking a balance between the competing interests of the different stakeholders in order to benefit the shareholders in the long run (Company Law Review Steering Group, 1999: 37). From this vantage point, it should, for example, be legally open to the directors to pursue a policy of minimum redundancies (to gain the cooperation of the workforce) or a preferred supplier policy (to enhance the quality of supplier relations), if the ultimate objective of these policies is to advance shareholders' interests. Section 309 of the Companies Act 1985 apparently goes further, imposing upon boards a duty to consider the interests of employees alongside those of shareholders when exercising their duty to act in the interests of the company. However, employee representatives do not have standing to enforce this duty, and unsurprisingly it has rarely been invoked in the courts. Moreover, during a takeover bid, neither section 309 nor the general law of fiduciary obligation has been interpreted as standing in the way of the principle of board neutrality, nor as diluting the specific obligations which boards have under the Takeover Code to ensure that objective financial advice is provided to shareholders on the merits to the bid, although there is clear potential for conflict between general company law and the Code's strong endorsement of shareholder primacy (Deakin and Slinger, 1997; Davies, 2002).

During its deliberations, the Company Law Review Steering Group considered two versions of what it called the 'scope' issue. The first was 'enlightened shareholder value', as just defined. The second was a 'pluralist' position according to which 'company law should be modified to include other objectives so that a company is required to serve a wider range of interests, not subordinate to, or as a means of achieving, shareholder value (as envisioned in the enlightened shareholder value view), but as valid in their own right' (Company Law Review Steering Group, 1999: 37). In the end, the Steering Group rejected calls for directors' duties to be modified in this way. Instead, it came down in favour of a restatement of duties in which there would be '[a]n obligation on directors to achieve the success of the company for the benefit of the shareholders by taking proper account of all the relevant considerations for that purpose' including 'a proper balanced view of the short and long term, the need to sustain effective ongoing relationships with employees, customers, suppliers and others; and the need to maintain the company's reputation and to

consider the impact of its operations on the community and the environment' (Company Law Review Steering Group, 2000: 13; see also Company Law Review Steering Group, 2001: 41). The Steering Group nevertheless coupled this with a proposal for a new statutory requirement for listed companies (and certain other 'very large companies with real economic power') to publish an operating and financial review ('OFR') as part of the annual report. This would 'cover all that is material in the directors' view for users to achieve a proper assessment of the performance and future plans and prospects of the business' including 'where relevant its relationships with employees and others and its impact on the community and environment' (Company Law Review Steering Group, 2000: 13). The OFR is based on an existing, non-statutory model for company reporting which is recommended by the UK Accounting Standards Board and is already in widespread use by listed companies.

The Steering Group's assessment of its own proposal was that it came down somewhere in between the enlightened shareholder value and pluralist points of view. The proposal's objective, it argued, was pluralist, in the sense that 'companies should be run in such a way which maximizes overall competitiveness and wealth and welfare for all' (Company Law Review Steering Group, 2000: 14). The means chosen to achieve this end were the 'inclusive duty' and 'broader accountability' (Company Law Review Steering Group, 2000: 15). The idea that acting genuinely in the best interests of shareholders, in modern companies, required directors to take into account a wider range of constituencies, was to be made transparent through a reporting framework that clearly recognised the importance to corporate success of 'qualitative and intangible, or "soft" assets such as the skills and knowledge of their employees and their corporate reputation' (Company Law Review Steering Group, 2000: 15).

But since no change to the substance of directors' fiduciary duties was proposed, this was in essence an endorsement of enlightened shareholder value. Moreover, even this endorsement was limited, since no proposal was made to amend the Takeover Code in such a way as to deal with its more narrow focus on the protection of shareholders' short-term financial interests during a takeover bid. Thus the question inevitably arises of whether the Steering Group willed the end without providing the necessary institutional means to achieve it. At the same time, the proposal for the extended OFR demonstrates that concerns over the negative implications for competitiveness of an excessive focus on shareholder returns were not ignored.

2.3 Board structure and accountability under the Combined Code of Corporate Governance

Running alongside efforts to reform company law through the Company Law Review there has been a continuing debate over the use of soft law mechanisms to promote transparency and accountability in listed companies. In particular, the corporate governance landscape in the UK has since the early 1990s been transformed by a series of quasi-voluntary codes which have specified a range of governance mechanisms ostensibly designed to increase the accountability of senior managers to shareholders. They originated with the Report of Cadbury Committee (1992), followed by that of the Greenbury Committee (1995) on Executive Remuneration, and the Hampel Committee (1997), following which the Combined Code was produced. While the Code is ostensibly voluntary, the UK Listing Rules require companies, as part of their annual report, to disclose how they have complied with the Code or, if they have not done so, to give reasons for this departure (rule 12.43A), hence the approach which has come to be known as 'comply or explain'.

The principal aspects of the Code (UK Listing Authority, 2002) emphasise the importance of non-executive directors as a mechanism of supervision of executives, with non-executives making up at least a third of the board and possessing sufficient experience, expertise and independence for their views to carry significant weight in the board's decisions (Principle A.3); the separation of the roles of CEO and chairman of the board (Principle A.2); automatic re-election of directors at least every three years (Principle A.6); the use of board sub-committees for nomination (Principle A4), remuneration (Principles B.2, B.4) and audit (principle D3), with a major role in each case for non-executive and independent directors; and the disclosure to shareholders of policy concerning remuneration (a 'significant element' of which should be performance-related) and of service contracts (for which there is a 'strong case' for a maximum duration of one year) (Principle B.1). In this way, the Combined Code has established itself as a focal set of issues around which the governance practices of companies are measured. Empirical research suggests that the structure of the boards of public companies and the way in which they operate have changed in response to the dissemination of the Code (see, for example, Pye, 2000). Compliance levels with the Combined Code are now high. For example, PIRC (1999) found that 87% of their sample of listed UK companies had separated the roles of Chairman and CEO, and 93% had non-executives comprising more than one-third of the board.

However, while levels of compliance are striking, the extent to which these measures have actually improved corporate performance is questionable. A recent study by Weir *et al*. (2001) investigated the relationship between a number of the governance measures outlined in the Combined Code and corporate financial performance, measured using annual corporate accounts. Specifically, they considered whether (i) the proportion of non-executive directors on the board, (ii) the independence of non-executive directors; (iii) the independence of audit committees; and (iv) the separation of the roles of Chairman and CEO, was significantly related to financial performance. None was. The authors concluded that 'the link between internal governance mechanisms and performance is, at best, weak' (Weir *et al.*, 2001: 27). This finding is not alone, but echoes those of Faccio and Lasfer (1999) and Buckland (2001), who also failed to find anything other than very weak relationships between the proportion of non-executive directors, and whether or not CEO/Chairman roles were combined, and firm performance. Rates of UK CEO forced turnover do not appear to have increased during the 1990s, suggesting that the greater preponderance of non-executive directors has done little to hasten the removal of underperforming executives (see Conyon and Florou, 2002). US studies also question whether there is a link between board structure and firm performance (Bhagat and Black, 1998). Pye (2000), in an interview study, provides qualitative evidence as to why this might be the case for the UK, noting that directors felt that non-executives were still selected and evaluated by unspoken rules. Furthermore, it was felt that the Combined Code approach had led to a culture of box-ticking with which it was straightforward for companies to comply, without necessarily engendering good performance.

But despite signs that compliance with the Code has been largely formal, with little impact as yet at the organizational level of companies, the approach initiated by Cadbury has been confirmed in the most recent corporate governance review, namely the examination by Derek Higgs of the role of non-executive directors in listed companies. His report, published under the sponsorship of the Department of Trade and Industry in February 2003 (Higgs, 2003), was intended as the UK response to the issues raised by Enron and other US corporate scandals. Higgs recommended a strengthening of non-executive representation and independence on boards, stricter rules on the separation of the Chair and CEO roles, and a new position of 'senior independent director' set up to facilitate liaison between the board and shareholders. By retaining the comply-or-explain approach to regulation, Higgs' proposals were aimed at avoiding the more rigid and punitive aspects of the US regulatory response to Enron, the Sarbanes-Oxley Act of 2002. However, the thinking underpinning the Higgs recommendations, allowing for differences between the UK and US regulatory frameworks, was essentially the same as for Sarbanes-Oxley: both

aimed to tighten further the mechanisms of accountability running from senior managers through the board to shareholders.

The corporate governance codes were developed against an assumption that, as Higgs put it, '[e]nsuring the highest standards of boardroom governance can only assist in closing the productivity gap that exists with our major competitors' (Higgs, 2003: 11). Thus the issue of competitiveness which was at the heart of the Company Law Review was by no means absent from the deliberations surrounding the making of the codes. But whereas the Company Law Review at least addressed the potentially negative implications of shareholder primacy for productive capacity, the various committees responsible for drawing up the codes have barely touched on this issue. This disjuncture is significant, since the code-making process has been much more productive than the Review, so far at least, in terms of the output of new rules and standards. Thus while the core institutions of corporate governance have been increasingly influenced by the shareholder-orientated agenda of the codes, they have been left largely untouched by the pressure for change initiated by the stakeholder debate. When, however, we look beyond the core, we quickly see that this pressure has been manifested in other ways.

3. Corporate governance beyond the core

A narrow focus on core institutions would suggest that UK corporate governance practice is heavily weighted towards shareholder interests. The interplay of ownership and control rights in larger companies is not, however, exhausted by a consideration of the rules governing shareholder rights and board structure. In the process of corporate restructuring, insolvency law and employment law often play a pivotal role. We consider, firstly, the functional role of employment and creditor representation in corporate governance, and then use a case study, the sale of Rover to Phoenix in 2000, to show how employment and insolvency law interact in practice.

3.1 The interplay between employee consultation and corporate insolvency law

In common with other developed countries, the UK has seen a considerable decline in trade union membership and in the coverage of collective bargaining since the late 1970s, a trend which has yet to be clearly reversed by the enactment of statutory recognition procedures in the Employment Relations Act 1999 (Oxenbridge et al., 2003). Alongside the collective bargaining system, however, employment law increasingly imposes obligations upon employers to

enter into processes of information and consultation with employee representatives. European Community legislation in the form of the Acquired Rights Directive ('ARD')[1] and the Collective Redundancies Directive ('CRD')[2] is particularly important in respect of the corporate restructuring process. If a business is transferred from one employer to another as part of a restructuring, or in the event of large-scale redundancies, representatives of the employees affected have the right to be informed and consulted by the relevant employer. Under UK law, applying the terms of the ARD and CRD as interpreted by the European Court of Justice[3], where an independent trade union is recognised by the employer for the purposes of collective bargaining over the terms and conditions of relevant employees, the employer must enter into consultation over redundancies or a business transfer with that union.[4] But equally, even where there is no recognised trade union, the employer must consult employee representatives who are elected or selected under procedures laid down by legislation.[5] Additional obligations of information and consultation arise if the employer is subject to the requirement to establish a European Works Council (EWC).[6] Under Article 12 of the EWC Directive, in the absence of a voluntary agreement between the relevant parties, the employer is required to consult once a year on a range of matters which include 'the structure, economic and financial situation, the probable development of the business and of production and sales, the situation and probable trend of employment, investments and substantial changes concerning organization, introduction of new working methods or production processes, transfers of production, mergers, cut-backs or closures of undertakings, establishments or important parts thereof, and collective redundancies'.

The ARD, in particular, also supplies individual employees with important job security rights. In the event of a transfer of employment, the rights and obligations of the transferor employer are automatically carried over to the transferee. In other words, the transferor's employment law obligations run with the assets and goodwill which are the subject of the transfer. Dismissal in connection with a transfer is automatically unfair, and, in addition, a claim for compensation arises in the event of the employer's failure to consult with the relevant employee representatives.[7]

Significantly, the ARD does not apply to takeovers or mergers which are effected through a share transfer. The issue of employee consultation rights during a takeover bid has proved highly controversial in the context both of the City Code on Mergers and Takeovers and the proposed Thirteenth Directive on takeover bids. Employees and employee representatives have no standing before the City Panel which administers the Code. The announcement of a takeover bid does not, in itself, trigger obligations to consult under the CRD;

this will only occur once redundancies are in contemplation which will not normally be until after the bid process has been completed. Rule 24.1.d of the Takeover Code provides that the bidder company must state its objectives with regard to the continued employment of employees in the merged company at the time it makes its tender offer. However, this is normally satisfied by a 'boilerplate' reference, in the offer document issued to shareholders, to the effect that the bidder will respect the existing legal rights of the employees. This provides them with no greater right to be consulted during the takeover bid over the effects of likely restructuring than they would otherwise have, and interview studies show that rule 24.1.d is thought by corporate governance practitioners to have little significance (see Deakin *et al.* 2003).

Outside the context of the takeover bid, however, the consultation provisions of European Community law can have a substantial impact on the restructuring process (Armour and Deakin, 2003). Their effect arises from the way they interact with insolvency law and procedure. UK insolvency law partitions residual control rights between debtor and creditor on a sequential and contingent basis. If default occurs, creditors become, in effect, the firm's residual claimants, excluding shareholders (Hart and Moore, 1997). At the same time, the enforcement of creditors' rights generates considerable decision-making costs. Lenders may engage in a wasteful 'race to collect', dismembering the firm's business and leading to loss of value where it is worth more as a going concern. Corporate insolvency law solves this problem by collectivising creditors' governance rights at precisely the moment when the costs of exercising them individually are highest (Jackson, 1982). Individual property rights in the firm's assets are thereby redefined as collective property rights to be dealt with by the creditors as a group. For this reason, insolvency law imposes a formal stay of claims.[8] Alternatively, security interests can be viewed as effecting a transformation of individual property rights into a unified asset pool (Picker, 1992). The English law administrative receivership procedure, although formally an enforcement mechanism employed by a single secured creditor, operates in this way (Armour and Frisby, 2001).[9]

The ARD and CRD play a similar, functional role to the rules of insolvency law in protecting stakeholder voice (see Armour and Deakin, 2003). Employees' collective information and consultation rights, like those of the creditors in relation to insolvency, lie dormant until the point when they are activated by the employer's decision to engage on a restructuring. It is principally those events which put at risk employees' firm-specific human capital or their entitlements to share in quasi-rents – large scale redundancies, the sale of the employer's business to a third party, the outsourcing of parts of the employer's operation – which trigger the obligation to consult. At this point, the mechanisms of

employment law operate in the same way as those of insolvency law: divergences of interest between different employees can be resolved, to some degree at least, through the employee representatives who are granted what are, in effect, monopoly representation rights in relation to information and consultation laws.

3.2 Stakeholder voice in action: the Rover case

The sale of Rover to Phoenix in 2001 illustrates how laws that grant employees voice rights may have an effect on the way in which corporate transactions are structured. In the autumn of 1999, Rover's overseas parent company (BMW) decided to sell it on the grounds that it was running losses of over £2 million per day. If no buyer were found, BMW had plans to liquidate Rover's business on the basis of a members' voluntary winding-up, making it possible to realise the company's assets and (it was thought) pay off the creditors in full. This would have meant the loss of an estimated 24,000 jobs, not only in Rover's Longbridge plant near Birmingham (which employed 8,000 workers) but also through knock-on effects upon suppliers and dealers and in the wider West Midlands economy.

The break-up option, while leaving shareholders and creditors comparatively unscathed, would have inflicted substantial losses upon other stakeholder groups, in particular employees, long-term customers and suppliers, and the local community. The best outcome for these other stakeholders was clearly the emergence of a buyer who would carry on the business as a going concern while preserving as many jobs as possible. As things turned out, employment law played a crucial role in achieving this outcome.

Negotiations for the sale of Rover to Alchemy Partners began in secret in October 1999, and were only made public in March 2000. It soon became clear that Alchemy intended significantly to reduce the scale of production at Rover's Longbridge plant, by focusing on the small niche market for MG sports cars and ceasing production of the main Rover brand. On this basis, its bid received a hostile reception from the trade unions and a frosty one from local authorities in the west midlands. In late March a rival bid, from a group that became known as the 'Phoenix consortium', was announced. This was led in due course by John Towers, a former chief executive of Rover, and was premised on retaining Longbridge as a volume car production facility. However, for most of April, BMW refused to enter into negotiations with Phoenix, and continued instead to move towards finalising the sale of Rover to Alchemy.

Neither Rover Group nor any of BMW's other UK subsidiaries had entered into consultation with employee representatives over the proposed sale to Alchemy. The relevant employee representatives were the recognised unions, who lodged claims against Rover before employment tribunals. These were on the basis firstly, that the ARD applied and that consultation should therefore have taken place about the transfer. Whilst BMW disputed this, the unions nevertheless had an arguable case (see Armour and Deakin, 2000, for an account of how this was framed). Secondly, it was also argued by the employees that a breach of the redundancy consultation laws (the CRD) had occurred, since both BMW and Alchemy had indicated that there would be redundancies arising from the sale of Rover Group and the other subsidiary companies. Furthermore, if the ARD did apply, then liability under any protective award made against BMW or its subsidiaries for failure to comply with the information and consultation requirements would have been transmitted to buyers of its businesses. Thirdly, steps were taken by lawyers acting for employees to prepare individual claims in respect of breach of contract for dismissals carried out in contravention of 'no compulsory redundancy' agreements entered into between Rover and the unions which, it was claimed, had been incorporated into employees' contracts of employment. Altogether, the potential value of these claims exceeded £300 million.

It was against this background that Alchemy withdrew from negotiations with BMW on 27 April, just before the deadline set for finalising the deal. The catalyst for this turn of events was BMW's insistence that Alchemy should offer it an indemnity against potential claims for (among other things) breach of the information and consultation laws, and contractual claims for wrongful dismissal. Press reports at the time indicated that Alchemy had been ready to pay £50 million for the company, with BMW meeting certain liabilities arising from restructuring, but that it was not prepared to agree to an indemnity extending to 'hundreds and hundreds of millions of pounds' (see Armour and Deakin, 2000, for further details).

The sale to the Phoenix consortium was completed on 10 May 2000. Rover was sold for a nominal £10, with BMW putting in £575 million to help meet short-term running costs. The Phoenix management pressed the unions to agree to a waiver of claims arising out of the failure of BMW (through Rover) to begin consultation at the time the prospective sale to Alchemy was announced. Although the claim was not waived, agreement was reached on its withdrawal on the basis that consultation between Phoenix and the unions had begun at an earlier date. The effect was to save £100 million. In return, Phoenix agreed to insert enhanced redundancy terms in the contracts of employment of Longbridge employees. A further £200 million was saved by Phoenix's

decision to dismiss fewer than 1,000 workers at Longbridge, thereby avoiding large-scale redundancy compensation claims. Without formally waiving their claims, the employees and their representatives had found themselves in a position where their involvement in the rescue process had led to the success of the one bid which was consistent with maintaining Rover as a volume car producer.

The Rover case is evidence that factoring employee interests into the restructuring process can result in outcomes that protect the firm-specific human capital of the workforce without undermining the preservation of jobs. Indeed, the role of the law in the Rover case was more positive than that – by requiring a potential purchaser to bear the costs of large-scale redundancies, it served to penalise a bid which would have broken up the company, leaving Rover a shadow of its former self. Clearly, the law did not operate here in isolation; Rover was a strongly unionized company and local communities were active in their support. But without the intervention of the law it is doubtful that these factors, alone, would have saved the company. Government support for the rescue option, while largely expressed behind the scenes, may also have been an important factor in the company's survival. To that extent, Rover may be a one-off. But the company's survival perhaps has wider lessons. It continues to operate today, using a corporate structure in which the share capital is split between an employee trust (35%), suppliers (25%) and senior managers (40%) (Brady and Lorenz, 2001). Thus the rescue of the company has given rise to a significant experiment in share ownership by stakeholders.

The Rover case is a reminder that mechanisms exist within UK corporate governance for the representation and articulation of the interests of non-shareholder constituencies. These clearly do not occupy the central place in management practice and corporate culture that the values associated with shareholder primacy do. But they nevertheless articulate one of the key tenets of the stakeholder argument, namely that managers need to engage the voluntary cooperation of non-shareholder constituencies if they are to build competitive success, particularly over the longer term. There are signs that this view is increasingly influencing the attitudes of institutional shareholders towards the strategies of the companies in which they invest. As the next section shows, this development has the potential to take the stakeholder argument from the periphery back into the core of corporate governance processes.

4. The changing role of institutional shareholders

Some institutional investors are beginning to use their influence to monitor performance by companies across a range of social and environmental issues which impact upon stakeholders. This is being done not solely or even predominantly from philanthropical or ethical motives, but through a perception that companies which disregard stakeholder concerns are also putting shareholder interests at risk. In this context, the increasing concentration of share ownership in institutional hands is significant, since it has the potential to reduce the costs of shareholder activism. As of early 1999, over 70% of listed UK equities were held by institutional investors, and this figure has grown steadily since the late 1940s (Stapledon, 1999). In principle, concentration should help to overcome free-rider effects among dispersed shareholders, and thereby enable shareholders to bring direct pressure to bear on managers. The proliferation of corporate governance codes in the 1990s is, from one perspective, evidence of this. The Cadbury and Greenbury Reports, from which the Combined Code evolved, responded to the concerns of institutional investors and many of their principles mirrored those found in their trade associations' statements of best practice (Stapledon, 1999: 69-76). This type of political activity has clear economies of scale, and so the standard free-rider problems do not apply (Davies, 1991: 87; Stapledon, 1996: 59). More problematic, however, is the manner of intervention by institutions in individual firms.

Governance activity on the part of UK institutional shareholders at firm level occurs in three main ways (Stapledon, 1996; Davies, 2000; Crespi-Cladera and Renneboog, 2000; Pye, 2001): firstly, through the exercise of voting rights at general meetings; secondly, through ongoing dialogue, meetings, information transfer and informal discussion with managers; and thirdly, through the attachment of conditions to further injections of funds ('pre-emption' rights give investors significant leverage where poor performance means further finance is sought: Paul, 1991). However, the type of insider control which characterizes the continental European systems, where dominant shareholders call managers directly to account is still very much the exception.

Concentration at market level may however shape incentives in other ways. Hawley and Williams (2000, 2003) argue that the institutionalization of share ownership which has occurred in the USA and UK since the 1940s has created a new category of 'universal owners' with strong incentives to become actively involved in the affairs of individual companies. This is because pension funds, in particular, tend to have holdings in a broad cross section of the listed company sector. As a consequence of the growth of the listed company sector

following, in the case of the UK, the privatization of state-owned industries, this increasingly means that they have interests in the economy as a whole. As a result, these shareholders do not benefit from short-term gains achieved through the operation of the market for corporate control. They are likely to take the view that takeover bids which result in substantial gains for target shareholders bring them little gain if, over time, they do not produce enhanced returns for shareholders in bidder companies, since they will most likely hold equity stakes in both sets of firms.

Universal owners are also likely to have an extended time horizon for assessing corporate performance. The more they are required by prudential investment standards to diversify their holdings across the market as a whole, the more they become locked in both to the market and to the individual firms in which they hold stakes. Being subject to lock-in makes them more likely to engage with management on a long-term basis to improve performance, and less likely to respond to managerial failure by selling their stakes in the companies concerned.

In addition, universal ownership provides pension funds with incentives to monitor the degree to which firms produce externalities in terms of social and environmental costs which fall on third parties or the wider community. The logic of universal ownership is that shareholders will, in the final analysis, bear the costs of externalities which cannot easily be absorbed by third parties or which produce dislocative effects upon society or the economy.

Trade unions are in a particularly sensitive position with regard to the logic of universal ownership. On the one hand, as representatives of employees, they have an interest in supporting corporate strategies which promote job stability and high quality employment. On the other hand, as representatives of pension fund beneficiaries, they have both an interest and, under certain circumstances, a legal duty, to obtain the highest possible investment returns for their members. There is plainly potential for conflict between these two sets of interests. The contradiction disappears if those companies that offer high quality employment are seen to be those that also best protect the long-term interests of shareholders. Where this is so, unions are able to pursue a dual strategy: in the sphere of production, engaging with management through partnership agreements and similar arrangements designed to enhance and sustain corporate performance while, in the sphere of finance, exercising their influence as shareholders to promote progressive human resource management practices. In practice, however, the matter is much more complex than this simple model allows. A crucial variable affecting union involvement in corporate governance processes is the ownership structure of pension funds and other collective forms of saving.

In the United States, unions jointly control, along with employers, occupational pension funds set up under the Taft-Hartley Act 1947, which account for a significant proportion of total equity investments, and they have a considerable say over the management of many of the large public-sector funds which have taken a lead in shareholder activism over the past decade. US unions have also developed a number of strategic alliances with corporate governance activist groups, aimed at using shareholder resolutions and the exercise of voting rights to bring influence to bear on management (Ghilarducci, Hawley and Williams, 1997). Notwithstanding a growing number of TUC initiatives in this area (Barber, 2002), UK unions generally have less influence over the management of occupational pension funds than their US counterparts do since most UK funds are ultimately controlled by employer-nominated trustees. Union involvement in the framing of shareholder resolutions and the conduct of campaigns over corporate governance issues is also at a comparatively early stage of development by comparison to the USA.

So far, in the UK, evidence for the existence of the universal owner model is largely to be found in the emergence of a number of new-style activist funds which engage with companies over issues of corporate performance and social responsibility (McLaren, 2002). A leading example of a focus fund which aims to improve corporate performance through direct engagement is that run by Hermes Investment Management Ltd. Hermes is one of the largest pension fund managers in Britain, controlling on behalf of its clients approximately 1.2% of all the shares on the FTSE All Share Index. It is one of the few large pension fund managers that is not owned by a bank or large financial institution; rather, it is owned by, and is the principal fund manager for, the British Telecom pension fund, the UK's largest. It also manages pension scheme portfolios for a number of other major corporate and public employers. This independence is said to allow Hermes to avoid a range of potential conflicts of interest which affect investment funds which are part of wider banking groups. Hermes is the first major investment institution in the world to have established an activist fund which invests in companies that are poorly performing but fundamentally sound, with the aim of improving performance and delivering long-term shareholder value through better management and corporate governance. In this process, a team of specialist professionals liaise closely with fund managers to monitor company direction and performance.

Whereas UK institutional investors typically do not become directly involved in the management of the companies in which they invest, Hermes' focus fund is set up on the stated belief that companies with concerned and involved shareholders are more likely to achieve superior long-term returns than those without. Hermes publicly supports a framework for corporate governance in

which directors of public companies and shareholders as owners together work to maximize long-term shareholder value: 'companies should manage effectively relationships with their employees, suppliers and customers and with others who have a legitimate interest in the company's activities' (Hermes, 2002: Principle 9). Ethical as well as environmentally and socially responsible behaviour are also given high priority.

While Hermes is undoubtedly an exceptional case, its approach carries wider significance because of the way in which the regulatory framework is currently being realigned in an effort to encourage institutional investors to place greater weight on voice and less on exit in their relations with companies. In this context, it has been argued that institutional shareholders' right to vote on company resolutions is a fiduciary asset, held for the benefit of fund beneficiaries (Monks and Sykes, 2002). If this were so, voting would in effect become mandatory. This is not yet the case in either the UK or the US. However, a milder form of the 'fiduciary asset' hypothesis would involve requiring funds to publicise and in some circumstances justify their voting record. In 2001 amendments to regulations governing occupational pensions schemes came into force, which require schemes either to indicate, as part of their investment statement, what their position is on a range of matters including the social and environmental performance of the companies they invest in or, in the absence of such a statement, to justify this stance.[10] In this way, the logic of comply or explain was extended to the investment community. The Myners report on institutional investment practices, published under the auspices of HM Treasury in 2001, issued a set of recommendations that would extend this approach further (Myners, 2001).

There are however several problems with the hypothesis that shareholder activism could bring about a closer alignment of company practice with stakeholder interests. Firstly, to the degree that investment practices become increasingly international, with both UK pension funds increasingly investing overseas and foreign funds investing in the UK, it is not obvious that institutional investors are necessarily locked into the fate of the UK (or any other) economy in the way suggested by the universal owner hypothesis (Davies, 1991). Secondly, it is far from clear that boards and managers will necessarily see stakeholder-friendly policies as in the best long-term interests of their companies. As the case studies carried out by Deakin *et al.* (2002) show, it is open to companies to take a low-human capital intensity route to competitive success, in particular in product markets with a lower quality segment. It is difficult to see how the logic of comply or explain would have much impact on this approach. Thirdly, accounting conventions for many aspects of social and environmental performance do not yet exist, or at least not in the form that they

do for financial performance. Capital markets can only act on the information available to them; at present, the mechanisms are not in place for producing information of the kind which is needed to factor stakeholder-related issues into a company's share price. As long as this situation persists, there is a need for regulation to counteract the distortions that could arise from capital market myopia on these issues.

But while the difficulties facing shareholder activism are considerable, they are not necessarily insurmountable. One way forward is to assist the creation of a market in information on how firms manage the creation of stakeholder value. The Company Law Review's recommendation for greater disclosure by companies of information relating to issues of social and environmental responsibility, through the proposed operating and financial review (Company Law Review, 2000: 180-193; 2001: 49-54), is of critical importance in this regard. As we have seen, this proposal directly addresses the need for shareholders and other stakeholders to make better-informed judgments on non-financial aspects of corporate performance.

5. Conclusion

In Britain and America, the rise of hostile takeovers and associated changes to corporate governance norms in the 1980s and 1990s revised expectations of the role and responsibilities of corporate management, emphasising accountability to shareholders above all else. In the 1990s, proponents of stakeholder voice pointed out that the very mechanisms which bind managers to shareholder value might harm not only other stakeholders but also shareholders' interests: by impeding firms' ability to make credible commitments not to expropriate stakeholders, these mechanisms created an environment in which firms were less able to establish an effective basis for long-term productive relations. However, this critique has had little impact on the core institutions of UK corporate governance, namely the Takeover Code, the law relating to directors' duties, and the corporate governance codes.

By looking beyond the core, however, we can see that the concerns raised by the stakeholder debate of the 1990s have not gone away. The success over time of productive systems still requires significant, long-term investments to be made, and cooperative, trust-based alliances to be fostered, between various stakeholders. Non-shareholder constituencies who are asked to make firm-specific investments in return for an implicit promise of a share of the quasi-rents generated by their investment and participation will still want protection against *ex post* expropriation by other groups, such as shareholders.

Participation or recognition in corporate governance mechanisms may be one important way of affording such protection. So corporate governance remains for many firms an exercise in setting the conditions for voluntary cooperation between stakeholder groups with divergent interests. The argument over the optimal form of corporate governance rules has not been concluded; there is a genuine choice to be made between mechanisms that place greater or lesser emphasis upon stakeholder involvement in governance processes. On this basis, a major countervailing force to shareholder primacy is provided by the information and consultation provisions of European Community Directives, which are increasingly reshaping UK employment law. By incorporating employee voice into the procedures governing large-scale restructurings, these laws alter the balance of financial advantage in commercial transactions in favour of stakeholder-orientated strategies.

Over the longer term we should not be surprised to see a clearer articulation within UK corporate governance of the importance for companies of creating long-term stakeholder value. This does not mean that the UK will converge upon a set of stakeholder-orientated norms of the kind observed in mainland Europe and Japan. In the short run, as the system continues to be skewed towards shareholder interests, we may expect considerable turbulence and instability in the system of corporate governance as the various actors try to make the existing model work. Managers committed to a strategy of investing in stakeholder relations will try, often in conjunction with unions, to convince shareholders that this approach is also in their long-term interests. Shareholders, in turn, may be prepared to accept this logic. By these means, shareholder primacy could be transformed into a mechanism favouring a stakeholder-orientated approach. But there is nothing inevitable about this outcome and it remains the exception, not the rule, in current practice.

Notes

[1] Council Directive of 2001/23/EC of 12 March 2001 on the approximation of the laws of the Member States relating to the safeguarding of employees' rights in the event of transfers of undertakings, businesses or parts of undertakings or businesses, OJ L 082, 22.3.2001, pp. 16-20. This version of the Directive codifies the original measure (Council Directive 77/187/EC, OJ L 61, 5.3.1977, p. 26) together with amendments made in 1998 (Council Directive 98/50/EC, OJ L 201, 17.7.1998, p. 88).

[2] Council Directive 98/59/EC of 20 July 1998 on the approximation of the laws of the Member States relating to collective redundancies OJ L 225, 12.08.1998, pp. 16-21, Arts. 1, 2. This Directive codifies earlier measures (Directive 75/129/EEC, OJ L 48, 22.2.1975, p. 29, and Directive 92/56/EEC, (OJ L 245, 26.8.1992, p. 3).

[3] Cases C-382/92 and C-383/92 *Commission* v. *United Kingdom* [1994] IRLR 392, 412.

[4] Under the Trade Union and Labour Relations (Consolidation) Act 1992, s. 188, the period over which consultation must take place is 90 days before the first dismissal takes effect if the employer proposes to dismiss 100 or more employees at one establishment, and 30 days before the first dismissal takes effect if it is proposed to dismiss between 20 and 99 employees at one establishment. See Deakin and Morris, 2001: ch. 9.3.1 for an account of the law.

[5] The relevant law for present purposes is contained in Trade Union and Labour Relations (Consolidation) Act 1992, ss. 188-188A, and in the Transfer of Undertakings (Protection of Employment) Regulations (TUPE) 1981, regs. 10-11A. See Deakin and Morris, 2001: ch. 9.3.1.

[6] Council Directive 94/45/EC of 22 September 1994 on the establishment of a European Works Council or a procedure in Community-scale undertakings and Community-scale groups of undertakings for the purposes of informing and consulting employees, OJ L 254, 30.9.1994, pp. 64-72. A later Directive formally extended the measure to cover the UK (which was initially exempt from it) and this was incorporated into UK law by SI 1999/3323. See Deakin and Morris, 2001: 827-934 for an account of the relevant law. Two more recent Directives which will extend the information and consultation model are the Framework Directive 2002/14 on national-level information and consultation of employee representatives

and Directive 2001/86 on employee consultation in the European Company or Societas Europea: see Barnard and Deakin, 2002.

[7] The protective award which is available under UK law for failure to consult will double (up to a statutory limit) the salaries and wages of the workforce for a period of weeks or months over which consultation should have taken place: TULRCA 1992, s. 189.

[8] As under the automatic stay of US bankruptcy law (11 USC § 362). A similar effect is had upon the claims of unsecured creditors by the commencement of winding-up proceedings in the UK (Insolvency Act 1986, ss. 128, 130(2), 183, 184), or on those of all creditors by the bringing of a successful petition for administration (*ibid* ss 10, 11).

[9] This is subject to changes introduced by the Enterprise Act 2002 which under certain circumstances will reduce the ability of the single secured creditor to intervene under the administrative receivership procedure.

[10] The Occupational Pension Schemes (Investment and Assignment, Forfeiture, Bankruptcy, etc.) Amendment Regulations, SI 1999/1849, reg. 2(4), amending SI 1996/3127.

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