AGENCY PROBLEMS IN TROUBLED COMPANIES: A UK-ITALY COMPARISON

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In this discussion I will try to understand if it is possible to talk about a
distribution of power between constituencies and how it is, eventually, regulated the
coeistence of a plurality of interests under the U.K. system and under the Italian law.
In this regard, I will focus on a particular “step” of the companies’ life, that is far from
the physiological phase: when a company is “in troubles”. The latter term, as it will be
explained, is used according to some UK courts’ decisions and commentators in order
to cover not only insolvency, but also the vicinity of insolvency and, maybe, the thought
of insolvency. For same aspects the correspondence under Italian law could be the
“crisis” state, but some distinctions are necessary to value the importance of the legal
strategies connected with it.

Necessary, speaking about corporate power in the pathological stage of
cOMPAnIES presumed to provide for a description of this power distribution between the
actors when companies are normally carrying on business activities.

The approach I want to suggest to perform this analysis is the so-called doctrine of agency problems, that can read the relationships between the various actors, beyond
what is suggested by law, in economic terms, that is in terms of agency costs.
As a result, the starting point in looking for the object above is an economic one, that is
a theoretical model that allows to understand, in principle, the relationship between
ownership/risk and power of control and the rationales connected with these issues.
More specifically, this ideal model is identified in a company where only the members
risk and have the property of the company. Are also the same members to make
business decisions. Then, the interest\textsuperscript{1} that is pursued is that of their ownership because they are solely to exercise control. Since that model does not exist in the real world,

\textsuperscript{1} It should be also an internal contrast between different interests belonging to different members, causing, for example, a discrepancy between majority and minority of ownership, but in this discuss this issue will not be taken into account.
where necessary the company needs director performances and requires relationships with creditors and other stakeholders, necessarily a plurality of interests came into play, all more or less attributable to the company or related to the business. Members are no longer the only category to take risks and make decisions, that is to exercise corporate power. Consequently, the transfer of risk even head to other than members, is reflected, by applying the economic theory of the correlation between ownership and control, in a new distribution of power.

This new scenario deals with legal strategies which are set up to prevent symptomatic potential corporate conflicts.

In this discussion I want to try to understand if in the UK system and in the Italian law the economic risk distribution model is respected and, eventually, if power is proportionate to the risk that the parties have taken, or there is a mismatch between interests. In this regards, it will be focus on different legal strategies: on the one hand, imperative rules, on the other, contractual remedies that could be seen as, respectively, regulatory and private responses to agency problems. For this aim it will highlight the many aspects of the Italian and the U.K. corporate and insolvency law.

Preliminary, I would say that, in doing so, this discussion will give merely some information of these two jurisdictions, being the purpose not to rehearse all that applies to every law areas, but just to outline some peculiar solutions of both the two jurisdictions which I will argue could be interesting in relation to the agency problems in troubles companies.

By the agency costs theory and the common English theoretical legal strategies distinction I wish to offer, respectively, a common language and a general analytic framework with which functionally compare the U.K. and Italy.

More particularly, Chapter 1 will address the functional model of agency relationships between constituencies of a solvent company. It will describe the main categories of those relationships, which in the real model of a solvent company become agency problems. In this regard, it will place emphasis on the justification of shareholders’ power as residual claimants and on managerial agency problems, showing how the corporate power can be distributed between shareholders and directors,

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depending on which legal (regulatory and/or governance) strategies are provided by legislators.

Then in Chapter 2 I will try to read the Italian and the U.K. distribution of power in terms of managerial agency costs. As a result, it will focus on which interests may arise, directly or indirectly, in managing business activities and, consequently, which legal strategies and approaches are adopted by the U.K. and Italian system to protect those interests.

Having define, although with no claims of completeness, the Italian and the U.K. distribution of management power in solvent companies, in Chapter 3 I will describe how the basic agency problems of the corporate form manifest themselves in troubles situations. In this new scenario it arises the need to protect creditors. In fact, according to the economic theory, if when a company is in normal business operation, creditors shall have no voice and it is right that the control is entirely up to shareholders, this justification no longer holds when risk capital, total or in part, has been lost. Therefore, becomes necessary to understand who, regardless any formal power, are substantially the “owners” of troubles companies. I will argue that in this context a reallocation of control is necessary, becoming creditors residual claimants. Focusing on these issues, I will try to explain the role of the corporate “indebtedness” in the distribution of power and the definition of “insolvency” with the purpose to outline to what extend creditors’ protection could be take into account by legislators.

Once I will have justified the transfer of control of troubles companies to creditors, it will be analysed in Chapter 4 whether the structures and rules in the U.K. and in the Italian system exist to protect creditors.

The final scope will be try to verify whether, according to the legal strategies adopted by Italy and the U.K., the model of distribution of power is faithful to and aligned with the economic ones, or whether there are any inconsistencies and to what extend it is possible to compare or distinguish those two jurisdictions.

Finally, I will highlight two methodological conditions: firstly, I will discuss only about company with limited liability, where the need to have a balance of power is strong; secondly, it is necessary a meaning clarification about the terms “director” and “creditor category” in order to define the context of this discussion.

The term “director” refers generally to the body that has the management of a company; as a result, I have chosen not to address the issues and the (agency) problems either related to internal management (i.e. the distribution of power between board and
managers or between executive and not-executive managers), focusing on relationships between “managerial power” and “out-of-managerial power”, nor connected to the possible presence of senior directors (i.e. the distribution of power between board of managers and board of senior managers). The latter choice is made in order to try to simplify the comparison between the U.K. system, where a body of corporal internal control does not exist, and the Italian jurisdiction, where the presence of this body is compulsory.

The term “creditor category” is limited to those who provide debt capital in order to try to highlight the relationship between the bearers of risk capital, on the one hand, and bearers of debt capital, on the other; moreover, the scope of this limit indication is try to understand whether, under the formal differences between the two categories, there are any substantial commonalities and connections between them when the company is in particular circumstances, that is a troubled company and, if this is the case, whether those similar aspects are or can be recognized by law.

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3 According to the Italian Civil Code, the senior directors’ body is called “collegio sindacale” (in the traditional corporate and control model, see art. 2328, c. 2, nn. 10, 11; art. 2397ss. For the s.p.a.; art. 2463, c. 2, n. 8, art. 2477 for the s.r.l.), “consiglio di sorveglianza (due to the dualistic corporate and control system, see art. 2409 octies-quaterdecies) and “comitato per il controllo sulla gestione (in the monistic system of corporate and control, see art. 2409 sexiesdecies-octiesdecies).
PART 1

DISTRIBUTION OF POWER BETWEEN MEMBERS AND MANAGERS
Chapter 1
AGENCY PROBLEMS AND CORPORATE CONTROL


1.1. Introduction

This Chapter deals with the agency problem doctrine as the language that will be used to read the Italian and the U.K. distribution of power in solvent companies and in companies in.

In this regard, I have outlined some aspects of this economic analysis, speaking about the main categories of agency problems. In particular, managerial agency costs have been stressed, distinguishing between, on the one hand, managerial costs which directly transfer value from shareholders to directors and, on the other, the indirect transfer of power in the same direction.

Furthermore, focusing on the relationships between shareholders as “residual claimants” and management, emphasis has been put on the role of the law in reducing agency costs when companies carry on business activities.

Finally, I have described the main legal strategies by which the corporate power may be distributed and balance between the actors of companies in ordinary activities.

1.2. The problem of non-aligned interests.

A company has a dual nature as both an association of its members and a person separate from its members\(^4\). A company’s property is owned by the company as a separate person, not by the members; the company’s business is conducted by the company as a separate person, not by the members neither by the directors; it is the

\[^4\text{P. Davies, Gower and Davies’ principles of Modern Company Law, 2008,p. 83; D. Kershaw, Company Law in context, Oxford University Press, 2009, pp. 5ss; S. Mayson, D. French, C. Ryan, Company Law, Oxford Press, 2009-2010, pp. 7ss.}\]
company as a separate person that enters into contracts in relation to the company’s business and property⁵.

In this regard, a company deals with the activities of three main groups of people: its shareholders (or members), its directors⁶ and its creditors. The law seeks to regulate both the relations between these three groups (for example, as against directors or creditors as against shareholders) and within these groups (for instance, majority as against minority shareholders or secured as against unsecured creditors). It also seeks to regulate the mechanisms by which people join, or leave, one of these groups as well as their rights and duties once they have joined a group. Thus, the law is interested in the process by which investors come to be shareholders or creditors of a company as well as their legal status once they have acquired shares or lent money to the company⁷. Moreover, a company which runs a business will need to generate successful relationships with other groups of people as well, notably suppliers of various inputs (such as labour or components) and customers, not to mention government or the community in which the company operates. Although all these constituencies play a crucial role in either financing or carrying out the economic activities which companies undertake and in having a significant influence on corporate decision-making, in this discussion it will be focused only on the three groups we mentioned above: directors, shareholders and creditors. More exactly, the aim is to highlight the relationships between those who provide venture capital and those who provide debt capital to the company. It is not easy to describe the role of each of these groups, because, as it will be seen, companies perform many different functions and the role of constituencies vary accordingly.

1.3. The language of economic agency costs

The starting point of this analysis is a theoretical premise, namely that power is linked to risk. Assuming a company ideal model where only the members are the owners and make business decisions and perform duties, it is obvious that the only interest to reach will be those of members which are entitled of control rights as the ultimate repository of authority in the company. There are three principal areas of

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⁵ The leading case on the fundamental importance of the separate personality of a company is Salomon v A Salomon and Co Ltd [1897] AC 22.
⁶ and, to a lesser extent, its senior managers, whether they are directors or not.
shareholder control: control over the company’s constitution; control over the company’s management; and control over the company’s economic surplus.

Otherwise, problems are generated when those who run the company do not themselves own the company and/or do not make business activities. Those issues are exacerbated if the shareholder body has poor incentives to monitor and sanction managerial misbehaviour. In order to give some conceptual clarity to the problems just described, one way could be to provide in the corporate legal world by the economic analysis of agency problems. An ‘agency problem’ – in the most general sense of the term- arises whenever the welfare of one party, termed the ‘principal’, depends upon actions taken by another party, termed the ‘agent’. The problem lies in motivating the agent to act in the principal’s interest rather than simply in the agent’s own interest. Viewed in these broad terms, agency problems arise in a broad range of contexts that go well beyond those that would formally be classified as agency relationships by lawyers. In particular, almost any contractual relationship, in which one party (the agent) promises performance to another (the principal), is potentially subject to an agency problem. The core of the difficulty is that, because the agent commonly has better information than does the principal about the relevant facts, the principal cannot costlessly assure himself that agent’s performance is precisely what was promised. As a consequence, the agent has an incentive to act opportunistically, skipping on the quality of his performance, or even diverting to himself some of what was promised to the principal. This means, in turn, that the value of the agent’s performance to the principal will be reduced, either directly or because, to assure the quality of the agent’s performance, the principal must engage in costly monitoring of the agent. The greater the complexity of the tasks undertaken by the agent, and the greater the discretion the agent must be given, the larger these ‘agency costs’ are likely to be.

Three generic agency problems arise in business firms. The first involves the conflict between the firm’s owners (as the principal) and its hired managers (that are the agents). The woe lies in assuring that the managers are responsive to the owner’s interests rather than simply to the managers’ own personal interests. The second agency problem involves the conflict between, on the one hand, owners who possess the majority or controlling interest in the firm and, on the other hand, the minority or non-

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controlling owners. Here the non-controlling owners are the principal and the controlling owners are the agents, and the difficulty lies in assuring that the former are not expropriated by the latter. The third agency problem involves the conflict between the firm itself (including, particularly, its owners) and the other parties with whom the firm contracts, such as creditors, employees, and customers. Agency problems arise in assuring that the firm, as agent, does not behave opportunistically towards these various other principals — such as by expropriating creditors, exploiting workers, or misleading consumers.

In the analysis proposed here, that is, in particular to highlight how the various interests are balanced between the different categories of constituencies, it will not take into account the second type (which refers to the internal problems of the same class, that is the members’ category) placing the emphasis instead on the two other species called respectively managerial agency problems and financial agency problems.

Law can play an important role in reducing agency costs. Obvious examples are rules and procedures that enhance disclosure by agents or facilitate enforcement actions brought by principals against dishonest or negligent agents. Paradoxically, in protecting principals against exploitation by their agents, the law can benefit agents as much as — or even more than- it benefits the principal. The reason is that a principal will be willing to offer greater compensation to an agent when the principal is assumed of performance that is honest and of high quality. To take a conspicuous example in the corporate context, rules of law that protect creditors from opportunistic behaviour on the part of corporations should reduce the interest rate that corporations must pay for credit, thus benefiting corporations as well as creditors. Likewise, legal constraints on the ability of controlling shareholders to expropriate minority shareholders should reduce the cost of outside equity capital for corporations. Moreover, rules of law that inhibit insider trading by corporate managers should increase the compensation that shareholders are willing to offer the managers.

Consequently, reducing agency costs is in the interests of all parties to a transaction, principal and agents alike. It follows that the normative goal of advancing aggregate social welfare is generally equivalent to searching for optimal solutions to the corporation’s agency problems, in the sense of finding solutions that maximize the aggregate welfare of the parties involved- that is, of both principals and agents taken together.
1.4. Managerial agency costs

The managerial agency costs\(^\text{10}\) are the incurred costs when managers act in their own interests to the detriment of the shareholders’ interests as agency costs. However, these costs do not necessarily represent value that is taken away from shareholders. Contractarian scholars would argue that when shareholders buy shares in a company they assess the scope that managers have to act in ways that incur managerial agency costs and reduce the price they are willing to pay for the shares accordingly. If this is correct then these costs are reflected in the reduced value of the shares and make it more costly for the company to raise equity finance. However, if such costs are not taken account of by shareholders when they buy the shares then the incurrence of such costs represents a real transfer of value from shareholders to managers.

There are two managerial agency cost categories. The first category involves behaviour and business decisions that directly transfer value to managers. One of the main species is the so called “self-dealing”, that involves a transaction in which the director is on both sides of a contract: as an individual on one hand, and as a director of the company on the other. If a manager enters into a transaction with the company there is a risk that the terms of that contract will benefit the manager at the company’s expense. If the company overpays for an asset sold to it by the manager or the manager purchases a company asset for less than it is worth, value is transferred directly into the manager’s pocket. This value transfer is an agency cost. If the company loans the manager money at a zero interest rate this is an agency cost as the interest it could have obtained by depositing the funds in a bank is effectively transferred into the manager’s pocket. Another direct transfer of value could be made by “management remuneration”. Remuneration is really an example of self-dealing: it is a transaction for employment services between the manager and the company. If a manager arranges for remuneration which is above the market rate this is an agency cost. Remuneration commands a sub-category of its own for, as we shall see, it receives specific regulatory attention. Finally, according to the economists analysis, the directors of a company, which are not required to own any of its shares, are believed to manage the business less efficiently than if they did own it. Rather than treating this as a consequence of the fact that wealth owners are not necessarily good business managers and good business managers are not necessarily wealth owners, the analysis adopted in the shareholder-primacy view of the company is that the inefficiency of managers is a detriment for providers of capital, for whom the managers are treated as ‘agents’. The role model for directors seems to be the 18th or 19th century steward or land-agent managing an estate for a temporarily absent landlord who might be expected to return to retake control.
managers during their employment and as a result of the position they hold will come across potential new “business opportunities”. If an opportunity identified by the manager would be valuable to the company but the manager decides to exploit the opportunity personally then the value generated by the project is transferred directly to the manager himself. This lost value for the company is an agency cost.

The second managerial agency cost category involves behaviour and business decisions that provides indirect financial and psychological benefits, but do not involve an immediate transfer of wealth to the director. It is the case, for instance, of “shirking and incompetence”. Managers as agents are employed to generate value. This requires that they give the company their full attention and that they work hard in the interests of the company. Managers who shirk their responsibilities destroy value. This lost of value is an agency cost. Another indirect source of indirect loss of value could be “perquisites”. If there might be good (business) reasons to provide a manager with perquisites, where the reason that drives the decision is the indirect financial or psychological benefit of the manager then the agency costs are incurred\(^\text{11}\). Finally, managers may be tempered to use corporate funds for projects that have poor returns relative to the returns that the shareholders could obtain if the funds were distributed to them. The motivation for investing in such projects may not be to generate value for the business but rather to expand the size of the business: the assets under management; the number of employees controlled by management. The benefits for management are twofold: first, managers might feel better about themselves (more important and more powerful) the larger the company they run and control; secondly, there may be indirect financial benefits as managers may legitimately claim they should be paid more the more responsibility that they have and the more work they have to do.

The agency cost doctrine set out above suggest that there are two options available to principals (in the economic use of the term) such as shareholders to respond to the possibility that an agent may act in his own interests to the detriment of the principal. The first option would be to reduce what the principal is willing to pay. The second would be to monitor the agent’s actions to ensure that he does not misbehave and to sanction him if he does. The first of these options would mean that shareholders,

\(^{11}\) A real life and extreme example -where the former CEO of Tyco International Inc, a US company, was accused of misusing corporate funds- highlights the problem of perquisites is commented by A. Hill and A. Michaels, *Paw taste condemns Kozlowski*. Report says Tyco bought $ 15,000 dog umbrella stand for chief’s apartment, in *Financial Times*, 18 September 2002.
rationally aware of the scope for management to incur agency costs, would simply reduce what they are willing to pay for the shares to take account of an estimate of these costs\textsuperscript{12}. The second chance to address an agency problem is the monitoring of the agent by the principal. An important consideration in determining the extent to which management can incur agency costs is the ownership structure of the company.

1.5. Legal strategies for reducing managerial agency costs

In addressing agency problems, the law turns repeatedly to a basic set of legal strategies. By ‘legal strategies’ we mean a generic method of deploying substantive law to mitigate the vulnerability of principals to the opportunism of their agents.

These strategies can be divided into two subsets, which we term respectively, regulatory strategies and governance strategies. Regulatory strategies are prescriptive; they dictate substantive terms that govern either the content of the agent-principal relationship, or the formation or dissolution of that relationship. By contrast, governance strategies build on the elements of hierarchy and dependency that commonly characterize agency relationships; they attempt to protect principals indirectly, either by enhancing their power or by molding the incentives of their agents.

1.5.1. Regulatory strategies\textsuperscript{13}

The most familiar pair of regulatory strategies constrains agents by commanding them not to make decisions, or undertake transactions, that would harm the interests of shareholders. If a share would be worth £10 under management that could guarantee that they would not incur any agency costs, it will be worth £8 if shareholders estimate that management will incur agency costs worth £2 a share.\textsuperscript{12}

This Part is primarily concerned with restricting the ability of managers who are given discretion to manage the company from abusing that discretion to benefit themselves personally. We are concerned with the legal strategies that are deployed to regulate this managerial agency problem. However, there is a danger contained within this viewpoint that we need to be aware of. Excessive focus on how to control and constrain abuses of discretion—that is, how to ensure managers behave responsibly—may distract us from giving due regard to a fundamental, if somewhat obvious, observation. The agency cost problem is a product of the corporate form that allows assets to be managed by professional managers for the benefit of those who have funds to invest but do not have the skills, the time or the inclination to manage. The limited liability company with separate legal personality is without doubt one of the most important inventions of the modern age. To enable value to be created through the corporate form we must give management the freedom and authority to make decisions and to make them quickly; to devise a business strategy and to implement that strategy. A manager that has to negotiate with the owners of a firm prior to making any decision which would be binding on the company would not be a successful manager. Giving authority and discretion to managers is a prerequisite to value creation through the corporate form.

Whilst we need to ensure that managers do not abuse their discretion, if in the quest for ensuring that management behave responsibly we deny management sufficient authority and discretionary freedom to do their job then we may destroy more value than the agency costs that are saved. Accordingly, when analysing and critiquing the legal strategies deployed by UK company law to regulate the managerial agency problem we must always bear in mind that company law must strike the right balance between reducing agency costs and giving managers freedom to act; the right balance between responsibility and authority\textsuperscript{13}.\textsuperscript{13}
their principals. Lawmakers attempt to regulate the substance of agency relationships by rules, which require or prohibit specific behaviours, or by general standards, which leave the precise determination of compliance to adjudicators after the fact. The latter, which prescribe behaviours *ex ante*, are commonly used in the corporate context to protect a corporation’s creditors and public investors. Thus corporation statutes universally include creditor protection rules such as dividend restrictions, minimum capitalization requirements, or capital maintenance requirements. By contrast, intra-corporate topics, such as insider self-dealing tend to be governed by open standards that leave discretion for adjudicators to determine *ex post* whether violations have occurred.

The importance of both these regulatory strategies depends in large measure on the vigour with which they are enforced. In principle, well-drafted rules can be mechanically enforced. Standards, however inevitably require courts (or other adjudicators) to become deeply involved in evaluating and sometimes molding corporate decisions *ex post*.

A second set of regulatory strategies open to the law is to dictate the terms on which principals affiliate with agents rather than—as with rules and standards— the terms on which the principal-agent relationship develops internally. The law can dictate *terms of entry* by, for example, requiring agents to disclosure information about the likely quality of their performance before contracting with principals. Alternatively, the law can prescribe *exit opportunities* for principals, such as awarding to a creditor the right to call a loan.

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15 Standards are also used to protect creditors and public investors, but the paradigmatic example of standards-based regulation relate to the company’s internal affairs, as when the law requires directors to act in ‘good faith’ or mandates that self-dealing transactions must be ‘entirely fair’.

16 The entry strategy is particularly important in screening out opportunistic agents in the public capital markets. Outside investors know little about public companies unless they are told. Thus it is widely accepted that public investors require some form of systematic disclosure to obtain an adequate supply of information. Legal rules mandating such disclosure provide an example of an entry strategy because stocks cannot be sold unless the requisite information is supplied, generally by the corporation itself.

The exit strategy, which is also pervasive in corporate law, allows principals to escape opportunistic agents *ex post*. Broadly speaking, there are two kinds of exit rights. The first is the *right to withdraw* the value of one’s investment. The second one is the *right of transfer*—the right to sell shares in the market—that permits the replacement of the current ‘agent’—the management team in a widely held company—by a new one that may be more effective in exercising control. Thus, unimpeded transfer rights allow hostile takeovers in which the disaggregated shareholders of a mismanaged company can sell their shares to a single active shareholder with a strong financial interest in efficient management. Such a transfer of control rights, or even the threat of it, can be a highly effective device for disciplining management.
1.5.2. Governance strategies

Key strategies for controlling the enterprise are the so called *appointments rights*- that are the power to *select or remove* directors (or other managers) are key strategies for controlling the enterprise. A second pair of governance strategies expands the power of principals to intervene in the firm’s management. These are *decision rights*, which grant principals the power to *initiate or ratify* management decisions. This set of decision rights is much less prominent in corporate law than are appointment rights strategies, as a logical consequence of the fact that the corporate form is designed as a vehicle for the delegation of managerial power and authority to the board of directors. Only the largest and most fundamental corporate decisions (such as mergers and charter amendments) require the ratification of shareholders *ex post* under existing corporation statues, and no jurisdiction requires shareholders to initiate managerial decisions.

Finally, a last pair of governance strategies alters the incentives of agents rather than expanding the powers of principals. These are *incentive strategies*. Firstly, there is the *reward strategy*, which –as the name implied- rewards agents for successfully advancing the interests of their principals. The more common form of reward is a *sharing rule* that motivates loyalty by tying the agent’s monetary returns directly to those of the principal. The reward mechanism that is less commonly the focus of corporate law is the *pay-for-performance regime*, in which an agent, although not sharing in his principal’s returns, is nonetheless paid for successfully advancing her interests. The second incentive strategy- the *trusteeship strategy* - works in seeking to eliminate conflicts of interests *ex ante* to ensure that ‘bad’ behaviour by an agent will not be rewarded. This strategy assumes that, in the absence of strongly focused – or ‘high-powered”- monetary incentives to behave opportunistically, agents will respond to the ‘low-powered’ incentives of conscience, pride, and reputation, and are thus more likely to manage in the interests of their principals. Agents serving as trustees may be internal to the corporation, as when disinterested directors must approve a self-dealing transaction by a controlling shareholder, or they may be external, as when the law requires an investment banker, a state official, or a court to approve corporate action.

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17 These strategies are at the very core of corporate governance. Moreover, the power to appoint directors is a core strategy not only for addressing the agency problems of shareholders in relation to managers, but also, for addressing agency problems of minority shareholders in relation to controlling shareholders, and of employees in relationship to the shareholder class as a whole.
1.6. Some conclusions

The legal strategies just described can in principle be deployed to deal with the agency problems presented by any type of organization. As the discussion below will demonstrate, the U.K. and Italian jurisdictions adopt a fluid mix of regulatory and governance strategies in addressing managerial agency problems.

This legal strategies presentation merely highlights the fact that half of the strategies take full effect before an agent acts, while the other half respond—at least potentially—to the quality of the agent’s action ex post. In the case of the regulatory strategies, for example, rules specify what the agent may or may not do ex ante, while standards specify the general norm against which an agent’s actions will be judged ex post. Thus, a rule might prohibit a class of self-dealing transactions outright, while a standard might mandate that these transactions will be judged against a norm of fairness ex post. Similarly, in the case of setting the terms of entry and exit, an entry strategy such as mandatory disclosure specifies what must be done before an agent can deal with a principal, while an exit device such as appraisal rights permits the principal to respond after the quality of the agent’s action is revealed.

The six governance strategies also fall into ex ante and ex post pairs. If principals can appoint their agents ex ante, they can screen for loyalty; if principals can remove their agents ex post, they can punish disloyalty. Finally, trusteeship is an ex ante strategy in the sense that it neutralizes an agent’s adverse interests prior to her appointment by the principal, while most reward strategies are ex post in the sense that their payouts are contingent on uncertain future outcomes, and thus remain less than fully specified until after the agent acts. We do not wish, however, to overemphasize the clarity or analytic power of this categorization of legal strategies into ex ante and ex post types. Indeed these strategies clearly overlap, and any given legal rule might well be classified as an instance of two or more of those strategies. Our purpose here is simply to emphasize the various ways in which law can be used as an instrument, not to offer a new formalistic schema that displaces rather than aids functional understanding.
Chapter 2

THE DISTRIBUTION OF POWER
BETWEEN MEMBERS AND MANAGERS

Summary: 2.1. Introduction - 2.2. The basic Italian distribution of power between members and managers - 2.2.1. Italian legal strategies protecting the firm’s owners as a class - 2.2.2. Italian interest primacy approach: shareholders’ and multi-party visions - 2.3. The basic UK distribution of power between members and managers - 2.3.1. UK legal strategies and approaches to protect members - 2.3.2. Division of power between members and directors under UK Court decisions - 2.4. Peculiar separation of ownership and control in the public companies) - 2.5. Some conclusions.

2.1 Introduction

The appropriate or optimal distribution of power in companies is likely to vary accordingly to the specific attributes of the company, including most importantly the attributes of the shareholder body.\(^\text{18}\)

Generally, looking to the law to provide the framework for legitimation and control power, it is possible to highlight different visions. According to a theory, the power of a company will be legitimate only if it is exercised in the interest of all those whom it affects. As a consequence, the law has to require companies to give due consideration to all relevant interests. Other thesis believe that corporate power is legitimated by the contribution that companies make to the economy and that the market provides adequate control of economic activity so that legal controls are either superfluous or produce damaging distortions of the market.

With no value considerations about these lines of thoughts, I will try to outline briefly how corporate governance power and control is shared between shareholders and directors regarding the UK and the Italian legal model.

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Preliminary, in order to understand the actual extent of the managerial agency problems in this two jurisdictions, it is important to focus on the typical ownership structure of the English and Italian companies. In this regard, it can be shown that small and medium companies play a vital role in the UK and in Italy. Consequently, the ownership structure of the two systems has some notable similarities, at list in size. Nevertheless, in the context of public listed companies there is a fundamental difference between the Italian and the UK reality: on the one hand, in Italy the ownership is highly concentrated\textsuperscript{19}, on the other, in the UK corporate ownership is splintered among numerous shareholders\textsuperscript{20}.

Regarding the relationship between ownership structure, company performance and corporate governance framework, the econometric analysis\textsuperscript{21} showed that the concentrated ownership structure is a particular important determinant of the configuration of the board. Indeed the increasing concentration shows the size of the board tending to shrink and to encourage the executive component, confirming that the majority shareholders have significant influence and bargaining power in the appointment of adviser of the board\textsuperscript{22}.

\textsuperscript{19} More exactly, SMEs are defined by the Companies Act as meeting two of the following criteria: a.) employing 250 people or less; b.) having a turnover of less than £ 11.2m (EC use less than Euro 40m); c.) having net assets of less than £ 5.6m (EC use less than Euro 27m). The UK’s 3.7 million SMEs account for approximately 40% of GDP and have an annual turnover of one trillion pounds, employing over 12 million people in the UK, that represents 56% of the employed workforce. Of these, 80% are employed in firms of less than 50 persons. This data are available at www.cabinetoffice.gov.uk. Italian SMEs have similar criteria: a.) employing 50 people (year average); b.) having net assets of less than Euro 3.125.000; c.) having a turnover of less than Euro 6.250.00019. The Italian SMEs are over than 4 million, that represents 67% of the employed workforce. There are also the so called “micro” companies, which employed less than ten people. Globally they account for 1/3 of the GDP.

\textsuperscript{20} H. Kanda, Comparative Corporate Governance Country Report, in K. J. Hopt et al. (eds), Comparative Corporate Governance: the state of the art and emerging research, 1998, pp. 1045ss.


According to this premise, the similarity of ownership structure of UK and Italian small and medium companies should have correspondence on managerial agency problems terms.

It is necessary to ask, then, whether the various strategies described in chapter 1 are embodied in the U.K. and the Italian systems. Preliminary, it can be argued that these legal remedies do not necessarily require law for their implementation. Indeed, they could in principle be adopted by contract, for example, through appropriate provisions in the articles of association agreed to by the firm’s owners. In addressing this issue, it is important to distinguish between legal rules that are merely default rules, in the sense that they govern only if the parties do not explicitly provide for something different and rules of law that are mandatory, leaving parties no option but to conform to them. Much of U.K. corporate law consist of default rules. To this extent, corporate law simply offers a standard form contract that the parties can adopt, at their option, in whole or in part. A familiar advantage of such a legally provided standard form is that it simplifies contracting among the parties involved, requiring that they specify only those elements of their relationship that deviate from the standard terms. In serving this function, default rules of corporate law will generally serve best if they reflect the terms that the parties themselves would most commonly choose. Default rules can also, however, serve a protective or information-revealing function. A rule that serves this function may not be the one that well-informed parties would generally choose, but rather a ‘penalty default’ that burdens the party most likely to have private information relevant to the transaction. The purpose of such a rule is to force parties to reveal their private information—in order to avoid the default outcome—and consequently induce explicit contracting between the parties that will lead to an outcome superior to that which would otherwise be expected. In the Italian system the wide majority of rules are mandatory. Firstly, mandatory rules serve a prescriptive function. Indeed, some parties might otherwise be exploited because they are not well informed, or that the interests of third parties might be affected, or that collective action problems (such as the notorious ‘prisoners’ dilemma’) might otherwise lead to contractual provisions that are inefficient or unfair. Moreover, in some circumstances, the rationale for mandatory rules is to serve an enabling function similar to that served by default rules. More particularly, mandatory rules can facilitate freedom of contract by helping corporate actors to signal the terms they offer and to bond themselves to those terms. The law accomplishes this
by creating corporate forms that are to some degree inflexible, but then permitting choice among different corporate forms.

2.2. The basic Italian distribution of power between members and managers

2.2.1. Italian legal strategies protecting the firm’s owners as a class

The Italian corporate law typically deals with the basic agency problem between the firm’s owners and its managers by a regulatory standard strategy, providing for a multi-member board of directors that is elected by the firm’s shareholders, which have also the right to remove the managers. As a consequence, it can be deducted that the law underpinning the corporate governance system relies also heavily on the governance-oriented remedies, represented by the appointments and decision rights strategies.

This governance structure seems to be designed principally to effectuate the interests of shareholders as a class. This fact should be connected with the two core features of the corporate form, that are, firstly, investor ownership, which implies that shareholders – as residual claimants – have a significant right of control over their companies. The second is delegated management, which implies that shareholders generally exercise this control indirectly, by participating in the selection or removal of directors.

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23 In order to reach this aim there are also important mandatory rules in the U.K. system. There are two principal variants to this approach. First, a given jurisdiction can provide for a menu of different standard form legal entities from which parties may choose in structuring an organization. Second, even with respect to a particular type of legal entity, such as the publicity traded business corporation, entrepreneurs or managers may be permitted to choose among different jurisdictions’ law. In this context, where there is intra-jurisdictional choice of alternative forms, mandatory rules in any given jurisdiction’s corporation law may serve not to constrain choice of form but actually to enhance it, by making it easier for firms to signal, and to bond themselves to, their choice among alternative attributes.

24 The management can be exercise by a single director or a board of directors, see art. 2380 bis c.c. for the s.p.a. and art. 2476 c.c. for the s.r.l.; for the latter it is also provided a different governance, that is the possibility to chose the partnership governance provided at srtt. 2257 and 2258 c.c. As we have already seen, Italian jurisdiction permits (for s.r.l.) a two-tier board structure for companies. In these cases the two boards are organized vertically, with an elected supervisory board that, in turn, appoints a “managing” board whose members are the principal managers of the firm. Thus, the two boards are in a semi-hierarchical relationship. In this discussion it will not focus on the supervisory board (that is called “collegio sindacale” in the traditional corporate governance system, “consiglio di sorveglianza” in the dualistic system and “comitato per il controllo sulla gestione” for the monistic corporate governance system.

25 For the s.p.a: the first managers can be appointed by the statute, ex art. 2328, c. 2, n. 11; managers are appointed by the shareholders in a general meeting, ex art. 2364, n. 2; for the s.r.l., the Code provides a default rule, on art. 2476 c.c., according to which management can be play by one or more members; as provided for the s.p.a., the first managers are appointed by the statute, ex art. 2463, c. 2, n. 8 and managers are appointed by members ex art. 2479, c. 2, n. 2.

26 See art. 2364, c. 2, n. 2, c.c. for the s.p.a. and art. 2463, c.2, n. 8, c.c. for the s.r.l.

27 As Continental Europe corporate laws, Italian law distinguishes between “open” corporate forms, which have freely transferable shares, and “closed” forms, in which transferability is restricted and often subject to company or shareholders approval. Managerial authority is delegated to a board in the former and to one or more individuals (that are called “managers”) in the latter.
follows that the law protects the interests of the shareholders class in the first instance by structuring the selection powers of the firm’s directors.

Consequently, the appointment strategy is the most basic protection of the collective interests of the member class.

The Italian Code enhances shareholders control over the company by shaping the basic structure, power, and composition of the board, and by establishing the electoral ground rules that structure shareholders voting. In addition, numerous subsidiary rules influence the board’s responsiveness to shareholders by fixing its fine structure and further adjusting its composition. In this regard, it can be focus on the rule which bears on how easily directors can be removed and on others which affect responsiveness by shaping the board’s internal structure and procedures.

Regarding the first one, it should be outlined that one aspect of the removal power is the ability to remove a director at the end of her term in office. This power turns on the length of the director’s term, that is a maximum of three years for staggered boards. A second aspect of this removal right is the ability to replace directors mid-term. Law gives the shareholder majority a strong non-wearable right to remove directors without cause.

Regarding to other Italian governance strategies, it can be highlighted that the principal rewards to management for pursuing shareholder interests are created by contract rather than by law, notably through the vehicle of compensation contracts. Nevertheless, the law facilitates this strategy mandates it. In this regard, there should be adopted different reward strategies, for example, a fix sum of money, allocation of securities, bonuses, pay-for-performance; the latter actually is not so use in the Italian system.

As regard constraints strategies, it can be said that, generally speaking, rules and standards play an important role in many areas of Italian corporate governance, typically involving, in particular, for the present purposes, conflict of interests transactions. More precisely, the Code, to ensure disclosure and prevent damage, provides that managers have to inform about all self-interests (that can be a conflict

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28 See art. 2383 c.c. for s.p.a.; cfr. art 2476 c.c. for the s.r.l. which refers to the s.p.a. disposition.
29 See art. 2364 n. 3 c.c.
30 The pay-for-performance is widely used in the U.S. and in the U.K., that are countries where there is a large numbers of widely held companies and, as a consequence, these jurisdictions rely the most on high-powered compensation incentives for managers, because the alternative monitoring strategy would produce more (agency) costs.
31 See art. 2391 c.c. in connection also with art. 2376-77 c.c.
interest or not with the company) in the company activities. Moreover, whether it is the case of a delegated director, he has to refrain to perform the operation, transferring the competence to perform it on the board. Furthermore, the sole director have to disclose his self-interest to the shareholders in the close general meeting. However, a standard strategy provides that the board has to check discretionally whether the operation should be adopted or not, giving adequate reasons. Whether the director does not perform this standard, remedies should be the invalidity of the decision made by the determinant vote of this director or the damages remedy according to art. 2391 c.c.

Standard strategies are also adopted by the Italian legislator in order to address manager duties of care. In this regard, the art. 2392 c.c., setting the manager liability to the company, is exemplary, identifying the criteria of the manager diligence with regard to her specific competences (a subjective standard) and the nature of the affair.

2.2.2. Italian interest primacy approach: shareholders’ and multi-party visions

At the beginning of the paragraph above, it has been said that managers act in the interest of shareholders. In order to understand if, according to the Italian law the members’ one is alone, or the main interest or solely one of the many interests that should be reached by managers’ activities, it will be examined some aspects and dispositions of the Code which seem open to different approaches, in particular, regarding the directors’ board structure and composition (art. 2380 bis ss. c.c.) and a peculiar intervention of the Court in the case managers’ major irregularities, ex art. 2409 c.c.

In the traditional corporate and control system, managers are entrusted exclusively to the management of the business and they should work to accomplish all the operations necessary for the implementation of the company object (art. 2380 bis c.c.). The centrality of their role is sculpted and articulated by the many functions of which they are invested by law.\textsuperscript{32}

\textsuperscript{32} In particular, for the s.p.a., directors shall take decisions-making on all matters relating to management which are not reserved by law to the members (art. 2364, n. 5, c.c.). This is the so-called managerial power \textit{stricto sensu}. Furthermore, they (or some of them) have the general representation of the company (art. 2384, c. 1, c.c.); moreover, they give impetus to the activities of the members’ body, as the calling and setting the agenda. They also give effect to the deliberations of the members’ meeting and have the power-duty to challenge those who violate the law or the articles of association (art. 2376ss c.c.). Directors must also have regard to the budgets and accounts of the company, in particular they should prepare annually a draft budget to be submitted for approval by the members’ body. They must also provide to advertising compliance under the law. Finally they must prevent the accomplishment of damaging activities or at least eliminate or limit the harmful consequences (art. 2392, c. 2, c.c.). For the s.r.l. there are similar dispositions [aggiungere articoli] but....
The duties of directors are mandatory. Therefore they cannot be deprived of their powers and their duties exempted, nor by the statute, neither by the shareholders, as this is an expression of the principle of separation of powers that serves as a counterweight to the irresponsibility of the members for company debts.

The directors are invested by law and not by mandate or by contract with the members. Moreover they perform their functions in positions of formal independence from the shareholders. This is justified primarily in the fact that they must ensure that members make decisions compliance with the law and, in this regard, they have the power-duty to refrain from implementing the decisions whether they are likely to cause a damage for the company. In addition, they are personally responsible for performance of their duties, both on civil (art. 2392-2395 c.c.; art. 2476 c.c.) and criminal terms (art. 2621-2638 c.c.).

As a consequence, the articulated the broad features of which the directors are legally entitled, the mandatory rules related to their powers, the position of formal independence from the members, all of these issues unambiguously militate against the possibility of setting up a relationship of dependency with members, in particular they seem against the possibility to configure that as a mandate relationship33. However, there is no doubt that the investiture of directors is based on a members’ body act for appointing them and they are freely revocable by shareholders’ body decision. It is also arguable that they manage the company to the others' interests, that is, in order to implement, to reach the aim of the company (“conseguire l’oggetto sociale”, ex art. 2380 bis, c. 1, c.c.).

In particular, relating to the s.p.a., the division of powers between shareholders and directors is founded primarily on two dispositions, that are art. 2364, n. 5, c.c. and art. 2380bis, c. 1, c.c.

The first article, in defining the powers of shareholders at the general meeting, states that they shall act on appropriate authorizations requested by statute for managerial activities, without prejudice to the directors’ liability for actions taken. According to the second disposition, the managerial decisions making is an exclusive competence on the chief of the directors, which act in order to reach the corporate aims. As a result, it can be deduced that, by mandatory rules, on the one hand, the shareholders’ managerial competence is specific and define, existing only when the law

explicitly provides in this sense; on the other hand, the managerial competence of directors is general, relating to every acts that are not expressly reserved to the shareholders’ body. Consequently, it is generally correct that neither the shareholders’ body can issue binding directives to directors about committing acts of governance, nor directors are obliged to submit to the prior approval of the shareholders’ body of their initiatives.34

2.3 The UK distribution of power between members and managers

2.3.1 UK legal strategies and approaches to protect members

The Companies Act 2006 makes no general statements about the power of the board of directors. In other terms, the board is not provided with any authority to make decisions by the law. In fact the Act establishes that a private company is required to have at least one director and a public company at least two directors,35 but it says nothing about what these directors are empowered to do. Nor does the Act provide any general statement about the authority or power of the shareholder body. In UK company law the general distribution of decision-making power is set out as a default rule in, prior to the 2006 Act, Table A Articles and henceforth in the Model Articles for public and private companies.

The fact that it is left to the articles to determine the distribution of decision-making power between the board and the shareholder body tell us that in UK company law the originating power of the company is located in the shareholder body acting in general meeting. The articles are default terms that can only be altered by the shareholder body by special resolution,36 which means that any powers given to the board by the articles are powers that could be retained by the shareholder body. If no powers are granted to the board through the articles, the board would be powerless and the company could only act through the shareholder body. In UK system it is the shareholder body that empowers the board of directors.

Under the 2006 Act, the provisions set out in the Model Articles provide for an identical default distribution of power.37 Article 3 states that directors are responsible

34 Different is the case of “substantial modifications”, such as a manager, where the managerial initiative needs the approval of the shareholders’ body, see art. 2364 bis ss. c.c.
35 See Sec. 154 CA 2006.
36 See Sec. 21 CA 2006.
37 Under the 2006 Act, although there are two sets of Model Articles for public and private companies, the provision dealing with the power of directors are identical and are set out in articles 3-5 in both sets of Model
for the management of the business and that they may exercise all the power of the 
company. Such authority is made subject to any other provisions of the articles. Articles 
4 provides the shareholder body with an instruction right, that is, the shareholder body 
retains the power to tell the board what to do by passing a special resolution\(^{38}\). Article 4 
recognizes that if the directors have already acted then the shareholder resolution does 
ot invalidate the board’s action. To the extent that the board has acted itself or through 
its agents to bind the company then clearly the company is legally bound and a contrary 
shareholder instruction could not alter the legal effect of that transaction. However, this 
limitation on the shareholder instruction right goes further than this: it does not affect 
the validity of anything the board has done, regardless of whether this has resulted in 
the company becoming legally bound or not\(^ {39}\).

What it has been described above support the Company Act 2006 establishing that the 
directors of a company can act only in the way they consider, in good faith, would be 
most likely to promote the success of the company for the benefit of its members as a 
whole\(^ {40}\).

This standard strategy is known as the “enlightened shareholder value” (ESV) 
approach to directors’ liabilities. In doing so they must have regard (among other 
matters) to: the likely consequences of any decision in the long term, the interests of the 
company’s employees, the need to foster the company’s business relationships with 
suppliers, customers and others, the impact of the company’s operations on the 
community and the environment, the desirability of the company maintaining a 
reputation for high standards of business conduct and, finally, the need to act fairly as 
between members of the company.
Consequently, this legal strategy preserves shareholders primacy while recognising that a company is both an association of its members and a person separate from them. Directors of a company must act to promote its success as a separate person, but for the benefit of its members, having regard to matters among others. It is the members who have the benefit while other constituencies have only regard.

In this regard, UK company law is often described as ‘shareholder-centred’ or based on a principle of shareholder primacy. Actually shareholder primacy is the subject of considerable (political and theoretical) debate.

The reform process that preceded the Company Act 2006 gave considerable attention to whether or not the common law approach to the “company’s interests” should be changed to require a broader more inclusive consideration of non-shareholders constituency interests when exercising corporate powers. The Company Law Steering Committee\(^41\) set out two different ways of taking into account non-shareholder interests. The first approach was referred to as the “enlightened shareholder value approach”. This view would not alter the priority given to shareholder value; however, it would require that consideration be given to the interests of, and relationships with, other constituencies, and would support corporate action to further those interests or support those relationships provided that in so doing the interests of shareholders are also advanced. For example, taking into account the interests of employees when exercising corporate power may make the employees feel more valued and possible more secure in their jobs. More content and secure employees are likely to work harder and to be more willing to make the necessary firm-specific investments of human capital and, therefore, will be more productive workers which, in turn, generates more shareholders value. Importantly, however, where consideration of non-shareholder interests conflict with shareholder interests then an enlightened shareholder value approach requires that the decision be taken in the shareholders’ interests. If the choice is between keeping a loss-making plant open to save jobs or shifting production to a developing country where it will not be loss making the decision is clear: the plant must be closed down.

The second alternative identified by the Company Law Review Steering Committee is the multiple-interest trusteeship model where no constituency interests

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takes priority and directors are required to act in ways that balance these interests. This is the so called pluralistic approach.

Defenders of the traditional shareholder primacy highlight that the ultimate objective of companies as currently enshrined in law is to generate maximum value for shareholders adding that this is in principle the best means of securing overall prosperity and welfare\textsuperscript{42}. As a result, the basic rule for directors is to operate companies for the benefit of members. Moreover, it is claimed that restricting company management to the single objective of maximising shareholder wealth is the most efficient means of using companies to increase the wealth of society as a whole\textsuperscript{43}.

On the other side, supporters of the opposite theory, that is the pluralistic analysis, claimed that incorporation is made available to encourage business for the good of society generally and not simply for the private profit of shareholders\textsuperscript{44}. It can

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  \item See F H Easterbrook and D R Fischel, \textit{The Economic structure of Corporate Law} (Harvard University Press, 1991, p 38, which argued: ‘Maximizing profits for equity investors assists the other ‘constituencies’ automatically. The participants in the venture play complementary rather than antagonistic roles. In a market economy each party to a transaction is better off. A successful firm provides jobs for workers and goods and services for consumers. The more appealing the goods to consumers, the more profits (and jobs). Prosperity for stockholders, workers, and communities goes hand in glove with better products for consumers […] Frequently the harmony of interest between profit maximization and other objectives escapes attention. For another expression of this view see M E De Bow and D R Lee, ‘Shareholders, non-shareholders and corporate law: communitarianism and resource allocation’ (1993) 18 Del J Corp L 393. See also Easterbrook and Fischel where they argued:’ Far better to alter incentives by establishing rules that attach price to acts (such as pollution and layoffs) while leaving managers free to maximize the wealth of the residual claimants subject to the social constraints. These issues are explored at length and in detail in J E Parkinson, \textit{Corporate Power and Responsibility} (Oxford: Clarendon Press, 1993), which argues in favour of the thesis that ‘…every large corporation should be thought of as a social enterprise; that is, as an entity whose existence and decisions can be justified only in so far as they serve public or social purposes (quoting R A Dahl, ‘A prelude to corporate reform’ in R L Heilbroner and P London (eds), \textit{Corporate Social Policy} (Reading Mass: Addison-Wesley, 1975), pp 18-24 at p 18). For the opposing point of view see A Alcock, ‘Corporate governance: a defence of the status quo’ (1995) 58 MLR 898. The description of large American corporations as more nearly social institutions than private enterprise was made by A Berle Jr and G C Means in \textit{The Modern Corporation and Private Property} (New York, 1932), p 46. Treating corporate managers as capable only of profit-making but incapable of taking moral and social decisions is regarded by Mitchell as unnatural and objectionable. Requiring managers to take moral and social factors into account is characterised by followers of Easterbrook and Fischel as unnatural and objectionable ‘social engineering’.

  \item The political debate in Britain was encapsulated by John Kay in his column in \textit{The Daily Telegraph}, 11 September 1995 (reprinted in \textit{The Business of Economics} (Oxford University Press, 1996), p 86, where he said: ‘Is the purpose of a large public company to maximize its profits? Or to develop its business, in the interests of costumers, employees, suppliers, investors, and the wider community? Like most people, I think the right answer is the second, but when I said so a few weeks ago institutions like the Institute of Directors denounced the prescription as wet, woolly, and vacuous’. Recognition by a company of the other interests listed by Kay is often seen as an element of the political idea of the stakeholding society; in this sense, see J. Plender, \textit{A Stake in the Future: The Stakeholding Solution} (London:Nicholas Brealey, 1997); P Goldenberg, ‘IALS Company Law Lecture-shareholders v stakeholders: the bogus argument’ (1998) 19 Co Law 34. For a discussion of arguments for and against the stakeholders analysis of companies, see T L Beauchamp and N E Bowie (eds), \textit{Ethical Theory and Business}, 5th edn (Upper Saddle River NJ: Prentice Hall, 1997) Chapter 2.

  \item See E M Dodd Jr, ‘For whom are corporate managers trustees?’ (1932) 45 Harv L Rev 1145 at p 1149:’…business is permitted and encouraged by the law primarily because it is of service to the community rather than because it is a source of profit to its owners’; T S Norwitz, ‘The metaphysics of \textit{Time}: a radical corporate vision’ (1991) 46 Bus Law 377 at p 387, which argued:’One must remember that the corporation is a

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be said that everyone connected with a company, whether as member, employee, supplier, customer or director, wants it to be well managed, or at least managed for their own benefit. Of these, the only group actually in a position to ensure that the company is managed for their own benefit are the directors and the only group who have the opportunity to control the directors are the members. It follows that the relationship between directors and members is of great importance. Following this theory, it is pointed out that requiring people working for companies to restrict the purpose of their working lives to maximising shareholder wealth is unhealthy, demeaning and morally corrupting. In this regard, due recognition was also needed of the importance in modern business of fostering effective relationships over time, with employees, customers and suppliers, and in the community more widely. If companies failed to address these interests effectively, then neither their own success, nor the overall competitiveness of the economy could be secured.

Recently, other commentators and economists has criticized both shareholder primacy (and its form as enlightened shareholder value) and the stakeholders analysis proposing an entity maximization and sustainability theory. This focuses on the company as a separate legal entity and maintains that the objective of the company is to maximize the wealth of the entity as an entity and, at the same time, to ensure that the company is sustained financially. The theory involves directors endeavoring to increase the overall long-run market value of the company as a whole, taking into account the investment made by various people and groups. But it maintains that maximization must be combined with aiming to ensure entity survival and feasible development. This theory does not specify any other persons as the intended beneficiaries of the company’s wealth. Instead, it requires the company’s directors to treat shareholders, employees, suppliers, lenders and so on as well as is necessary to ensure the company’s prosperity and longevity. As beneficiaries are not specified, the theory avoids having to resolve conflicts of interest between the company and its members or other constituencies, or between different groups of persons interested in the company’s prosperity.

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47 See Ascertaining the corporate objective: an entity maximization and sustainability model (2008) 71 MLR 663.
In conclusion, the shareholder-centered vision of the company is not universally held among advanced economies. Supporting the latter thesis, it can be argued that there are several indicators in the UK system, such as social, environmental and ethical considerations. For instance, CA 2006, s 417(5), requires companies whose shares are traded on the London Stock Exchange and some other exchanges to give information in a directors’ report about the following matters to the extent necessary for an understanding of the development, performance or position of the company’s business: environmental matters, including the impact of the company’s business on the environment, the company’s employees, and social community issues.

Moreover, the United Kingdom, together with the other members of the Organization for Economic Cooperation and Development (OECD), has recommended the OECD Guidelines for Multinational Enterprises to multinational enterprises operating in or from its territory. The first general policy set out in these Guidelines is that enterprises should contribute to economic, social and environmental progress with a view to achieving sustainable development.

Economics analysts who favor explanations in terms of markets suggest that economic forces are significant in controlling the behavior of directors of companies whose shares are publicly traded: they think that when the stock market is informed that the directors of a company are not acting in the best interests of its shareholders, the price of the company’s shares will fall and it will be taken over by new owners who will install new directors to run the business more efficiently. They believe that directors

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48 In Germany companies are seen as serving both shareholders and employees, and in German company law this is reflected in the ‘co-determination’ principle that both shareholders and workers should take part in the governance of large companies. The conflict between the German and the British views of the company has caused significant difficulties in the harmonisation of EC company law. In Japan a company is seen as a long-term coalition of investors, employees and trading partners, who are all concerned with the company’s continuing prosperity. Japan’s company law is modelled on Germany’s, and the concern in both countries with the position of the company in society has been heavily influenced by the thinking of the German industrialist and statesman, Walther Rathenau (1867-1922) whose writings are cited by and clearly influenced Berle and Means. See M Yoshimori, ‘Whose company is it? The concept of the corporation in Japan and the West’ (1995) 28(4) Long Range Planning 33; J Groenewegen, ‘Institutions of capitalism: America, European, and Japanese systems compared’ (1997) 31 Economic Issues 333; M Yavasi, ‘Shareholding and board structures of German and UK companies’ (2001) 22 Co Law 47. The German and Japanese experience has influenced the development of the idea of the stakeholding society. For discussion of differing forms of capitalism in different national cultures see Groenewegen, op. cit.; C Crouch and W Streeck (eds), Political Economy of Modern Capitalism (London: Sage, 1997).

49 The Guidelines do not have the force of law, but are a statement of internationally recognized good practice. The BIS website, www.berr.gov.uk includes a UK National Contact Point for OECD Guidelines for Multinational Enterprises. A United Nations initiative launched in 2000, the Global Compact, is a voluntary network which seeks to promote responsible corporate citizenship. The Global Compact has 20 principles in the areas of human rights, labour, the environment and anti-corruption, which it invites companies to adopt. See www.unglobalcompact.org and a draft adopted by a sub-commission of the United Nation Commission on Human Rights in August 2003 (E/CN.4/Sub2/2003/12/Rev.2).

50 See H G Manne, Mengers and the market of corporate control, (1965) 73 J Pol Econ 110.
will be so frightened of this happening, because they will lose their jobs and will not be
employed in such good jobs again, that they will realize that it is in their own interests
to act in the interests of the shareholders. It is said that the market for corporate control
and the market for directors’ employment will align the interests of directors and
shareholders. However, it is admitted that in some cases a director may be able to make
more by diverting money from the company than he or she can hope to make
legitimately and that such a director would not be deterred from taking the company’s
money merely by fear of losing legitimate earnings\(^{31}\).

2.3.2. Division of power between members and directors under UK court decisions

The principle that the articles divide the company’s powers between the
directors and the members, and the members cannot instruct the directors on how to
exercise the powers assigned to them, is reinforced by the Court in **Howard Smith Ltd v
Ampol Petroleum Ltd**\(^{52}\). Lord Wilberforce, delivering the judgment of the Privy
Council, said: “The constitution of a limited company normally provides for directors,
with powers of management, and shareholders, with defined voting powers having
power to appoint the directors, and to take, in general meeting, by majority vote,
decisions on matters not reserved for management [...] it is established that directors,
within their management powers, may take decisions against the wishes of the majority
of shareholders, and indeed that the majority of shareholders cannot control them in the
eexercise of these powers while they remain in office”. Moreover, in **Grindt v Great
Bouder Proprietary Mines Ltd**\(^{53}\), Cohen LJ said: “[...] there is nothing unusual in the
shareholders not being allowed to interfere in matters which have been deliberately
placed under the control of the directors”. In **Towcester Racecourse Co Ltd v
Racecourse Association Ltd**\(^{54}\), Patten J said: “[...] in the absence of articles permitting
the members to control the board, it is entitled to govern the company and exercise its
powers without interference. If the directors act unlawfully, then will be accountable for
their action and for any losses suffered by the company as a result [...] the proper
claimant in such proceeding is the company and not the shareholders”.

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\(^{52}\) **Howard Smith Ltd v Ampol Petroleum Ltd** [1974] AC 821, p 837.


The principle of division of powers is often described also by Courts as achieving a “separation of ownership and control”. In this context, no statutory power of dismissal was available to the members in *Teck Corporation Ltd v Millar* in which the majority of members of a company authorized legal proceedings against its directors, seeking to halt an allotment of shares by the directors on the ground that it would be a misuse of their powers. Berger J, however, found that the allotment would not be an abuse of the directors’ powers so that it could not be prevented.

In the model Articles of association in SI 2008/3229, the directors’ general power of management is conferred by art 3 of both the model articles for private companies and the model articles for public companies: ‘Subject to the articles, the directors are responsible for the management of the company’s business, for which purpose they may exercise all the powers of the company’. This general power of management applies only to managing the company as a going concern and is expressed to be subject to provisions of the company’s articles. It does not imply a power to pay bribes to secure business for the company. What is controversial is whether the members have a general supervisory power: the courts have generally adopted the theory that they do not.

The general power of management conferred by art 3 of the Model Articles for private and public companies is expressed to be subject to the articles. In *Salmon v Quin and Axtens Ltd* the articles of Quin and Axtens Ltd conferred a general power of management on directors (art 75) but art 80 made directors’ decisions on certain matters subject to the veto of either of two named shareholders (who between them held the majority of shares in the company do not want the directors so to act’. In this regard, see *Re Standard Bank of Australia Ltd* (1898) 24 VLR 304; *Re Galway and Salthill Tramways Co* [1918] 1 IR 62- a case concerning a statutory company with power of management governed by the Companies Clauses Consolidation Act 1845, s 90. Accordingly, art 3 of the Model Articles does not give the directors power to petition for the winding up of the company (see *Re Galway and Salthill Tramways Co*, op. cit.; *Re Emmadart Ltd* [1979] Ch 540) or to oppose the restoration to the register of a company struck off by the registrar (Re *Regent Insulation Co Ltd* (1981) *The Times*, 5 November 1981). However, the directors of a company now have a statutory power to petition for its winding up (IA 1986, s 124).

55 It is important to bear in mind that only some companies are affected by this: in the vast majority of private companies the directors and the members are the same persons. The law gives directors freedom to exercise the powers assigned to them but this freedom is subjected to their duty to exercise powers only for the purposes for which they are conferred (CA 2006, s 171) and their duty to act in the way they consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole (s 172). Within these limits, directors’ actions cannot be controlled by the members.

56 *Teck Corporation Ltd v Millar* (1972) 33 DLR (3d) 288.

57 Berger J, at pp 307-8, adopted the following statement by Barwick CJ in *Ashburton Oil NL v Alpha Minerals NL* (1971) 123 CLR 614 at p 620: ‘Directors who are minded to do something which in their honest view is for the benefit of the company are not to be restrained because a majority shareholder or shareholders holding a majority of shares in the company do not want the directors so to act’.

58 In this regard, see *Re Standard Bank of Australia Ltd* (1898) 24 VLR 304; *Re Galway and Salthill Tramways Co* [1918] 1 IR 62- a case concerning a statutory company with power of management governed by the Companies Clauses Consolidation Act 1845, s 90. Accordingly, art 3 of the Model Articles does not give the directors power to petition for the winding up of the company (see *Re Galway and Salthill Tramways Co*, op. cit.; *Re Emmadart Ltd* [1979] Ch 540) or to oppose the restoration to the register of a company struck off by the registrar (Re *Regent Insulation Co Ltd* (1981) *The Times*, 5 November 1981). However, the directors of a company now have a statutory power to petition for its winding up (IA 1986, s 124).


60 *Salmon v Quin and Axtens Ltd* [1909] 1 Ch 311.
bulk of the company’s shares). These two named shareholders were also appointed directors and managing directors of the company by the articles. The Court of Appeal upheld the validity of a veto issued by one of the named shareholders under art 80 and held that an ordinary resolution of the members was ineffective to override the veto because it was an attempt to amend art 80 by ordinary resolution instead of special resolution. The Court of Appeal’s decision was affirmed by the House of Lords.

In the model articles both for private and public companies, art 4 provides that “The shareholders may, by special resolution, direct the directors to take, or refrain from taking, specified action. No such special resolution invalidates anything which the directors have done before the passing of the resolution”. This article appears to confer a specific rather than a general supervisory power. Directors may wish to have a resolution passed under this article to make clear to persons they are dealing with that they have actual authority to enter into some unusual transaction. In practice, it is unlikely that this article would be used contrary to directors’ wishes. Members who have disagreed so seriously with their directors that they have to adopt a special resolution under art 4, to tell them to do something they do not want to do, might just as well adopt an ordinary resolution under CA 2006 s 168, to dismiss the directors.

In versions of model articles prior to 1985, the general power of management was expressed to be subject “to such regulations […] as may be prescribed by the company in general meeting”. The articles of some companies provided that the general power of management was subject to regulations made by extraordinary resolution. Such provisions would appear to give members a general supervisory power over directors. However, judges have taken the view that these provisions are not enough to confer on members a general supervisory power: to do that it would be necessary to use the formula adopted for statutory companies in the Companies Clauses Consolidation Act 1845, s 90, which makes directors’ exercise of their powers ‘subject also to the control and regulation of any general meeting specially convened for the purpose’.

The absence of words as strong as this in the Model Articles for registered companies shows that directors of a registered company have a different status from those of

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61 Art 4 is titled shareholders’ reserve power in the model for private companies and members’ reserve power in the model for public companies.
62 For the operation of this provision, see Exeter and Crediton Railway Co v Buller (1847) 5 Ry & Can Cas 211; Isle of Wight Railway Co v Tahourdin (1883) 25 ChD 320.
statutory companies and that the members of registered companies do not have a
general supervisor power.\footnote{See Automatic Self-Cleansing Filter Syndicate Co Ltd v Cuninghame [1906] 2 Ch 34 per Collins MR at p 43 and per Cozens-Hardy LJ at p 46; Salomon v Quin, op. cit., per Farwell LJ at p 320; Breckland Group Holdings Ltd v London and Suffolk Properties Ltd [1989] BCLC 100; Rose v McGivern [1998] 2 BCLC 593; see also Charter Oil Co Ltd v Beaumont (1967) 65 DLR (2d) 112 at pp 119-20 where it was said that a majority of members do not have a right to manage the company.}

If a company’s directors are of the opinion that a particular course of action is
not in the company’s best interest, they may refuse to pursue that course of action, even
though the entire membership wants it to be pursued and even though the agreement of
the entire membership would relieve the directors from liability for breach of duty if
they did pursue it.\footnote{In this regard, see Lonrho Ltd v Shell Petroleum Co Ltd [1980] 1 WLR 627 per Lord Diplock at p 634.}

The court will not add implied terms to the articles of association of a company
concerning the manner in which a general power of management is to be exercised by
the directors.\footnote{See Towcester Racecourse Co Ltd v Racecourse Association Ltd [2002] EWHC 2141 (Ch), [2003] 1 BCLC 260}

Directors of a company are not regarded as delegates of its members; the members
cannot hold meeting to tell the directors what to do. As Buckley LJ said in Gramophone
and Typewriter Ltd v Stanley,\footnote{Gramophone and Typewriter Ltd v Stanley [1908] 2 KB 89, at pp 105-6.} “The directors are not servants to obey directions given
by the shareholders as individuals; they are not agents appointed by and bound to serve
the shareholders as their principals”.

The courts have generally ruled provisions in articles making the general
management power of directors subject to directions given by ordinary resolution
ineffective because they are inconsistent with the principle of division of power.\footnote{In this regard, see John Shaw and Sons (Salford) Ltd v Shaw [1935] 2 KB 113; Scott v Scott [1943] 1 All ER 582; Macson Development Co Ltd v Gordon (1959) 19 DLR (2d) 465 at p 470; Black White and Grey Cabs Ltd v Fox [1969] NZLR 824; Winthrop Investments Ltd v Winns Ltd [1975] 2 NSWLR 666; per Samuels JA at p 683; National Roads Gear Co Ltd v Manning Wardle and Co Ltd [1909] 1 Ch 267 and Dowse v Marks (1913) 13 SR (NSW) 332 following an obiter remark by Warrington J in Thomas Logan Ltd v IMO Pte Ltd [1993] 2 SLR 370.} Similarly, a provision making the general power subject to extraordinary resolution is
ineffective.\footnote{See Queensland Press Ltd v Academy Instruments No 3 Pty Ltd [1988] 2 QdR 575 and in Re Coachman Tavern (1985) Ltd [1988] 2 NZLR 635, Gallen J said, at p 639: ‘In terms of the theories enunciated in the leading cases, it would be difficult to justify a contention that the company in general meeting could usurp poker reserve to the directors by using a special resolution’.

In conclusion, the principle of division of powers, and separation of ownership
and control, are not universally popular under Courts’ decisions; many critics believe
that directors should be subject to members’ control and should be regarded more as
members’ delegates than as company officers. This is, in particular, crucial to proposals that in some companies, directors should be appointed to represent the interests of employees. Critics of the division of powers principle have regarded statements of the principle by judges as obiter. This was the view taken by Neville J in *Marshall’s Value Gear Co Ltd v Manning Wardle and Co Ltd*, in which his Lordship held that members of a company have an inherent right to supervise directors by ordinary resolution unless the articles specify otherwise. According to this theory, a provision in articles that the power of management is subject to regulations prescribed by the company in general meeting merely restates the general law, and so does s 90 of the Companies Clauses Consolidation Act 1845. His Lordship distinguished *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cuninghame* on the ground that the general management article in that case had subjected the power of management to regulations made by extraordinary resolution and thereby disentitled the members from interfering by ordinary resolution.

Treating the principle of division of power as a mere *obiter dictum*, critics assert that there is no basis for the decisions that provisions in articles subjecting directors’ power of management to regulations made by ordinary resolution are ineffective. Several commentators offer lengthy discussion of the true construction of such articles and conclude that they do give members the right to control directors. In our view, however, the principle of division of powers is the reason for holding such provisions ineffective.

The principle of separation of powers seems to have been generally adopted by the courts in recent years, but criticism of it has continued in academic writings.

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70 This was the view taken by the learned judicial commissioner in *Credit Development Pte Ltd v IMO Pte Ltd* [1993] 2 SLR 370.


In debates about how companies should be governed by their members and directors, the company is often viewed, consciously or unconsciously, as a microcosm of the State, and writers on the topic often take over political theories. For a discussion of this, see R Romano, *Metapolitics and corporate law reform*, (1984) 36 Stan L Rev 923.
2.4 Peculiar separation of ownership and control in the public companies

In the particular context of the public companies it is often claimed that the concept of shareholders as owners and directors as steward does not correctly describe the actual relationship between directors and shareholders. This can be seen both in the UK and in the Italian corporate law system.⁷²

The whole idea of the public company has always been that it offers the opportunity to invest in a company without any involvement in management. Public company shareholders treat their shares as their property which they can do what they like with, but they see ownership of shares in a company as separate from ownership of the company. Usually a person buying company shares on a stock exchange does not obtain them from the company and does not give the company money for them – normally shares are bought from other shareholders. It is alleged that in many public companies, the wide spread of ownership of shares means that no one shareholders or group of shareholders can exercise effective control over the directors and that if owners of the shares in a company do not like what its directors are doing then, rather than try to influence directors, they sell the shares. The situation was described as a "separation of ownership and control". In particular, it is argued that the shareholder-centred

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⁷² The role of the Combined Code on Corporate Governance should be mentioned for the UK system as a mix of a statement of principles of good governance with a code of best practice for listed companies. The current edition of the Combined Code is dated June 2008. There are similar codes elsewhere in Europe. In this regard, see the website of the European Corporate Governance Institute, www.ecgi.org. Every UK company with listed shares is subjected to listing rules which require an annual statement of how it has applied the main principles set out in s 1 of the Combined Code. This must be followed by a statement of whether or not the company has complied with the principles throughout the accounting period being reported on. The company must give reasons for any non-compliance. This is known as the ‘comply or explain’ philosophy.

Also for the Italian law there is a special regulatory discipline, that is the “Testo Unico degli Intermediari Finanziari”, TUFIN, d. lgs. 356/98.

The Combined Code originated in the report of a committee chaired by Sir Adrian Cadbury, see Report of the Committee on the Financial Aspects of Corporate Governance (London: Gee, 1992). The report noted that: ‘Companies whose standards of corporate governance are high are the more likely to gain the confidence of investors and support for the development of their businesses’. The report included a Code of Best Practice (known as the ‘Cadbury Code’), which rapidly assumed great practical importance because every listed company was required to state in its annual report and accounts whether or not it had complied throughout the accounting period with the Code. A combination of a revised code and a statement of principles of corporate governance was prepared by a committee under the chairmanship of Sir Ronald Hampel, see: Committee on Corporate Governance, Final Report (London: Gee, 1998). In consultation with the London Stock Exchange, the Hampel Committee produced a new ‘Combined Code’- the Hampel Code- containing principles of good governance and a code of best practice. The Combined Code took its present form in 2003 when it was revised in the light of a report by the late Sir Derek Higgs, Review of the Role and Effectiveness of Non-Executive Directors (London: DTI, 2003).

The European Commission has established a European Corporate Governance Forum to encourage the coordination and convergence of national corporate governance codes. If a company has transferable securities admitted to trading on a regulated market, Directive 78/660/EEC, art 46a (which was added by Directive 2006/46/EC), requires its directors’ report to include a corporate governance statement.

model of the company and the traditional view that the profits of an enterprise should go to the providers of its capital arose at a time when individual business people both provided capital for and directed their enterprises, so that profits, through the reward and incentive for both investment and direction, went to a single owner who combined both functions. The separation of ownership and control separated the two functions, which meant that the shareholder providers of capital could no longer claim the exclusive need to be incentivized by profits. So the directors are given a self-effacing role working purely for others.

Even classical economists acknowledged that a business’s profit reward the successful direction of the business, by what called the ‘entrepreneur’, as well as the passive supply of funds. This became clearer when capital markets developed and appeared to establish a price (rate of return) for the supply of capital, dependent on the riskiness of the investment. Investors could be regarded as supplying capital for a fixed return (at least, fixed from time to time by the capital market) just as workers worked for a fixed wage, and, some would argue, the balance of profits should go to the entrepreneur, though there is much room for disagreement over exactly which entrepreneurial function deserves the reward.

A different approach sees a business organization as a coalition of individuals, including managers, workers, shareholders, suppliers, customers, lawyers, tax collectors and industry regulators. Sharing the profits may be a matter of bargaining between these groups.

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74 In this regard, Berle and Means made the not altogether obvious leap from this argument to the proposal that large American corporations in which ownership and control had been separated should serve ‘all society’ and that: ‘the control of the great corporations should develop into a purely neutral technocracy, balancing a variety of claims by various groups in the community and assuming to each a portion of the income stream on the basis of public rather than private cupidity.


76 For an exploration of companies in terms of bargaining between managers and shareholders, analyzed using game theory, see M A Utset, Towards a bargaining theory of the firm, (1995) 80 Cornell L Rev 540; E F Fama, Agency problems and the theory of the firm, (1980) 88 J Polit Econ 288, who suggested that ‘ownership of capital should not be confused with ownership of the firm. Capital is just one input supplied to a company for the purpose of its operations and each input is owned by some person. Management is just another input. Using the nexus of contracts image Fama went on to say: ‘The firm is just the set of contracts covering the way inputs are joined to create outputs and the way receipts from outputs are shared among inputs. In this ‘nexus of contracts’ perspective, ownership of the firm is an irrelevant concept’. But in a later article, E F Fama and M C Jensen, Separation of ownership and control, (1983) 26 J Law and Econ 301, re-established primacy by describing the equity shareholders of a company as the ‘residual claimants’ – that is, they are entitled to whatever is left of the company’s assets after its debts have been paid. They may receive amount from zero upwards, but in a limited company, provided their shares are fully paid, they will not be required to pay anything more. Fama and Jensen offer the alternative description ‘residual risk bearers’ and this has become a popular description, but it may perhaps exaggerate the heroism of shareholders. Members of companies risk
As we have already said, in the UK corporate ownership is more splintered than in Italy; as a result, the former is more familiar with agency costs which deals with collective action problems. Although the law can enhance or diminish shareholder influence by facilitating or deflecting collective action by the shareholder majority, a

losing their investment, but this is no different from the risk that all creditors of limited companies bear of not being paid. The ‘residual risk’ that members bear is just the risk of not receiving the return that they expect on their investments. The idea of equity shareholders as residual claimants rather than owners allows for other claimants such as creditors in whose interests the company may be operated. But as residual claimants, equity shareholders members can argue that the company ought to be run in such a way as to maximize their residue and that may not be in the interests of other constituencies.

For a restatement of the view that the shareholders of a company should not be seen as its owners, either economically or legally, see R Sappideen, Ownership of the large corporation: Why clothe the emperor?, (1996-7) 7 King’s College LJ 27. Professor Sappideen argues that the only owner of a company is the company itself so that it is meaningless to talk of a separation of ownership and control. Some commentators prefer to think of control of a company as a variety of political process. In this regard see A A Berle Jr, ‘Control’ in corporate law, (1958) 58 Colum L Rev 1212 at p 1215; Ib., Modern functions of the corporate system, (1962) 62 Colum L Rev 433 at p 445; ‘In fact a large corporation is a variety of non-statist institution’. J Pound, The rise of the political model of corporate governance and corporate control, (1993) 68 NYU L Rev 1003, observes that in democratic politics, influence may be exerted by discussion and lobbying as well as by intermittently changing the government by general election, and claims that in the US in the early 1990s changes in board personnel and policies were more often brought about by the lobbying of large investors than by takeovers, which Pound claims are an inefficiently drastic method of correcting mismanagement. The increase in shareholder activism in the US, where large public employee pension funds are particularly significant shareholders, is discussed by B S Black, Shareholder passivity re-examined, (1990) 89 Mich L Rev 520. Black notes that shareholding is becoming more concentrated as institutions such as pension funds invest large amounts in the leading companies whose shares are publicly traded. It is possible for large institutional shareholders to control enough shares to overcome the separation of ownership and control in large public companies and have a direct influence on their management. For similar comments in the British context see J Farrar and M Russell, The impact of institutional investment on company law, (1984) 5 Co Law 107. However, several commentators, have pointed out that active participation in the management of companies is an inappropriate activity for many institutional investors, such as pension funds and insurance companies, which have duties to their own members or costumers requiring them to avoid risk. In this regard, see R Sappideen, Ownership of the large corporation: Why clothe the emperor?, (1996-7) 7 King’s College LJ 27; T A Smith, Institutions and entrepreneurs in American corporate finance, (1997) 85 Calif L Rev 1. Main principles D.1 and E.1 of the Combined Code for listed companies state that the board and institutional shareholders should enter into a dialogue based on mutual understanding of objectives. The members of the Association of British Insurers (ABI) and the National Association of Pension Funds (NAPF) between them control about half of the equity shares of United Kingdom listed companies. A joint statement by the ABI and NAPF, Responsible Voting, issued in July 1999 said:’ …voting rights and the exercise thereof, in pursuit of responsible and effective corporate governance and the achievement of long-term shareholder value, may be recognised as an important and integral part of the investment management function…Voting, though, is only part of the dialogue that should exist between investors and boards of directors’. The ABI and NAPF were members of the Institutional Shareholders’ Committee which issued The Responsibilities of Institutional Shareholders and Agents – Statement of Principles in 2002 (the June 2007 version is at institutionalshareholderscommittee.org.uk).

The board of a listed company should appoint one of the independent non-executive directors to be the senior independent director, who should be available to shareholders if they have concerns, which they cannot communicate to, or have failed to resolve with, the chairman, chief executive or finance director (Combined Code, para A 3.3.). The board should keep in touch with shareholder opinion in whatever ways are most practical and efficient (Combined Code, supporting principle D.1) and there should be a statement in the directors’ report if the steps taken to ensure that members of the board, particularly non-executive directors, develop an understanding of the views of major shareholders (Combined Code, para D.1.2).

The trustees of occupational pension schemes are required by Pension Act 1995, s 35, to produce a statement of their investment principles. As from 3 July 2000 this must state the trustees’ policy in relation to the exercise of voting rights attaching to investments (SI 1996/3127, reg 11A(b)). The same requirement has been imposed on authorised administering pension funds for local government employees in England and Wales (SI 1998/1831, reg 9A(2)(g)) and Scotland (SI 1998/2888, reg 9A(2)(g)).
review of the UK voting procedures suggests that no regime has attempted to minimize the costs of participation in corporate governance by disaggregated shareholders.

However, there are clear differences among Italian and UK jurisdictions in how their procedures are likely to affect collective action by small and middle sized shareholders. Voting mechanisms are the most conspicuous example. Indeed both jurisdictions provides a mechanism for allowing small shareholders to vote at shareholders meeting without the need to be present at the meetings. Generally there are three principal strategies: mail voting, proxy solicitation by corporate partisans, and proxy voting through depository institutions.

In Italy, as in Continental Europe, depository institutions –banks or trusts- can manage the proxies of small and middle-sized shareholders. In the UK proxies, that are relative regulated, are solicited by corporate partisans themselves: by management alone in the case of an uncontested vote, and by both management and its opponents in the case of a contested vote. The principal alternative is proxy management by financial intermediaries and depository institutions (e.g. pension funds, mutual funds and unit trusts), which hold title to shares and play a large and growing role in corporate governance. For the most part, however, the stakes held by these institutions do not rise to a level where they qualify their holders as corporate insiders. By contrast, the brokerage houses that serve as depository institutions play little role.

2.5 Some conclusions

The trusteeship strategy is a device for controlling managerialism most attractive for UK companies. In fact the value of trusteeship remedy for the protection of the interests of the shareholders as a class is closely tied to ownership structure. As a result, for the UK public companies with dispersed shareholders, it places the main role and authority over the interests of a vulnerable constituency in the hands of decision-makers

who lack strong conflicting interests. In the case of shareholders as a class, trusteeship protection implies a decision-making authority within the firm that does not share the financial interests of hired managers.

Although in this discussion I will not focus on agency problems inside the managerial class, it should be mentioned that trusteeship, especially in the public companies context, is a matter of degree. At one extreme, simply defining a subset of the firm’s managers as “directors”, with powers and liabilities not shared by other managers, creates a measure of trusteeship insofar as the new manager-directors take more of the credit when the firm does well and face more of the blame when it does badly. They have a greater incentive than other managers to respect the interests of shareholders. At the opposite extreme, directors without a management role or other ties to the company have no reason not to respect shareholder interests, and potential ethical and reputational reasons to do so. In addition, the UK law reinforce trusteeship roles by removing opportunities for conflict with shareholder interests. This is done, not just by imposing restrictions on the ability of directors to enter into self-dealing transactions, but also by completely separating directors and managers: that is, by mandating that some directors cannot be salaried employees of the firm. The UK law strongly encourages non-employee (and otherwise independent) directors on the boards of public companies, while UK exchange rules require a majority of independent directors on the board of listed companies. Moreover, it can be outlined the UK peculiarity in dividing the roles of the CEO and chair of the board of directors and assigning the powerful chairman’s role to a non-employee director.

From a different point of view, it can be argued that trusteeship strategies are related with fiduciary relationships. Following this thought, directors’ duties are expression of trusteeship remedies, being all the directors’ duties described in the Act, save for the duty of care, skill and diligence, fiduciary duties. Loyalty is the distinguishing obligation of a person who owes fiduciary duties. The fundamental aspect of loyalty is that the director acts for proper purposes and without self-interest, and fiduciary, is someone who agrees to act for another person’s interests.

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80 A. Scott, The fiduciary principle, in California Law Review, 1949, 37, pp. 539ss. According to Millet LJ in Bristol and West Building Society v. Mothew, “The principal is entitled to the single-minded loyalty of his fiduciary [...] he may not act [...] for the benefit of a third person without the informed consent of his
Section 171 of the Act sets out two duties that are encompassed by the broad title to the heading “duty to act for proper purposes”. The first duty is that directors must act in accordance with the company’s constitution; secondly, they must only exercise their power for the purposes for which they were conferred. This states that it matters not if directors believe in good faith that their action is in the best interests of the company if the courts assess that the directors substantial purpose in taking the action was improper.\footnote{For some of the leading cases, see Piercy v. S. Mills & Co Ltd [1920] 1 Ch 77; Teck Corporation Ltd v. Millar [1973] 33 DLR (3d) 288; Hogg v. Cramphorn [1967] Ch 254; Howard Smith Ltd v. Ampol Ltd [1974] AC 821, PC; Extrasure Travel Insurances Ltd v. Scattergood [2003] 1 BCLC 598. In the latter it is summarized the iniquity of the Court as below: “Identify the power whose exercise is in question; identify the proper purpose for which that power was delegated to the directors; identify the substantial purpose for which the power was in fact exercised, and decide whether that purpose was proper”.

Section 172 (1), which is probably the most controversial and challenging duty in the legislation, sets up that a director of a company must act in a way that he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard amongst other matters. The provision includes several unknown elements, such as the meaning of the “success of the company” and “have regard to” in the context of the section. So it appears to give almost unfettered discretion to directors in their decision-making. Critically provided that the directors act in good faith and can point to the fact that they have considered the factors set out in the subsection (employee interests etc.), it would seem that their decisions are unassailable. Nevertheless the courts might, as they did with the former duty of acting bona fide in the best interests of the company, take the view that they will not accept a director’s evidence of honest belief in his or her actions in situations where the facts seem to suggest the contrary.

Section 173 states that directors must exercise independent judgement and then goes on to provide virtual exceptions to that rule when it says that the duty is not breached if directors act in accordance with an agreement entered into by the company that restricts the future exercise of discretion by the directors or in a way authorised by principal”. Moreover Millet LJ said in this case that “fiduciary duty” is restricted to duties that are peculiar to fiduciaries and if it is breached it leads to different consequences from the breach of other duties. The effect of the provisions in the Act is cumulative so more than one duty may apply to a particular state of affairs. Where this occurs, a director must comply with each applicable duty. A director cannot claim immunity if he or she was fulfilling one duty but fails to comply with another.

the company’s constitution. The duty is clearly based on the duty at common law that
directors are not to fetter their discretion.\textsuperscript{83}

In the area of care, skill and diligence, the classic case is \textit{Re City Equitable Fire
Insurance Co Ltd}\textsuperscript{84} which sets out the basic principles covering care and skill largely,
but not exclusively, in subjective terms. The case provided, inter alia, that directors need
not to manifest, while undertaking their duties, any more skill than someone as
competent or as inexperienced as they are. Somewhat famously, the court said that
directors were not bound to give continuous attention to the affairs of their companies
and this has been said to have caused the poor attendance of some directors at board
meetings. Also, the court stated that if it is prudent, from a business point of view (and
taking into account the constitution), that some duty be left to some other official, then a
director, in the absence of grounds for suspicion, is justified in trusting that official to
perform such a duty honestly\textsuperscript{85}. The cases that have the most profound effect on the
area are probably \textit{Norman v. Theodore Goddard} and \textit{Re D’Jan of London Ltd}\textsuperscript{86}, where
the courts held the wrongful trading provision, section 214 of the Insolvency Act,
embodies the standard required of a director at common law, in terms of care, skill and
diligence. It will be recalled that section 214 provides that a director is liable if he or she
“knew or ought to have concluded that there was no reasonable prospect that the
company would avoid going into insolvent liquidation” unless the court is satisfied that
the director “took every step with a view to minimising the potential loss to the
company’s creditors’ as ought to have been taken. The section requires directors to act
as a reasonable diligent person having the knowledge, skill and experience that may be
reasonably expected of a person performing the same functions, as well as having the
knowledge, skill and experience which the director has. Jonathan Parker J\textsuperscript{87} considered
the duties of directors in general. As far as duties of care and skill are concerned, his
Lordship said that, firstly, directors have, both collectively and individually, a

\textsuperscript{84} \textit{Re City Equitable Fire Insurance Co Ltd} [1925] Ch 407.
\textsuperscript{85} The law has tightened things more in the past 15 years or so recent times and the indication is that the courts
of today will require greater vigilance on the part of directors. See, in this regard, \textit{Re Majestic Recording
Studies Ltd} (1988) 4 BCC 519. The older cases that devised the law did so with the post of non-executive
director in mind. It was generally accepted that non-executive directors had no serious role to play within the
according to which the principle that were formulated are totally inappropriate for executive directors and, of
course, the commercial world has changed significantly over time and the role of non-executive directors is
more demanding than it once was.
\textsuperscript{87} In \textit{Re Barings plc (n.5)} [1999] 1 BCLC 433.
continuing duty to acquire and maintain a sufficient knowledge and understanding of the company’s business to enable them to discharge their duties. Moreover, while directors are entitled (subjected to the articles of association of the company) to delegate particular functions to those below them in the management chain and to trust their competence and integrity to a reasonable extent, the exercise of the power of delegation does not absolve a director from the duty to supervise the discharge of the delegated functions. Finally, no rule of universal application can be formulated as to that duty. The extent of the duty and the question whether it has been discharged, must depend on the facts of each particular case, including the director’s role in the management of the company.

Section 174 of the Act has codified the duty, adopting, for the most part, the approach taken in more recent times at common law. Indeed, section 174 (1) provides that a director of a company must exercise reasonable care, skill and diligence and this means the care, skill and diligence that would be exercised by a reasonably diligent person with (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and (b) the general knowledge, skill and experience that the director has. This provision lays down both a subjective test and an objective test.

Following on from rules regulating trustees, company law has always been concerned to ensure that directors do not place themselves in conflict situations, for example, where their personal interest and their duty to their company conflict. The idea behind this is to ensure that the fiduciary is not swayed by concerns for his or personal interests in any given situation. Section 175, building on what was referred to as the no-conflict rule at common law provides that a director of a company must avoid a situation in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interest of the company. According to the next subsection, this rule applies in particular to the exploitation of any property, information or opportunity. This provision bring in an aspect of what was known in equity as the no-profit rule, that is, directors are not to profit from their positions unless they are expressly permitted to do so and they are not to exploit what really belongs to their company. The classic breach of this rule is where a director discovers a commercial opportunity when a director of a company and rather than passing on this to the board,

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89 For example, see Aberdeen Rly Co v. Blaikie (1854), Macq, 1, HL 461.
he or she exploits it for his or her own benefit either whilst a director or after resignation\textsuperscript{90}.

Section 176 deals with another aspect of the no-profit rule, providing that a director of a company must not accept a benefit from a third party conferred by reason of his being a director, or his doing (or not doing) anything as director. This is designed, inter alia, to proscribe directors taking secret commission or bribes.

Furthermore, section 177 (1) sets out that if a director of a company is in any way, directly or indirectly, interested in a proposed transaction or arrangement with the company, he must declare the nature and extent of that interest to the other directors.

\textsuperscript{90} For example, see \textit{Regal (Hastings) Ltd v. Gulliver} [1967] 2 AC 134; [1942] 1 All ER 378; \textit{IDC Ltd v. Cooley} [1972] 1 WLR 443.
PART 2

CREDITOR PROTECTION

In this Part we explore the agency problem faced by creditors in the context where the need for legal protection is arguably greatest, that is when a company is in troubled or close to insolvency. In this regard, we address the legal strategies employed by the UK and the Italian jurisdictions to protect corporate creditors.

Preliminarily it can be said that corporate creditors’ category includes not only banks and bondholders, but also the members of other corporate constituencies, such as employees or suppliers, who accept claims on corporate cash flows in exchange for their goods and services. In other terms, all parties who contract with corporations benefit from creditor protection. The main ratio for placing creditor protections in company law is that corporate creditors face a unique risk specific to the corporate form, that is the risk that arises from the power of shareholders to manipulate limited liability to the detriment of business creditors.91. The law can often provide a useful foundation and supplement for contractual protections. In the first instance, it can define the parties’ background expectations. Standard legal protections can save costs in some cases by offering ready-made terms and, in other cases, by inducing explicit negotiation when default terms do not suffice. In addition, standard legal protections are essential when

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91 See: Re Exchange Banking Company, Flitcroft’s [1882], 21, Chancery Division, 518; V. L. A. Bebchuk & J. M. Fried. The Uneasy Case for the Priority of Secured Claims in Bankruptcy, 105, Yale Law Journal, 1996, p. 857.; V. Company Law Review Steering Group. Modern Company Law for a Competitive Economy: The Strategic Framework, 1999; J. Armour, Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law, 63, in Modern Law Review, 2000, p. 355; B. R. Cheffins, Company Law: Theory, Structure and Operations, 1997, pp. 75-78. Both individual debtors’ creditors and corporate debtors’ ones face the same forms of debtor misbehaviour. Ex ante- before borrowing- debtors may lie about their assets to obtain a loan. Ex post –after borrowing- debtors may violate the terms of their agreements, either by ‘diluting’ the assets available to satisfy their creditors or by pursuing risky projects that shift the risk of failure to their creditors. Limited liability exacerbates both of these risks. Ex ante, it assist shareholders in misrepresenting the value of corporate assets by falsely claiming that the firm holds title to assets that shareholders control but that actually belong to other entities or to shareholders themselves in their personal capacity. Ex post, shareholders can siphon assets out of corporate solution directly, or do so indirectly by pursuing risky projects knowing that creditors will bear the costs if these projects fail. If follows that both creditors and shareholders can benefit from enhanced creditor protections that reduce the costs of raising debt capital through the corporate form.
parties cannot negotiate protections for themselves; this is the case, for instance, when transactions are too small to support negotiation, or when creditors are too naive to protect themselves; moreover, it is also the case when collective action problems prevent creditors from obtaining terms that might benefit all creditors ex ante, such as mandatory public disclosure or debtor registration of large corporate debts and, finally, when the company is near insolvency. The need to protect corporate creditors, however, does not necessarily imply that corporate law must do this job, thus today major business creditors rely not on the law, but on contract, credit agencies and a host of other self-help measures to safeguard their interests.

As a result, it will be argued that there are various legal strategies in order to reach that goal, both regulatory and governance remedies, as we will see with reference to the two jurisdictions, in Italy and in the U.K., here considered. Furthermore, it will be highlighted that all the benefits of legal protections for creditors come at a cost. In theory, they are supposed to reduce costs, that are, primarily, agency costs, but in practice, they can also increase transaction costs when they are overly rigid and intrusive. In the context of troubled companies, in particular, the risk of shareholder opportunism is likely to be especially severe and, accordingly, the benefits of creditor protections particularly large. Consequently, the point is not to eliminate opportunism entirely, but to bring its costs into rough equilibrium with the costs of controlling it\textsuperscript{92}.

Since there are agency problems between the various actors to be seen how they can be resolved, it was said that this crisis is a projection of the management of an enterprise in physiological stage; therefore there must apply the same principles outlined in that context. It follows (abstractly) the possibility to use the same remedies. I will try to consider in this discussion whether these policies, legislation and governance remedies, are planned and/or retrievable from UK system and Italian law.

3.1. Introduction

As we have analyzed in Part 1, according to the doctrine of the agency costs, the justification of control as shareholders is traditionally found in the fact that they are residual claimants, that is they are holders of a claim on the residual after all debts have been paid or has been set aside what is necessary to pay them. If the company is in normal operation, the creditors shall have no voice, and it is right that the control is entirely up to the shareholders.

This justification no longer holds when risk capital has been lost, becoming the creditors, in that changed context, investors without rights. It therefore becomes necessary to understand who are “the owners” of a troubled firm, and how they change, the onset of insolvency, the rights belong to those interested in his assets.

Hence the question about who should run the business in this stage and with what goals and liabilities, and one wonders if through insolvency proceedings a reallocation of control is possible, transferring from the old shareholders to creditors. These are questions of great importance, which can be answered only supported by a wider context, analyzing if there are legal or private remedies and/or proceedings, whose theoretical justification is to transfer company control to creditors when they have become residual claimants, and to create an organization for the creditors which can effectively exercise control (in view of a liquidation of assets or a financial
Moreover, it becomes crucial to understand whether people with incentives and power to control are entitled to make business decisions such as to reduce the agency costs.

The purpose of this discussion is primarily to highlight the close connections between the interest of company law and insolvency law with reference to creditor protection. In this regard, it is proposed to restore the consistency between the solvent firm law and the in troubled firm law, lining up the protection of creditors to that enjoyed by the shareholders to creditors. So the discussion leads to whether creditors have to be guaranteed the power to direct the management decisions making and the power to control and, if it is the case, which strategies are they entitled to use.

These reflections are presented in either the need to evaluate the strategies that nowadays exist in the UK and Italian jurisdiction, both to verify whether these mechanisms can deal with the situation of today's crisis, that is, do they provide the tools to build a general model of ownership and control of solvent and insolvent company.

3.2. Creditor protection in a solvent company

In a system of corporate governance of a solvent company both the UK and Italian jurisdiction, even if in different terms, as it has been seen above, nearby the interests of the shareholders, put other interests. In this discussion I will outline that between these “other interests” there is a direct or indirect protection to creditors.

One of the point in this regard is the institution of limited liability, while it may have the perverse effect of encouraging indiscriminate risk taking, is a great compromise between the encouragement of entrepreneurship and the creditor protection. Indeed, in terms of relations with creditors, limited liability is substantiated by the fact that creditors, agreeing to give credit to a society whose members are only liable for accepting a condition imposed on them by the same shareholders, albeit with the cooperation of law: a requirement that, on the one hand, the company asset is intended primarily to their satisfaction, but on the other hand, in case of troubles, the personal assets of members cannot be touched. In a perspective of the prevalence of substance of the company on the corporate form, be a member means above all to be among the many who chose to provide funding of venture capital. Than "owners" of the company, the shareholders, are the residual claimants, i.e. persons who are entitled to
receive all that remains once the creditors have been paid. They, like creditors, are therefore holding a claim of a financial nature, but is at a lower step, the last one.

So if the members can receive the surplus only once all creditors have been satisfied, they have an incentive to ensure that the company may produce sufficient wealth (at least) to pay creditors. The members are real concerned then that the management is as efficient as possible: if it is, they will gain, if it is not, they lose the paid amount to the company. Precisely, this assumption is based on the justification of the power to choose the managers of the company, that the law leaves exclusively to members. This then is the foundation of “control” arrangements, for what he finds here, as the right to appoint directors.93

Besides the power to carry on business activities, moreover, the law gives shareholders the right to satisfy them (chronologically) first that creditors have been met. Single but necessary condition is to be periodically produced a sort of assessment and plan of apportionment of the wealth produced by the company, which shows that, even in prospect, there are sufficient resources to pay for creditors. This periodic distribution plan, whose function is vital for the functioning of financial markets, is obviously the balance sheet. The operating budget is drawn up by administrators appointed by the shareholders acting in their interest, and is therefore a powerful tool in their hands. On the basis of this fact, members have the power to allocate to themselves, by dividend or other distribution (purchases of shares, reduction of capital) resources of the company even when the creditors were not paid. The budget is essentially the instrument of a potential reversal to the detriment of creditors, the order of priority in the payment and repayment of principal. It is also in view of this that the law requires that, in drafting the budget, property is assessed on prudence, based on mandatory rules and particularly severe penalties provided for the drafting of infidel budgets. If, once observed these criteria, it appears that creditors may be paid in full, the law allows the distribution to the shareholders of any surplus. Just this great power has led someone to believe, implicitly, or requiring the establishment by law, on an additional requirement

93 The presence in law and practice of intermediate categories between shareholders and creditors, such as the meaning of Article 2346 and 2411 c. 3 cc, complicates the equation, but not revolutionary. In fact it emerges a sort of continuous line that has, at one end, the holder of fixed claims (and therefore usually devoid of management powers) and, at the other one, holders of a mere expectation not coercible (therefore normally holders of voice), along which the lack of protection ex post (ie the right to a guaranteed remuneration) tends to be offset by a power ex ante (the right to choose the managers).
as the dividends can be paid: that the company, after payment, remains solvent (so-called solvency test). As a result, the law thus gives great confidence and authority to the members not (only) on the basis that they are owners of the company, but (rather) on the assumption that they, and not creditors, have everything to gain and to lose respectively from a good and bad management, being the creditors’ rights fully safeguarded by legal strategies which are for the major part *ex ante* remedies. This is the model of control of the solvent company, according to the Italian and the U.K. law and rules of the financial market.

3.3. Ownership and corporate control of a troubled company

The company belongs economically to those who, from a formal point of view, have the property and the corporate control until company debt is kept within limits of sustainability (sufficiency of cash flows) and governance (ability to manage and govern the company). Indeed, if the debt remains sustainable and government, it does not threaten, but rather strengthens the power of control of the shareholders or of the control group. As a matter of fact, as evidenced by studies of financial economics, the cost of capital for existing owners is, under certain conditions, lower if the increases in financing needs are satisfied with debt capital rather than risk capital. Moreover, the use of debt capital can more easily maximize the rate of profit, thanks to the leverage inherent in supply, financed by borrowing.

The company with an unsustainable debt or government (that is, when financial or economic or legal troubles arise) ceases to belong economically (at least exclusively) to the shareholders or the control group.

Transferring this economic theory in law terms, it can be said that, if in normal operation is entirely justified under law that creditors are outside the control of the company, there is a serious question about the control of the company when it is not in

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94 It should however be noted that while the above is valid for European countries traditionally based on social capital (also in accordance with Directive 77/91/EEC, the second EU directive on company law), it is only in part for the American. The conditions that legitimize the distribution of dividends are in fact significantly different in the two systems. While in European law require the existence of a budget surplus, in the U.S. law system, not based entirely on the capital, necessary and sufficient condition is that the company will remain solvent after the payment of dividends. It is up to directors, appointed by the shareholders, (not the determination of the surplus in the budget, but) the determination of the solvency of the company. The adoption of the so-called solvency test in the place of the share capital was registered in the Community by the ratio of the High Level Group of Company Law Experts, who noted that the rules on social capital may preclude the distribution of dividends to the solvent company and allow it to insolvency company or however with assets less than the balance sheet liabilities. In this regard, see High Level Group of Company Law Experts – A Modern Regulatory Framework for Company Law in Europe, 4.11.2002, Ch. IV, par. 4, 86ss. For a Commission’s opinion see Modernizing Company Law and Enhancing Corporate Governance in the European Union: a Plan to move forward, 21.5.2003, par.3.2, 17ss.
normal operation and the discharge of debts is in danger: a problem of control of the company that is in troubles. Assuming that, as a result of operating losses, it occurs, at this stage of the life of the company, a financial structure entirely made of debt that initially would be unacceptable to creditors. However, while at the beginning the lender had the choice of whether credit or not, now he is a “prisoner” of the debtor. It is now creditors who provide the true risk capital, but it is still debtor (members) who makes the decisions about the company and may by its conduct worse. Indeed neither the race of creditors to enforce recovery of their loans can eliminate the problem. On the contrary, it worsens as risks destroying the very values on which the creditors could rely. The situation needs a remedy also because the debtor, in this condition, has a strong economic incentive to invest in high risk projects, because, if the result is positive, he will enjoy the benefits, while, if the result is negative, the losses will fall on the creditors. Directors of an insolvent company have the same incentive, if they pursue the interests of unscrupulous members (and have not paid social security for the debt).95

It is precisely for this reason that, in case of danger to creditors, that is when companies are “in troubles”, it is necessary to verify if the law raises specific protection duties, that are limitations of the management power and corporate control, on the debtor-in-chief or on the directors.96

The control of the company should dissolve (because the company is subject to a disruptive liquidation), or should pass block to others in an open and transparent way (through a voluntary or compulsory sale of the entire assets) or it should undergo a non-linear process of control transfer. This passage of control to creditors can occur through

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96 In English law (not in the Italians) is provided for a specific obligation to resort to judicial authority activating an insolvency proceeding; see: R. Kraakman, P. Davies. H. Hansmann, G. Hertig, K. Hopt, H. Kanda, E. Rock (nt.3), 73. According to the Italian system there is a similar duty, but in an indirect and incomplete form, under art. 217, n. 4, l. fall., which punishes the entrepreneur who has aggravated his insolvency by not requiring the declaration of its bankruptcy. This rule is extended to company’s directors under art 224 l. fall. Moreover, Italy requires corporate managers (boards, liquidators) to initiate bankruptcy proceeding upon the onset of insolvency. The U.K. jurisdiction imposes liability for failure to take timely action in the event of insolvency. Here, where the fate of insolvency closely held companies has historically been reserved out of court, directors are liable for damages under the Insolvency Act for failing to respond adequately to the insolvency of their companies.
a non uniform way, by judicial or extra-judicial, legal or contractual strategies, and it is far for simple to delineate when this transfer process, that is a different distribution of power of control, begin producing effects.

In this discuss I will try to outline the rules that govern the transfer of control power when this step is driven by an evolutionary pathology of debt. In this sense, it will deal with the cross border between the decreased of control on the owners and the transfer process of (total or partial) corporate control to creditors or to a part of them. Furthermore, I will focus on the rules that delineate the role assigned to the holders of debt\textsuperscript{97} in order to outline, in particular, the relationship between the latter and the power to carry on business activities.

Although it is not here the place to stress, in terms of indicators and economic analysis, the threshold "critical" that defines debt as unsustainable, it seems necessarily refer to some critical aspects associated with such a threshold, that is the undeniable decline of the concept of insolvency; this state of distress will be outlined with regard also to the (new) rule of the social capital which needs to be reinterpreted in light of more flexible criteria. Furthermore, it must be emphasize the relationship between the formal corporate governance power and the rules of behavior that the holders of this power must observe in cases of troubled companies.

3.4. Regulatory role in creditors’ protection

In order to protect corporate creditors, both Italian and U.K. jurisdictions adopt some common strategies, relying primarily on three classes of legal remedies: affiliation rights (in the form of mandatory disclosure), rules and standards\textsuperscript{98}. Reliance on a common set of remedies, however, does not imply a uniform level of creditor protection.

Corporate law adopts entry strategy by requiring companies to publicly disclosure certain basic information before borrowing funds\textsuperscript{99}. For example, both Italian and U.K. jurisdictions require companies to file their charters in public registers, which makes available information about legal capital, restrictions on director liability. This is a consequence of the E.U. approach, where Member states must establish user-friendly

\textsuperscript{97} As noted above, in this discuss it will not be taken into account all the categories of creditors, nor the class of creditor as a whole, but it will highlight only a specific class of creditors, that are the holders of debt.

\textsuperscript{98} See Part 1….

\textsuperscript{99} To the contrary, voluntary creditors often contract for an exit opportunity in the form of an acceleration clause that makes a debt due and payable upon the occurrence of a significant default.
In addition, all jurisdictions require companies to keep appropriate accounting records. In addition to mandatory disclosure (that helps creditors protect themselves), agent constraint strategies provide standard-form protections for creditors. This is the case of the rules that govern “legal capital.” According to both U.K. and Italian jurisdictions, these rules regulate corporate distributions, minimum capital requirements and the ongoing maintenance of corporate capital. Each of these rules is clear-cut and even mechanical in its application. In particular, such formal rules have always been integral to the regulation of legal capital. One reason should be that the information costs of applying and enforcing them are low. Ease of enforcement may also explain why rules governing legal capital were undoubtedly more important for creditor protection than they are today. More precisely, three aspects of corporate finance can be highlighted, that are, firstly, the maximum permissible outflow of capital; secondly, the minimum

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Regarding public companies, it can be said that disclosure is traditionally more heavily regulated in the U.K. than in our jurisdiction. Under U.K. securities law, a company issuing publicly traded securities—including debt securities—must disclose all material information bearing on the value of the issue and the issuer’s financial condition in a registration statement filed with the Central bank. In addition, public companies must periodically file financial statements that are prepared in accordance with U.K. GAAP, and immediately report on new material developments. Italian law, as all EU continental jurisdictions, still impose much less demanding accounting principles and disclosure requirements.

In theory, U.K. GAAP seek to protect shareholders interests by accurately depicting company finances. By contrast, continental Europe’s accounting practices attempt to protect creditors by reliably signaling that a company’s assets and revenue can cover its liabilities—or if this is not the case, that creditors know it. Anglo-Saxon accounting gives better information, but continental accounting gives more reliable assurance of solvency and solidity. In any event, traditional differences are likely to be short lived because it seems that the capital markets and regulation are inexorably pressing European continental companies towards the U.K. and U.S. model of financial reporting. For a focus on the relevant of the financial situation connected with the themes above, see: A. Lolli, Mandatory rules on financial situation, dividends distribution and fair value accounting in the EU IRFS/IAS regulation, in Corporate Ownership and Control Journal, 2009.

Although the U.K. is traditionally among the most credit-friendly jurisdiction, in this context U.K. law is very close to U.S. law, that are commonly called the Anglo-Saxon disclosure and accounting rules which are the birthplace of shareholders-oriented accounting principles. See C. Nobes & R. H. Parker, Comparative International Accounting, 2002, pp. 54ss.

102 In most jurisdictions, legal capital is the aggregate nominal (or par) value of issued shares, which is typically much lower than the actual issue price of these shares. In U.S. jurisdictions that permit “no par” shares, legal capital is initially set by a company’s organizers, and may be any amount less than (or equal to) the issue price of a company’s shares. Generally speaking, legal capital does not include reserves although some jurisdictions require companies to set aside non-distributable reserves from current earnings as an additional hedge against shareholders opportunism. Note too that a few U.S. jurisdictions permit companies to use economic value rather than book value to set dividend policy, see § 6.40(d) RMBCA and Comment 4.b; § 500 California Corporation Code.
initial investment of capital, and finally, the level of capital that must be maintained during corporate life. Company law restrict the outflow of distribution—i.e., dividends and share repurchases—in order to prevent shareholders from diluting the pool of assets that implicitly bonds a company’s debts. Although these distribution restrictions vary across jurisdictions, the most common rule is one that prohibits payment of dividends that would impair the company’s legal capital, i.e. distributions that exceed the difference between the company’s book value and legal capital as fixed by the company’s charter. As one might expect, dividend restrictions are more protective—and more confining—when they are combined with conservative accounting practices, such as those of Europe. Conversely, dividend restrictions do less to protect creditors where, as in common law jurisdiction \(^\text{103}\), accounting principles are less conservative and the shareholders meeting, or even the board of directors in some cases, can reduce a company’s legal capital with comparative ease.

The minimum capital rules, that are the rules governing the minimum investment levels for incorporation, focus on the concept of legal capital to regulate how much shareholders must invest to qualify for incorporation. EU firms that adopt the open corporate form must have initial legal capital of at least Euro 25,000, although Member states may set higher thresholds if they wish \(^\text{104}\). Although these numbers are large by U.S. standards (which generally require nothing at all), they are actually quite small in comparison to the actual capital requirements of almost all European businesses. Presumably they are small precisely in order to permit almost all legitimate businesses to incorporate as “open” corporations. Nonetheless, it remains unclear how much real protection these rules provide to creditors, particularly since any firm’s initial capital is likely to be long gone before it files for bankruptcy \(^\text{105}\).

Finally, the rules governing the reduction of legal capital in established companies, called capital maintenance rules, should make legal capital a credible financial cushion for creditors. In Italy, for instance, companies that reduce legal capital distributing assets to shareholders, may be required to provide guarantees for unsecured creditors (2445 cc). Moreover, EU law requires open companies to call a shareholder

\(^{103}\) For an overview of a variety of dividend restriction rules used by U.S. jurisdictions, see, e.g. R. W. Hamilton, *The law of corporations*, 2000, pp. 585ss.


\(^{105}\) It has been argued that in theory, company law could toughen minimum capital requirements by, for example, forcing companies to meet a specific debt-equity ratio. As the on-going debate about debt-equity ratios suggests, however, any such requirement would be perceived as intolerably rigid, first of all according to the “rule” that different businesses carry different risks. See also the Basle Accord on Bank Capital Adequacy (although the figures used there are not simple balance sheet numbers but rather adjusted, “risk-based” figures).
meeting to consider dissolution after a serious loss of legal capital. Creditors clearly benefit from the latter requirement, since earlier bankruptcy proceedings generally leave more on the table for distribution to creditors. In theory, moreover, creditors might benefit from mandatory shareholders meetings for the same reason: a shareholders decision to dissolve before exhausting the firm’s legal capital leaves more assets available for distribution to creditors and shareholders. In addition, a meeting requirement might also provide creditors with an early warning of impending financial crises.

One difficult issue is whether the possible benefit of the European capital maintenance rules are realized in practice. Italy and the U.K., such as most of the European States, maintain only a thin layer of legal capital between the layers of unrestricted shareholder equity and debt on their balance sheets. Thus, by the time the difficulties of most failing companies come to light, they have long since exhausted their legal capital and become deeply insolvent. There is simply no time for early warnings or shareholders meetings. Even so, however, the capital maintenance rules may still have some value for creditors. They benchmark the points at which boards and controlling shareholders must liquidate or restructure failing companies, and so make it easier for creditors and bankruptcy receivers to sue these parties if they fail to discharge their duties.

Traditionally, the rule strategy is popular in continental Europe but not among common law jurisdictions. This divergence does not turn on whether a jurisdiction is debtor- or creditor- friendly.

3.4.1. Different approaches to creditors’ protection

Conventional wisdom has it that the world divides into “debtor-friendly” and “creditor-friendly” jurisdictions. Thus, the U.S. is reputed to be debtor-friendly, while EU, with differences between the members, is usually characterized as creditor-friendly (so, the U.K. and, to a lesser extent, Italy). Many global explanations of why entire jurisdictions might be creditor- or debtor- friendly can be found, but the point is

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106 Art. 17 Second Company Law Directive. EU law also protects creditors against reduction through charter amendments or share repurchases, but not against capital reduction to restore financial soundness- the reasoning being that shareholder opportunism is then less an issue. For a comparison, see also: H.D. Assmann, B. Lange & R. Sethe, The Law of Business Associations, in W. F. Ebke & M. W. Finkin (edn.), Introduction to German Law, 1996, 159.

107 Thus, in addition to sheer historical inertia, some jurisdictions might favor debtors because the market already protects creditors, or because politically dominant shareholders believe that strong creditor rights
whether any of these explanations can account for the fine structure of the law. There are significant variations within jurisdictions in the treatment of different classes of debtors and creditors. In addition, a jurisdiction’s weighting of debtor and creditor interests evolves over time\textsuperscript{108}.

The creditor-friendly UK would probably follow the debtor-friendly U.S. in preferring standards over rules, if it were not for the constraints imposed by EU directives\textsuperscript{109}. Instead, it can be argued that there are two main related explanations for Continental Europe’s preference for rules. Firstly, according to the familiar divide between common law and civil law, judges in the latter jurisdictions, such as in Italy, are uncomfortable with open-ended standards, and much prefer to enforce relatively bright-line rules\textsuperscript{110}. By contrast, the second explanation looks to differences in the capital markets. Rules strategies such as capital maintenance requirements are more effective when financing is conservative and bank-centered, and law or market institutions restrict wholesale leveraging or share repurchases\textsuperscript{111}. In the past, these conditions generally prevailed in continental Europe, with the result that capital maintenance requirements posed little or no burden on financial transactions. Today, however, they impose a considerably larger burden in a riskier, market-oriented environment. For instance, EU restrictions on using company assets as security significantly impede leveraged buy-outs of smaller EU firms\textsuperscript{112}. Similarly, capital maintenance requirements are thought to handicap larger EU firms that wish to switch
discourage entrepreneurship. Similarly, jurisdictions might favor creditors because banks are politically powerful while populist mistrust of “capitalists” undercuts the influence of shareholders. Even firm size might play a role: if smaller companies often fail, demand for creditor protections may be greater in the fragmented EU market, with its traditionally smaller companies, than in the U.S. See C. M. McHugh (edn.), \textit{The 2000 Bankruptcy Yearbook and Almanac}, 2000, pp. 332s. See also K. B. Kumar, R. G. Rajan & L. Zingales, \textit{What determines firm size}, Working Paper, available at ssrn.com.

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\textsuperscript{108} See E. Berglof, H. Rosenthal & E. von Thadden, \textit{The formation of legal institutions for bankruptcy: a comparative study of legislative history}, Working Paper 2001, available at \url{www.hec.unil.ch}. For example, recent European reforms that encourage the early restructuring of failing companies diminish the differences between EU and the U.S. insolvency regimes. Similarly, the willingness of U.S. courts to allow U.S. creditors to choose between U.S. and foreign insolvency regimes in international bankruptcies suggests a degree of convergence in the rights of corporate creditors.
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\textsuperscript{111} Comapre art. 17, 19 and 23 Second Company Law Directive.
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from bank financing to raising equity capital on the share markets\textsuperscript{113}. Some commentators suggest a public choice explanation, that is that these rules remain in place because they benefit powerful European interest group, such as the banks, who are the primary lenders, and incumbent managers, who face less pressure to perform with a larger equity cushion\textsuperscript{114}.

Fiduciary duties in the form of standards are widely used in the U.K. to protect corporate creditors. Also Italy, even if in a different and less labeled way, imposes a species of fiduciary duty on a company’s insider and professional partners on behalf of its creditors.

Both jurisdictions provide a risk of personal liability on corporate directors in certain circumstances, notably when a company falls into “the vicinity” of insolvency or is insolvent and the risk of shareholders opportunism is large. In this regard, it seems that these jurisdictions employ a broadly similar approach to framing the liability of board members to protect creditors. Directors, including de facto or shadow directors, may be held personally liable for damages to creditors resulting from the board’s gross negligence or narrow pursuit of shareholder interests when the company is insolvent or nearly so\textsuperscript{115}. The extent to which such personal liability provides significant protection for creditors varies with the circumstances. Directors of smaller firms are often principals who are likely to lose their personal and business assets simultaneously. Large firms, however, frequently purchase liability insurance for their board members, which protects directors while it can also compensate injured creditors\textsuperscript{116}.

It Italy hold directors who act negligently on the brink of insolventcy are personally liable to creditors. In particular, they become negligent \textit{per se} by failing to observe capital maintenance rules. However, this liability is less far-reaching than it might seem. Firstly, it is not easy to show that a board failed to act at the precise point when the company lost half, respectively, of all of its legal capital. This point depends \textit{inter alia} on whether the board uses going-concern or liquidation value. In practice, alternative valuation methodologies often give directors a one-to-two year window to act without violating their duty to creditors. Secondly, even if directors do violate their

\textsuperscript{114} See L. Enriques and J. R. Macey, \textit{supra op. cit.}, pp. 1202ss., suggesting to repeal the Second Company Law Directive in favour of rules modelled after U.S. corporation law; see also Mühlbert and M. Birke, \textit{supra op. cit.}, suggesting liberalization to allow for regulatory competition.  
\textsuperscript{115} See for the U.K.: § 213, 214 Insolvency Act (which cover fraudulent and wrongful trading); for Italy: art. 2392-95 c.c.  
\textsuperscript{116} Directors and officer liability insurance is authorized by § 310 Companies Act.}
duty, establish that they caused a creditor’s injury is not easy. Finally, creditors cannot recover if the board’s violation of duty did not increase their consolidated damages, or if they assumed the risk of dealing with an insolvent company.

Hence, it is the U.K. that imposes a somewhat heavier duty on directors to attend to creditor interests in the vicinity of corporate insolvency. In particular, it has recently increased enforcement of the Company Directors Disqualification Act of 1986, which allows courts to disqualify directors of insolvent companies who have proven themselves to be “unfit” from future management activities, whether these parties are actual directors, de facto directors or shadow directors\textsuperscript{117}. This standard apparently includes disqualification for failing to attend accounting matters or engaging in reckless conduct. Thus, it appears that disqualification may be a more effective remedy than liability, although the disqualification action has yet to achieve any real traction in continental Europe\textsuperscript{118}.

Furthermore, it can be mentioned that, in addition to the liability of directors, there is the auditor liability. Outside auditor function, in the first instance, to ensure that a company’s financial statements reflect the laws and accounting standards of the jurisdictions in which it is domiciled or its securities trade. Moreover, shareholders and creditors alike increasingly rely on auditors to play a broader role in monitoring for breaches of fiduciary duties by managers. Auditors, of course, disclaim any duties beyond verifying financial statements. Nevertheless, the sharp investor reaction worldwide to accounting scandals, form Enron until the recent cases such as Lehman Brothers may eventually force auditors elsewhere in the world to accept a broader scope of responsibility to the investing public\textsuperscript{119}. The auditor’s monitoring role is of special importance for large companies that must retain outside auditors by law. In both the Italian and the U.K. jurisdictions, the courts have been the principal architects of auditor liability, even though Italian law imposed statutory liability on auditors who fail to report breaches of managerial duties to creditors. As a result of the increasing volume of suits against auditors, Italian and English Courts have tended to extend auditor liability by finding that creditors were foreseeable users of financial statements or that they had a


\textsuperscript{118} See: \textit{Re Sevenoaks Stationers (Retail) Limited} [1991].

special relationship with the auditors, for example because the latter have specifically confirmed their support for the company’s accounts.\(^{120}\)

3.4.2. Reflecting upon the standard strategy

There are several influential corporate insiders – directors, auditors, “inside” creditors, or controlling shareholders – liable for participating in corporate opportunism in the vicinity of insolvency. Holding these people liable can benefit creditors and shareholders, but the fact depend on costs that arise from imposing such liability. For instance, imposing liability on directors or on large creditors such as banks, may harm creditors as well as shareholders, inter alia by discouraging these parties from initiating or consenting to corporate workouts.\(^{121}\)

Jurisdictions resolve this tension in different ways. In order to try give some explanations of the extent of such divergences, it can be said, firstly that strategies of creditor protection reflect different styles of adjudication and enforcement. For example, rules are more popular in continental Europe than they are in the common law systems. This difference is rooted in the reluctance of civil law courts to interpret standards – or, conversely, in the willingness of common law courts to apply often ambiguous norms.

In addition, divergent strategies for protecting creditors also reflect jurisdictional differences in insolvency proceedings. For instance, director disqualification was originally important in the UK partly because it was the principal sanction available against directors when companies were subject to receivership in lieu of insolvency proceedings.\(^{122}\)

Finally, creditor protection diverge because jurisdictions do not attach the same importance to this issue. While not as significant as conventional wisdom has it, the traditional distinction between creditor- and debtor- friendly jurisdictions continues to matter. Thus, the UK, which is reputed to be the most creditor-friendly jurisdiction, has in fact the best record of enforcing the disclosure rules governing small companies and

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\(^{120}\) For the U.K., see P. Davies, Gower and Davies’ principles of modern company law, pp. 585ss. Compare also with the appeal case: Hedley Byrne & Co. v. Heller & Partners, 1964, p. 645.


For Italy: see E. Barcellona, Responsabilità da informazione al mercato: il caso dei revisori legali dei conti, 2003, pp. 131ss.

\(^{121}\) As it will be noted in this discussion, the two jurisdictions, Italian and U.K.’s, resolve this tension differently.

sanctioning directors who breach their duties to creditors. Italy, who is said to be less creditor-friendly than the UK, is in fact less eager to enforce small company disclosure and directorial duties, even though they maintain strict capital maintenance rules.\textsuperscript{123}

\textbf{3.5. The state of insolvency in the U.K. system}

In the U.K., to talk of “troubled” or “failing” companies is to refer to companies encountering a variety of problems and in different stages of decline or regeneration. As a consequence, the term “troubled” deals with both distress and insolvent companies. Distress companies are those that encounter crises that cannot be resolved without a sizable recasting of the firm’s operations or structures.\textsuperscript{124} Such distress may be seen in terms of default, where the company has failed to make a significant payment of principal or interest to a creditor.\textsuperscript{125} Alternatively, distress can be seen in terms of financial ratios. Thus, calculations based on a company’s accounts can be used to reveal profitability ratios, liquidity ratios and long-term solvency ratios.\textsuperscript{126} Assessing whether a company is in distress may involve reference to these ratios individually or collectively, but the central issue is whether the company is revealed to be in such a state of crisis that drastic action is required.\textsuperscript{127}

A company is insolvent for the purpose of the law if it is unable to pay its debts.\textsuperscript{128} No legal consequences attach to a firm simply by virtue of its insolvent state. Such consequences only follow the institution of a formal proceeding such as winding.

\textsuperscript{123} It is necessary highlight that these divergences are not so deeper in practice. The main reason for this affirmation is that UK creditors rely far more on contract and market institutions than they do on legal strategies for their protection. In particular, lenders to small business rely on credit agencies and the personal guarantees of shareholders to protect their interests, which may explain why the European Commission has been unable to extend “pro-creditor” regulations such as an audit requirement to small, closely held companies.


\textsuperscript{125} A. Keay, \textit{Insolvency Law, corporal and personal}, Jordans, 2009, pp. 21ss.


\textsuperscript{127} See K. Wruck, \textit{Financial distress, reorganization and organizational efficiency}, in \textit{Journal of Financial Economics}, 1990, 27, pp. 419ss. where the author defines financial distress as “a situation where he cash flow is insufficient to cover current obligations, These obligations can include unpaid debts to suppliers and employees, actual or potential damages from litigation and missed principal or interest payments”.

up or the appointment of an administrator or administrative receiver. Moreover, there is no single legal definition of inability to pay debts. Within the Insolvency Act 1986 and other insolvency-related statutes there are a number of tests of insolvency and these relate to the purposes of different legislative provisions. As a result, what is a debt depends on the particular test of insolvency that is being applied. In this regard, there are two primary tests, on the one hand, the “cash flow” or “commercial” insolvency test and the “balance sheet” or “absolute” insolvency test on the other.\textsuperscript{129}

Under the former test a company is generally regarded as insolvent when unable to pay debts as they become due. This means that there are insufficient resources available to the debtor to pay creditors. The fact that the firm’s assets exceed its liabilities is irrelevant. The critical issue is whether the company can pay his way in carrying on her business or conducting her affairs.

The second test holds that a company is insolvent if the total liabilities are greater than value of the assets, with the consequences that the debtor has insufficient assets to discharge the liabilities.

It is quite possible for a business to be insolvent in cash flow terms, but be asset rich and able to be regarded as solvent on the balance sheet test.\textsuperscript{130} Similarly, a business may be able to pass the cash flow test, but its liabilities are greater than its assets. Notwithstanding this, in practice, businesses usually tend to fail or pass both tests.\textsuperscript{131}

\subsection*{3.5.1. Insolvency Act tests}

Both tests are set out in U.K. Insolvency Act. Thus, section 122\textsuperscript{132}, for instance, provides that a company may be wound up if it is “unable to pay its debts”, that is it is insolvent. This phrase is explained in section 123 in two ways, using the two tests.

\begin{itemize}
  \item \textsuperscript{130} Neither test is perfect. Primarily, the difficulty with the cash flow test is that its meaning is vague and imprecise and, determining whether a company (or a person) is, on a particular day, insolvent is often difficult. With the balance sheet test the problem lies with marginal cases, which is often the situation where a company is being attacked for the failure to pay debts or claims; the problem is that it is not easy to assess whether the test is satisfied. A critical reason is the fact that assets have to be valued and this, according to Prof R. M. Goode:” is not an exact science but to a considerable extent a matter of judgment as to the amount a willing buyer would pay in the market when dealing with a willing seller”. Moreover, establishing the value of some assets, particularly where circumstances can affect them, is not easy. Furthermore, it is sometimes difficult to estimate the value of some kinds of liabilities, notably unqualified existing liabilities and contingent liabilities.
  \item \textsuperscript{131} Professor Sir Roy Goode makes the point that:” there is a close link between cash flow insolvency and balance sheet insolvency that where a company is a going concern and its business can be sold as such with its assets in use in the business, those assets will usually have a substantially higher value than if disposed of on a break-up basis, divorced from their previous business activity. So a company which is commercially solvent has a much greater chance of satisfying the balance sheet test of insolvency than one which is unable to pay its debts as they fall due”.
  \item \textsuperscript{132} Section 122 Insolvency Act 1986
\end{itemize}
Indeed, section 123 (1) (e) provides that a company is unable to pay its debts if it is unable to pay its debts as they fall due. Section 123 (2) incorporates the balance sheet test, stating that a company is unable to pay its debts if it is proved that the value of the company’s assets is less than the amount of its liabilities.

The concept of cash flow insolvency seems simple *prima facie*, but in some cases it may be far from easy to determine whether the test is satisfied at any particular point of time. In this regard, a quite developed jurisprudence has been laid down by English Courts. Firstly, Courts, in examining whether a company is suffering cash flow insolvency, will consider whether the company is actually paying its debtors. Then, it must take into account what current revenue the company has as well as what the company can procure by realizing assets within a relatively short time\(^{133}\). A company can rely upon money which might be obtain form the sale of assets or upon money which might be obtain by a loan on the strength of its assets\(^{134}\). It is possible that sometimes a debtor might be able to establish solvency by demonstrating that funds can be obtained through an unsecured loan\(^ {135}\). Furthermore, in considering whether a company is insolvent, the debtor’s whole financial position must be studied\(^ {136}\) and a temporary lack of liquidity does not necessarily mean that the company is insolvent. In *Lewis v Doran* the following were seen as usual indicia of insolvency (from a cash flow perspective): a history of dishonored cheques; suppliers insisting on cash on delivery before providing goods; the issue of post-dated cheques; special arrangements with creditors; inability to produce timely audited accounts; demands from banks to reduce overdrafts; and the receipt of letters of demand; and statutory demands under the insolvency legislation. It is probable that the presence of the words “as they fall due”, under sec. 123 (1), means, as far as the debts to be taken into account are concerned, that Courts may look into the future to see what debts will fall due in the future\(^ {137}\). To what extend a court is permitted to gaze into the future is not really settled, although what is clear is that it will depend on the debtor and the debtor’s circumstances. The issue has not been

\(^{133}\) See: *Re Capital Annuities Ltd* [1979] 1 WLR 170 at 182, 188.


\(^{136}\) See *Hymix Concrete Pty Ltd v Garrity; M & R Jones Shopfitting Co Pty Ltd v National Bank of Australasia Ltd* (1983) 7 ACLR 445.

\(^{137}\) *Bank of Australia v Hall* (1907) 4 CLR 1514 at 1528; *Kyra Nominees Pty Ltd v National Australia Bank Ltd* (1986) 4 ACLC 400 at 402.
canvassed in England and Wales. In Australia there is some divergence in the cases as to whether or not “debts due” includes liabilities not payable because creditors had granted the debtor extended terms of repayment. It seems that the better supported view now is that it is proper to take into account any extensions of time granted to the debtor to pay its creditors and, in turn, to take into account the dates when it might be reasonably expected that the creditor would receive debts due and owing to it\textsuperscript{138}.

Until recently, it has been unclear whether in English law future debts can be taken into account when assessing insolvency. It has been argued that “contingent and prospective liabilities” are not to be taken into account in determining a debtor’s solvency under the cash flow method, because, unlike section 123 (2) – dealing with balance sheet solvency –, which includes a reference to “contingent and prospective liabilities”, section 123 (1) (e), does not\textsuperscript{139}.

At one time Courts were rather strict on what they required to be established before they were willing to deem a company insolvent, but in more recent times they have become more liberal as far as creditors are concerned and have held that a debtor is insolvent if a creditor is able to prove that he has not been paid an undisputed debt after a demand has been made\textsuperscript{140}.

Whether a company is cash flow insolvent is principally a question of fact and one which may be established in any number of ways, such as the existence of a large number of outstanding debts and unsatisfied judgments or a lack of assets on which execution can be levied\textsuperscript{141}.


\textsuperscript{139}This has led to the following comment:” For, given a reliable balance sheet and the assistance of expert evidence, there seems to be no reason why it should be beyond the court’s poker to arrive at a conclusion that the company is insolvent in this sense without becoming involved in speculation about its future business prospects”, by A. Keay, \textit{McPherson’s Law of Company Liquidation}, p. 88. But recently, Briggs J in \textit{Re Cheyne} [2007] EWHC 2402 Ch, accepted the fact that courts could take into account future debts of insolvents that will fall due in determine whether a debtor was cash flow insolvent.

\textsuperscript{140}See: \textit{Re Camburn Petroleum Products Ltd} [1979] 3 All ER 297; \textit{Re Taylor’s Industrial Flooring Ltd} [1990] BCC 44, CA; and in this case even if there is other evidence which suggests that the value of assets outweighs liabilities, see also \textit{Cornhill Insurance plc v Improvement Services Ltd}, where the Court was asked to restrain the presentation of a petition against a well-known and apparently profitable company. The Court declined to do so and agreed with Vaisey J in \textit{Re a Company} (1950) 94 Sol Jo 369, that the delay in the discharge of a company’s obligations creates some suspicion of financial embarrassment.

Moreover, it has been said that a debtor is not to be regarded as solvent just because if sufficient time were granted the debts could be paid off\textsuperscript{142}.

The balance sheet test actually looks at the affairs of the company and is provided for, for example, in section 123 (2), which considers whether the company’s assets are insufficient to discharge its liabilities, taking into account, as it has already mentioned above, its contingent and prospective liabilities. This may involve assessing the value of assets and judging the amount the asset would raise in the market; through a difficulty arises through the Act’s failure to indicate whether valuations should be made on the basis of a “going concern” or “break-up” sale. Particular difficulties may arise where there is no established market value for the commodity. The test, moreover, gives rise to potential problems in so far as there is no statutory definition of prospective liabilities. Standard accounting practice treats contingent liabilities more subtly than section 123 (2) and that section does not include any particular basis for measuring assets and liabilities\textsuperscript{143}.

In this regard, court decisions states that, in determining whether the assets are outweighed by the liabilities, a Court is able to take into account contingent and prospective liabilities, but not contingent and prospective assets\textsuperscript{144}, added that “liabilities” is a broader term compared with “debts”\textsuperscript{145}. “Liabilities” is defined for the purposes of winding up in rule 13.12 (4) to mean “a liability to pay money or money’s worth, including any liability under an enactment, any liability for breach of trust, any liability in contract, tort or bailment and any liability arising out of an obligation to make restitution”. Then rule 13.12 (3) states that it is immaterial whether the liability is present or future, whether it is certain or contingent, or whether its amount is fixed or liquidated, or is capable of being ascertained by fixed rules or as a matter of opinion. Clearly with this test it is only possible to take into account the assets owned by the company, including the uncalled capital of the company\textsuperscript{146}. Finally, in establishing balance sheet insolvency in court a creditor might need to adduce expert evidence from a person such as an experienced accountant.

In conclusion, defining “insolvency” at law is further complicated by the use of further tests in statutes other than the Insolvency Act. Legal definitions, moreover, are

\textsuperscript{142} See: Re Attiwell: Official Receiver v Braithwaite Bross (1932) 5 ABC 54; Re Whitgift Nominees Pty Ltd (1983) 7 ACLR (1983) 1 ACLC 1133.
\textsuperscript{143} See Re A Company (N. 006794 of 1983) [1986] BCC 261.
\textsuperscript{144} See: Byblos Bank SAL v Al-Khudhairy (1986) 2 BCC 99, 549, (CA).
\textsuperscript{145} See: Re A Debtor (No 17 of 1966) [1967] Ch 590, [1967] 1 All ER 668.
\textsuperscript{146} See: Re National Livestock Insurance Co (1858) 26 Beav 153, 53 ER 855.
not the only measures for corporate failure. Thus, “insolvency” is defined in different ways for different purposes which indicate that the firm is “in troubles”. Insolvency under the cash flow is a ground for a winding-up order\textsuperscript{147} or an administration order\textsuperscript{148} or for setting aside transactions at undervalue, preferences\textsuperscript{149} and floating charges given other than for specified forms of new value\textsuperscript{150}. The balance sheet test is also one of the tests prescribed for the purpose of grounds for wining up\textsuperscript{151}, administration\textsuperscript{152} or the avoidance of transaction at undervalue\textsuperscript{153}, preferences and certain floating charges\textsuperscript{154}. It is also a test relevant in considering the disqualification of directors\textsuperscript{155} and is the one test used in identifying insolvent liquidation for the purposes of assessing directorial liabilities for wrongful trading\textsuperscript{156}.

3.6. The state of insolvency under the Italian system

With reference to Italian Insolvency Law, the state of insolvency is not precisely defined and no tests are explicitly adopted by theLegislator. The art. 5 explicitly provides for “events of default”\textsuperscript{157}. The object of this events is the “inability of the debtor to meet regularly his obligations”, whatever the causes that generate this situation. This demonstrate that the data more closely balance sheet remains in the background than the financial data. In other words, what is important is that the debtor is no longer able to meet its obligations because he does not have the necessary resources or he still cannot obtain them. “Regularly” means promptly and “by normal” means regarding the ordinary management of the company. The Courts have been expressed in terms of “structural crisis of the corporate organization”, the “functional state of helplessness and not transient, irreversible, to meet the obligations of the company”. Moreover, with the Court’s words, the state of insolvency deals with the “inability to produce goods with profit margins likely to be sufficient to cover the needs

\textsuperscript{147} Insolvency Act 1986, s. 122 (1) (f).
\textsuperscript{148} Insolvency Act 1986, Sch. B1, Paras. 11, 111 (1).
\textsuperscript{149} Insolvency Act 1986, s. 239, 240 (2).
\textsuperscript{150} Insolvency Act 1986, ss. 238-42 and 245, expecially ss. 240 (2) and 245 (4).
\textsuperscript{151} See R. Goode, Principle of corporate insolvency law, op. cit., p. 90.
\textsuperscript{152} See nt. 33 above.
\textsuperscript{153} Insolvency Act 1986, ss. 238-40 (2).
\textsuperscript{154} Insolvency Act 1986, s. 245, in particolar 245 (4).
\textsuperscript{155} Company Directors’ Disqualification Act (CDDA) 1986, s. 6 (2).
\textsuperscript{156} Insolvency Act 1986, s. 214.
of business” or the situation where “there is a talk of inability to borrow on normal terms”.

As a consequence, it can be said that there is generally a lack of ordinary liquidity, that is the liquidity which is generated by carrying on normal business activities.

The insolvency becomes relevant when it occurs outside. The main form of this manifestation is the repeated failure of performance\textsuperscript{158}, as deduced from the already mentioned art. 5, c. 2, l. fall.

Regarding the relationship between “debts” and “corporate governance” of the company, the rule of the state of insolvency is essential in the Italian jurisdiction because it performs a fundamental function of discrimination. In fact, so long as the debt does not degenerate into insolvency, it is assessed as a manifestation of manager freedom, and, as such, it does not affect the ownership of corporate assets; consequently, the shareholders are entitled of the corporate governance power.

Otherwise, when the debt becomes insolvency, manager freedom ceases, any act in violation of \textit{par condition creditorum} is banned, the duty not to aggravate the failure by delaying the use of bankruptcy or other insolvency proceedings arises; as a result, the rule is dispossession\textsuperscript{159}, first, and loss of control of the company, then.

Italian insolvency law confines the term “insolvency” to formal legal proceedings, such as “fallimento”, “liquidazione coatta amministrativa”\textsuperscript{160} and

\textsuperscript{158} For the purposes of bankruptcy, there is also shown a consistency of these failures inferred from Article 15, u. c., l. fall., that is overdue debts unpaid amount of at least euro 30.000. Other external facts that may constitute events of default, that is insolvency, can be deduced by art. 7 l. fall.

\textsuperscript{159} Under art. 42, c. 1, l. fall., the first effect of the decision declaring bankruptcy is dispossession, according to which the bankrupt is deprived of management and availability of its assets at the date of the bankrupt sentence.

“amministrazione straordinaria”\textsuperscript{161}. At the same time, the “insolvency” is not the only legal state relevant in law. Indeed, the state of “crisis” is codified as the objective legal condition to access to the “concordato preventivo”\textsuperscript{162} procedure.

As a result, according to Italian law, as under U.K. legislation, it is recognized that the starting point of a pathological state arises at a pre-insolvency step. This “step” seems not to be exactly the same, while the U.K. sets out and codifies specific “troubles state” tests which explicitly give relevance to economics rules, Italy states standards of manifestation of company troubles which needs to be interpreted, maybe, in economic terms. However, it can be argued that under both Italian and U.K. jurisdiction it is possible to speak about a “trouble situation” of a company which, at the same time, marks the final defeat of freedom of governance of the owners and the requirement for a forced replacement. Excessive debt may be relevant in law and affect the power of governance of the company, that is the control, although the threshold of insolvency is not exceeded. Both Italian and U.K. systems seem focus on this phenomenon, providing, as a consequence, legal strategies to discipline the change of control and remedies to protect creditors. In this discuss I will outline the situations in which the pathological debt affect the power of control of the formal owners of the company.

3.6.1. The nature of the company’s “troubles” under Italian interpretation

Italian strategies to protect creditors are connected with three main default occasions, which play a fundamental role in understanding when companies are “in troubles”. These are: economic imbalance, financial imbalance and governance imbalance.

The company expresses an economic imbalance when revenues generated from its activities are no longer able to cover operating costs and, therefore, operates in a condition clearly uneconomic. If the owners do not interfere with efforts to redress the trend, and if these inefficiencies are eliminated technically, the imbalance will inevitably have to generate operating losses for the end to eat into equity up to his zero.

In order to face the economic imbalance, where there is not merely a transitory event,\footnote{The Italian term “fallimento” is the bankruptcy procedure of the Italian insolvency law, which is provided in R. D. 16.3.1942, n. 267 as modified in several occasions; the last one is the d. lgs. 12.09.2007, n. 169 which came into force in the 1st of January 2008. The “amministrazione straordinaria” is a special Italian procedure for large and very large businesses which is provides in d. lgs. 8.7.1999, n. 270, so called “Prodi-bis law” which is followed by the d.l. 23.12.2003, n. 347 (so called “decreto Parmalat”) converted in l. 18.2.2004, n. 39 which in turn has been modified by the d.l. 28.8.2008, n. 134, conv. In l. 27.10.2008 (so called “decreto Alitalia”).}

\footnote{See artt. 160 ss. l. fall.}
but it is a stabilized condition and structural integration, with no doubts that it is a situation of default risk, the law does not intervene powerfully as it would if there was a declaration of insolvency. Rather, the Legislator intervenes, specifically, in particular circumstances providing mandatory rules or behavior for owners. A typical example in this sense is the discipline of the default of the banks, according to which the mere anticipation of heavy losses, as they appear in the accounts or in the findings of inspections carried out by supervisors, is a prerequisite for the access to the bank insolvency procedure called “amministrazione straordinaria”\(^ {163}\); in the case of exceptional losses, it is opened the bank liquidation procedure called “liquidazione coatta amministrativa”\(^ {164}\). Both procedures are arranged by an order of the Minister of Economy, on a proposal from the Banca d’Italia, which should order a provisional management called “gestione provvisoria”\(^ {165}\). The serious or exceptionally serious qualities of the losses are sometimes interpreted in quantitative relation to the effects produced by losses on equity or, otherwise, on the balance sheet of the company (capital reduction under the legal minimum, heritage losses). Actually, this reading does not seem necessary, given that the difference in intensity of losses determines the access to a procedure rather than another. Moreover, the option between “amministrazione straordinaria” or “liquidazione coatta amministrativa” depends on the forecast evaluations, whose reliability can be improved through management replacement.

These measures are clearly aimed at making it extremely timely intervention of supervisors of possible crisis situations on the company; the scope is to prevent further deterioration and to limit the damage, in regard to the specific material interest in these areas and the impact on the whole economic system that the instability of such investment companies may result.

Regarding the discipline under the Code about companies with shares, the evident loss of management requires shareholders take certain legal remedies. More precisely, these losses become relevant when they have affected the share capital causing a reduction of more than one third. In this circumstances, the managers should immediately call the shareholder meeting to adopt the appropriate provisions. Whether the losses would be

\(^{163}\) Artt. 70ss T.U.B.
\(^{164}\) Artt. 80ss. T.U.B.
\(^{165}\) This model was then substantially covered by T.U.F. with the extension to Consob the power to propose for the sim and other market securities covered therein. Similar measures are planned for the insurance companies (cod. Ass., art. 238ss.; see also safeguards and rehabilitation measures at art. 222-229). In the latter case the power to propose the procedure belongs to the Isvap and the procedure takes place by the order of the Minister of Productive Activities.
not restored to less than one third within the next financial year, the shareholder meeting should proceed to the reduction of share capital in proportion to the losses incurred (art. 2446 and 2482-bis c.c.). It is also established that in the case of any omission by the shareholder meeting, that reduction of the share capital would be provided by the Tribunal, called by the managers.

Whether the loss brings the capital below the legal minimum, the managers should immediately convene the shareholder meeting to deliberate the reduction of the share capital and the contemporary increase of the same to a figure not less than that minimum or, alternatively, it should be deliberate the merger of the company (art. 2447 c.c.). The rules which provides the power of the shareholders to reduce the share capital is a default rule; as a consequence, it can be delegated this power to managers.

The discipline described above, albeit briefly and with no claim to completeness, has multiple purposes. Primarily, it intends to restore, where possible, a situation of effectiveness of the share capital, so that the nominal capital of the company must match resources actually present. In the case of capital reduction to below the legal minimum, the shareholders are obliged to opt for a new organizational structure appropriate to the existing capital (merger) or, alternatively, to liberate, through the dissolution of the company, the resources allocated to a project already unproductive because they may find new activities.

However, the presence of qualified operating losses is not necessarily symptomatic of a state of default of the company. Definitely, it expresses the economic dysfunction that is reflected on the investment made by the participants, who see their unmet expectations of profit in line with the business plan to which they have subscribed, but no profits may be physiological in some cases, as typically happens in stages starting a business. Moreover, even in cases where the losses would imply a pathological state of economic imbalance, it is doubtful that these legal strategies adopted by the Italian legislator will be able to effectively play a role in the prevention of insolvency and the protection of the creditors of the company. Indeed, despite claims that traditionally the minimum share capital, through the "net system" acts as the buffer between the insolvency of the company and the total loss of its assets, the minimum capital required by law are so insignificant that they cannot certainly ensure a truly payment of all debts.

Conclusively, it can be argued that the minimum legal share capital cannot be effective index of an adequate capitalization of the company to prevent or counteract
specifically the future indebtedness of the company. This assumption raises the debate about the role of the share capital in a company as the guarantee offered to protect shareholders and creditors and the relationship between the so called “capital maintenance regime” and the promotion of business efficiency.\footnote{In this regard see: A. Lolli, *Situazione finanziaria e responsabilità nella governance delle spa*, Milano, 2009; compare also with: Enriques Macey, *Creditors versus capital formation: the case against the European legal capital rules*, 86, Cornell L. rev., 2001, pp. 1165ss. In particular, regarding the problem if the legal capital system is sufficient to protect shareholders and creditors and the connected arguments about how to complement that system with another, which will be more effective in preventing a distribution which could compromise the life of the company as a going concern, see: A. Lolli, *Mandatory rules on financial situation, dividends distribution and fair value accounting in the EU IRFS/IAS regulation*, in *Corporate Ownership and Control journal*, 2009, pp.}

It is true that the security of creditors is not statically represented by the share capital, or otherwise the assets of which the company currently has, but rather by its ability to generate income and this situation of efficiency (and hence trend solvency) is facilitated by the constant presence of an adequate capital resources to fund the planned activities.

In the EU context\footnote{For more details about this discussion compared Directive 2006/68/EC with 77/91/ECC; The European Commission Directorate General for Internal Market and Services, in *EC*, 2008, pp. 1-2. See also for a discussion about the relevant of the financial situation for a distribution of dividends and the possibility to apply an alternative criteria of the fair value, see: A. Lolli, *Mandatory rules on financial situation, dividends distribution and fair value accounting in the EU IRFS/IAS regulation*, op. cit.} has been arising the idea of reforming the current legal capital regime as established by the 2\textsuperscript{nd} Company Directive, believing that the financial situation of a company and its future evolution are legally relevant in providing solvency tests either as an alternative or as an additional system to legal capital.

The second type of imbalance which will be considered here is the financial situation.

A situation of financial imbalance arises when the company finances its activities with its modest means and mainly by means of third parties. The equity of the company is failing to fund the activities planned, in particular to support those durable investments needed for their development. Hence the need to resort to borrowing (the so-called leverage) to continuing management.

It is undeniable that the use of leverage in many cases is part of the physiology of the financing techniques of the company. More precisely, the expansion of borrowing can be beneficial for the company when the expected income from the use of new resources exceed their cost, or when it is really able to allow the company to exceed a period of temporary difficulty.

Nevertheless, when these conditions are not met or whenever an imbalance of debt compared to equity exceeds certain limits (or certain parameters that the economics
have tried to identify) may trigger a pathological situation which threatens the future of the company itself and, then, can lead to an irreversible crisis of solvency. In these cases, the urgent need to external finance and the difficulty of providing guarantees to lenders for the lack of own resources can put the company in a weak bargaining position, forcing her to accept high financial burdens, if not unsustainable. Indeed, ordinary, lenders, especially if professional, would offset the increased risk that comes from the low capital base of the party with the rising cost of financial transfer. The rising cost of credit raises the cost of managing the funded company, reducing its profitability and further depress the equity. Ultimately, the financial imbalance in physiological conditions are not likely to trigger a spiral of degeneration that can deal with or accelerate the economic decline of feeding a growing debt, especially in short term, to lead inevitably to the insolvency of the company.

In these cases the financial troubles lead the company to a particular serious dangerous situation and this is the foundation of the legal strategies that sometimes the Italian legislator provides for counteract the characteristic risk of insolvency produced by such imbalance.

In order to understand these legal remedies, it seems useful, preliminary, make some reflections on the phenomenon of the so called “thin capitalization”, that is a choice, taken by the company, to minimize the portion of wealth exposed to the risk of business, with creditors on the consequences of an eventual insolvency. The phenomenon is widespread and encouraged by the modesty of minimum capital requirements which, as already mentioned, have no real selective function, allowing the company to be in a permanent state of financial imbalance and deliberate, so even the good that was produced the management would probably have been drained by shareholders and certainly not used to recapitalize the company.

Although in the Italian corporate law system there are no express rules which prohibit this practice, or that, otherwise, would oblige members to provide what is necessary to make the company more capitalized, it can be focused on a normative tendency of the Italian Legislator to take into account that problem, which can be deduced under art. 2467 c.c.168 This disposition deals with the practice, carried out by members of s.r.l., of

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168 Art. 2497-quinquies c.c. in the context of group of companies (more exactly, management and coordination activities) makes an express reference on art. 2467 c.c., providing that the latter discipline applies also to inter-companies loans in the context of group. For problems and discussion about the application of this rules to s.p.a. and other connected reflections, see generally: Maffei Alberti……G. Guerrieri
those financial activities consisting in supporting the company business by founds which, as they are not attributed to venture capital, are subject to claim to return, as if the sums awarded under loan. In a troubles company situation, the legislative solution is consist of postponing the satisfaction of the financing members to creditors. This happens when the loans are such as described under c. 2 art. 2467 c.c., that are loans granted by the members in favor of the s.r.l. at a time when, even in the type of activity conducted by the company, there is an imbalance of too much debt compared to equity, or in a financial situation of the company in which would have been useful funding. Indeed, whether that loan has been granted during the year preceding the declaration of insolvency, it must be returned.

In conclusion, what these provisions are designed to counteract is the so called “nominal (or formal) thin capitalization” of the company, that is the situation in which the company is financed, but not in the forms of risk capital. Members opportunistically exploit this state by continuing to support the activity until the latter proves viable, while leaving the company bankrupt at the time of difficulty; in doing so only after having promptly recovered their credit, with a large and obvious translation losses and risk chief creditors. As a result, this becomes a practice which encourages irresponsible management and, consequently, which exposes the company to a more specific risk of insolvency.

In the Italian legal system are absent, however, legal strategies designed to prevent or remedy to a substantial thin capitalization of the company, that is the specific lack of adequate capital investment for the performance of the planned activities. In this context there may report only hints at a different approach, a sign of an opening of the Italian Legislator to this subject, in terms of “assets intended for a specific purpose” (the Italian “patrimoni destinati ad uno specifico affare”) for whose constitution the Italian law requires the establishment of a specific business plan showing the adequacy of capital compared to the creation of business, within the meaning of article 2447-ter c.c.

In the face of provisions such as those described it is undoubtedly the problem of try to extrapolate, in a systematic way, a principle for further generalization, but it is certainly a complex issue that cannot be addressed here. What in this discussion I would highlight

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169 The reference is intended to those assets listed in art. 2447-bis, let. a.), c.c., that is the first type, known as management asset, separate from the second type, known as financial assets which are provided in art. 2447-bis, let. b.), c.c.
is that, operationally, the problem is how identify parameters of increased technical prowess likely to indicate the conditions under which the company can be considered in a situation of adequate capitalization, that is financial balance. For these purposes economics have developed certain criteria based on the relationship between equity and debt (debt / equity ratio)\textsuperscript{170}, which seem able to indicate, approximately, the condition of financial equilibrium of the company.

In this regard, it is interesting to note the Italian law begins to take up these tools, for example, in accordance with that purpose in the companies called “cooperative”, under art. 2545-quinquies c.c., it is possible the dividends distribution, the purchase of own shares, the allocation of divisible reserves to members only if the ratio between equity and total debt of the company is in excess of one quarter.

In conclusion, it can be argued that the situation of financial imbalance, even if not considered by the Italian law generally and systematically, is the subject of attention of the modern Legislator in contexts where exposed to greater danger and where the fate of the company lends itself to opportunistic strategies of its members. As well as being indicative of a greater sensitivity to the problems that the situation arises, this approach highlights the particular importance of preventive strategies in the protection of creditors when companies are in troubles.

The third type of imbalance concerns the balance sheet, arising when all the activities of the company is less than its liabilities. The sufficiency of the company's own resources is not viewed here in relation to the funding needs of its business, as a function of ability to pay its current debts. Despite not having sufficient resources to address its debt, the company could, nevertheless, still be solvent, if unable to obtain from third parties necessary financial resources to meet regularly with its obligations or, otherwise, complete or partial deferral of the deadline from its creditors.

This condition may also be physiological in the company life, whether temporary and with the intention to be eliminated by an increase of profit capable of restoring the assets to an extent sufficient to cover liabilities.

The capital imbalance is, thus, more or less according to the worrying economic development of the company. Whether the latter pays in a situation of economic imbalance, with a negative trend in profitability, it is clear that the already limited

\textsuperscript{170} AGG fir art fotocopiati del prof cartellina con cane
financial situation of the company will make less and less able to absorb losses up to the crisis of solvency.

Normally, capital imbalance is accompanied by an unbalanced financial situation, since the lack of assets implies a reduction in resources available to finance its ongoing activities.

Facing the mere asset imbalance, which then also gives rise to a financial imbalance, and that does not yet translate into a full-blown bankruptcy, the Italian system does not intervene to impose special legal measures or, better, it provides only for indirect strategies.

It is the case, for instance, of the discipline, under art. 2394\textsuperscript{171} c.c., of directors' liability to creditors for social obligations regarding the conservation of the integrity of corporate assets. Assumption of this liability is that the assets are insufficient to satisfy creditors. Consequently, managers should be encouraged to ensure a permanent balance sheet situation, that is a situation in which the assets of the company are (basically) always adequate to cover existing liabilities. Such \textit{ex post} remedies can be seen also in a same provision under art. 2485 and art. 2486, c. 2, c.c. in the context of dissolution and liquidation of the company\textsuperscript{172}.

Although there are no general rules or principles providing a stronger remedy for avoiding dangerous thin capitalization, however, in special sector of activities, the Italian system has established stronger and more direct measures, requiring to comply with, on the one hand, specific standards of capitalization (i.e. a minimum allocation of equity, because of certain specified type of business) and, on the other hand, solvency ratios capable to deal with risk to exposure and which need to be observed on an ongoing basis. For banks and brokerage companies, for instance, these coefficients are usually given in fixed relationships that should exist between certain activities and capital instruments deemed useful for supervisory purposes. Moreover, for insurance companies, the special Code\textsuperscript{173} (and the secondary legislation enacted by Isvap) states the preservation of a clear margin of solvency and of a guarantee amount consisting of specifically designated assets\textsuperscript{174}.

\textsuperscript{171} This article provides the liability of directors of s.p.a. For problem connected with the application of this discipline to s.r.l.

\textsuperscript{172} Stanghellini, \textit{Proprietà e controllo dell'impresa in crisi}, in Riv. soc., 2004, pp. 345ss.

\textsuperscript{173} It is the Insurance Code, art. 44ss.

\textsuperscript{174} The high technicality and the opportunity to timely adjustments to rules justify the provision of a statutory intervention in the chief authority for the specific sector: Banca d'Italia, for banks and operators of the security
The above outlined precautions are dictated by the primary protection of relationships which are typically established in carrying out the recalled activities and by the public relevance of the interest therein underlying, potentially compromised by an economic crisis, no less than a crisis of legality. It accompanies (and may even be regarded as the ultimate goal of these measures) the protection of the general interest to the firm stability in the mentioned sectors and the financial system as a whole, for his reflections on the world economic system.

3.7. The Relationship between balance of equity/debt and balance of corporate control

It has been shown that excessive indebtedness, which determines the troubles of a company, from whatever source it originates, is relevant in law in particular, as it is pointed out in this discussion, because it affects the corporate governance of the company, that is the corporate control, even if the threshold of insolvency is not exceeded. From the substantive point of view, that freedom of carrying on business is compressed and redirected as a result of the rules protecting the assets. This fact reflects, and this is the next step that I would to outline here, a limitation of the power of control of the members or of the control group. In this case the control does not pass to subjects other than those already held. However, the imbalance between equity and debt, made evident by the existence of losses, results in a significant downsizing in the freedom of management choices in chief of the directors and, consequently, in chief who holds control.

These corporate governance rules are not only important from a procedural prospective, but they are also relevant as an expression of a general principle which, it can be argued, should be expressed by the prohibition, in certain circumstances, to continue the business activities if it is not reconstituted for such continuation an adequate level of equity. The typical circumstance, already cited above, which trigger that ban is the existence of an imbalance between liabilities and assets to an extent to set

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market; Isvap, for the insurance companies; v., respectively, art. 53, c. 1 and c. 2, T.U.B.; art. 6ss. T.U.F. and art. 44ss. cod. ass.
These requirements have been harmonized at Community level, including on the basis of agreements between the supervisory authorities of the major industrialized countries appear finally, the Basel 2, which engages participants in their respective states to promote the adoption of a new system detection and containment of banking risks.
the continuation of the concern without any recapitalization, as a conscious and improper risk translation on creditors.

This duty of good business management, which can be translated into a duty to correct asset organization, leads to, if it is not met, a fault-based liability on the part of those who, in practice, are empowered of the governance of the business activities of the company and which continue to operate not as a going concern. Thus, in economic terms, this is the going concern principle as a ratio to evaluate the debt condition of a company in order to highlight a possible situation of excessive indebtedness. In other words, the going concern principle expresses the economic and financial capacity of the company in normal activities to auto-generate, in the foreseeable future, the conditions for its economic balance. In this regard, it is one of the basic assumptions that must be made in order to proceed with the preparation of the balance sheet of any company which is not deemed to be in liquidation.

The concept of going concern related to the financial situation of the company can be applied concurrently to the detriment of the concepts of “losses” or “insolvency”. Indeed, the opportunity to continue the business activity is based on the assumption that the company is in a financial condition to continue doing so, that, the company will be able to generate and/or raise enough resources to stay operational. It can be argued that the lack of the going concern, which usually depend on over-indebtedness not refreshed by a substantial injection of venture capital, as on a lack of financial resources (but which can also arise from non-financial factors, providing the same effect of not to render predictable the continuity of the business activities), marks the starting point of that phase in which the duties and the conduct obligations of correct business originate.

In other respects, it can be shown that it is possible to deduce a fault-based liability for breaches of rules of correct business organization also by the criminal provisions of the Italian Insolvency Law. In particular, the reference is to articles 216-222, which provide a duty of good management and / or maintenance of the activities which are part of the assets subject to business risk, dealing with prudence and

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176 The reference to the Italian Insolvency Law will be by the Italian expression “l. fall.”, which is R. D. 16.3.1942, n. 267, in G.U. 6.4.1942, n. 81, s.o., modified by the recent L. 14.5.2005, n. 80 and d. lgs. 12.9.2007, n. 169.
fairness ratios compared to the interest to maintain the solvency of the company. In this regard, it is particular significant the article 218 l. fall., which make managers criminally liable whether they have concealed the troubles of the company, continuing the use or misuse of credit.

As a result, the Italian Legislator prohibits criminal conduct which may also consist in continuing to resort to credit when there is a pathological situation that is not insolvency, but that already contains the structural imbalance of economic and financial factors capable of maturing that default state.

Another area where it is possible to highlight the relationship between the going concern principle, the solvency situation of the company and the fault liability connected with the violation of that principle is, paradoxically, the context of the Italian discipline of the liquidation of the company under articles 2484ss. c.c. The law allows, at least in theory, business activities during the extinstive procedure of the company. More exactly, art. 2486 c.c. provides the possibility for the directors (in the time between the cause of the dissolution and the commencement of liquidation) to continue business activities even though in a perspective prepared for liquidation. Indeed, the discipline, as reformed by the legislator in 2004, no longer provides the prohibition of “new business activities” as it was the case under the repealed article 2449, c. 1, c.c.; moreover, nowadays, it has failed the reference to the “preservation of social goods”, which was indicated under the former article 2449, c. 3, cc; furthermore, the law speaks in terms of “continuation” of activities, not shooting, unlike the case under, for instance, the different hypothesis ex article 90 l. fall. Finally, art. 2486, c. 1, c.c., specifies the aim of the directors, that is the preservation of the integrity and value of assets, connected with the liability ex c. 2 of the same article, for damage caused to the company, the members, the creditors or third parties in general, whether they do not respect the previous mandatory rule ex c. 1.

Problematic is the point whether such a duty to continue the business activities is a real duty or a mere faculty for directors, as an arrangement to ensure the maintenance of the assets view to the possible cession of business. Connected with this theme it is

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177 The provision deals with the terms “insolvency” of the company and “distress state”.  
also the discussion about the necessity of a decision of the shareholder meeting in order to continue the business activities\textsuperscript{179}.

The interest of a correct management is also apparent when the activities are carried out by the liquidators. The main difference between the role of liquidators and directors is that the latter have carried out their activities to meet the profit interest of the company, otherwise liquidators have to manage for the interest of the company that is, at this stage, conservative. Liquidators, under the default rule \textit{ex} art. 2489 c.c., have the freedom to perform all the acts useful for the liquidation of the company, but, according to art. 2487, c. 1, let. c), c.c.\textsuperscript{180}, only those necessary for the maintenance of the value of the assets. However, this means that to be preserved, must pre-exist a \textit{correct} business organization.

The liquidation is in the exclusive interest of the members. Nevertheless, the satisfaction of that interest is normatively subject to the creditors’ satisfaction. This is the case, for example, under art. 2491, c. 2\textsuperscript{181}, which provides the rule under which liquidators cannot distribute among the members the interim result of the liquidation. However, that distribution is permitted if it does not affect the availability of appropriate amounts to the integral and timely satisfaction of the creditors. Liquidators may still affect the distribution of benefits by a member of eligible collateral. Furthermore, if the funds are insufficient for the payment of the company’s creditors, liquidators may ask shareholder \textit{pro rata} capital contributions.

In this context, one wonders whether between members and creditors there is a conflict and/or a relationship of unique implication, namely in the fact that members can achieve their interests in so much, as the one of creditors has already fulfilled. As a consequence, when the company is in troubles, it seems the settlement being intended primarily to permit the satisfaction of creditors. In this regard commentators call for management in the hands of the creditors themselves\textsuperscript{182}.


\textsuperscript{181} This is the case, although the timing of the subordination of reason to those members of the creditors has been a significant attenuation after the 2004 reform.

\textsuperscript{182} G. Ferri Jr., \textit{op. cit.},
Chapter 4

LEGAL STRATEGIES TO PROTECT CREDITORS


U.K.

4.1. Creditors’ interests under U.K. jurisdiction

The mechanisms that U.K. insolvency law establishes to protect creditors are expertise-accountability remedies which can be specified as rules on disqualification\(^{183}\) and rules that provide for directors’ liability\(^{184}\) with the associated issues of enforcement\(^{185}\). Mention should then be made of the processes that are designed to control the activities of directors by providing that a company may be wound up in the public interest.

\(^{183}\) Disqualification Act.

\(^{184}\) Company Act 2006.

\(^{185}\) A starting point in examining directors’ liability is the set of common law duties that a director owes to a company. In general, a director cannot be made liable in insolvency for the obligations of his or her company. It has long been established, that a director owes a **fiduciary duty** to act in bona fide in the best interests of the company and, in an insolvency, this duty may come into play. A liquidator, for instance, may mount a claim against the director personally where the director’s negligent conduct has diminished the insolvency estate. In this regard the leading case is: *Salomon v. Salomon & Co. Ltd*, [1897], AC, 22. See generally A Keay, *Company Directors' Responsibilities to creditors*, Routledge-Cavendish, London, 2007; See *Re Smith and Fawcett Ltd*, [1942] Ch 304. On the degree of care owed see Romer J in *Re City equitable fire insurance Co. (1925) Ch 407; Dorchester Finance Co. Ltd v. Stebbing* [1989] BCLC 498; V. Finch, *Company directors: who cares about skill and care?*, 1992, 55 MLR 179; see also the statutory encapsulation of this duty in the Companies Act 2006 s. 172.
The set of duties that directors owe to company creditors are usually underpinned by the arguments that, as a company approaches insolvency\(^{186}\), the commercial risks involved fall increasingly on the company's creditors rather than shareholders; that not all creditors will be well placed to protect themselves (by, for examples, taking security, demanding guarantees, spreading risks, or costing such risks into their loan agreements); and that the directors of the company may, in the absence of legal controls, both breach the canons of commercial morality and take unreasonable, unfair and inefficient risks with the creditors’ money\(^ {187}\).

As for the nature and content of the duties, the Company Act 2006 codifies the common law’s provision of directors’ duties in a statutory statement but in a manner that leaves the decisions of the courts of relevance with regard to duties to creditors. This is because the 2006 Act section 170 (4) stipulates that its codified terms are to be applied in a like manner to the common law and equitable principle that predated section 172 (3) of the 2006 Act, moreover, states that the directors’ general duties to promote the success of the company (under section 172) have 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”.

The court, however, have taken divergent views on the nature, as well as the content, of the duty owed by directors to creditors. On one approach it is seen as an aspect of the traditional fiduciary duty of directors to act bone fide in the interests of the company, on another, it is viewed as an independent, positive duty owed directly to creditors and founded either on ordinary principles of directors’ duty of care or on tortious principles\(^ {188}\).

In favour of the idea that duties to creditors flow from the traditional fiduciary duty to act in the best interests of the company, there are a number of English court decisions that build on a series of Commonwealth cases. Notable among the latter is

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Walker v. Wimborne\textsuperscript{189} in which the Australian High Court spoke of “directors of a company in discharging their duty to the company [having to] take account of the interest of its shareholders and its creditors.”\textsuperscript{190} Similarly, in Nicholson v. Permakraft\textsuperscript{191} Cooke J, sitting in the New Zealand Court of Appeal, concluded obiter that directors’ duties to the company “may require them to consider \textit{inter alia} the interests of creditors.”\textsuperscript{192} During the 1980s the English courts echoed this approach. In Lonrho v. Shell Petroleum\textsuperscript{193} Diplock LJ indicated that the “best interests of the company” might not be exclusively those of shareholders “but may include those of creditors”. Buckley LJ in Re Horsley and Weight Ltd referred to the “loose” terminology of “directors owing an indirect duty to creditors not to permit any unlawful reduction of capital to occur” and stated that it was more accurate to say that directors “owe a duty to the company in this respect”. In both the Court of Appeal and the House of Lords decisions in Brady v. Brady\textsuperscript{194} it was indicated (by Nourse LJ and Lord Oliver) that directors need\textsuperscript{195} to consider creditors’ interests if they were to act in the interests of the company.

Contrasting with this approach are dicta suggesting that there is a direct and specific duty that is owed to creditors. Thus, in Winkworth v. Edward Baron Developments Co. Ltd\textsuperscript{196} Lord Templeman stated: “A duty is owed by directors of the company and to the creditors of the company to ensure that the affairs of the company are properly administered and that its property is not dissipated or exploited for the benefit of directors themselves to the prejudice of creditors”. His Lordship’s distinction between the company and the creditors here implied the motion of a specific duty to the latter\textsuperscript{197}.

\textsuperscript{190} Maison J., \textit{op. cit.}, pp. 134ss.
\textsuperscript{192} [1980] 1 WLR 627 at 634.
\textsuperscript{193} [1989]3 BCC 535 (CA), [1988] 2 All ER 617 (HL).
\textsuperscript{194} For an attack on the view that fiduciary duties should shift to creditors when the company is in financial distress see J. Lipson, \textit{Directors’ duties to creditors: power imbalance and the financially distressed corporation}, 2003, 50 UCLA L Rev. 1189 (arguing for advertising to power imbalances expressed as disparities of volition, cognition and exit when considering who should benefit from directors’ duties. For opposition to the shift towards duties owed to creditors at any stage before a formal filing see H. Hu and J. Westbrook, \textit{Abolition of the corporate duty to creditors}, in Columbia Law Review, 2007, 107, p. 1321.
\textsuperscript{195} [1987] 1 All ER 114 at 118.
\textsuperscript{196} In this regard see also Hooker Investments Pty Ltd v. Email Ltd (1986) 10 ACLR 443. If a direct duty to creditors were to be recognized routinely by the courts (which seems unlikely) then the question as to the nature of that duty would arise. Is the duty, for example, to be seen as an extension of the directors’ traditional
The most recent indications are, however, that the courts are unwilling to recognize a duty owed directly to creditors and, indeed, academic opinion now seems to accept that the duty is an indirect one. In the *Yukong case* Toulson J considered *West Mercia* and stated that where a director acted in breach of his duty to the company by causing assets of the company to be transferred in disregard of the interests of its creditor (or creditors), he was answerable through the scheme Parliament had provided in the Insolvency Act 1986 section 212 (misfeasance or breach of fiduciary or other duty) but “he does not owe a direct fiduciary duty towards an individual creditor nor is an individual creditor entitled to sue for breach of the fiduciary duty owed by the director to the company”.

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200 *West Mercia Safetywear Ltd v. Dodd* [1988] 4 BCC 30, where it was noted that shareholders are replaced by creditors on insolvency as residual claimants, thus implying that the company’s interests are now represented by the creditors’ interests.


202 As Toulson J indicated, enforcement of the duty can be effected through s. 212 of the Insolvency Act 1986 – a summary remedy which applies if, in the course of winding up, it appears that an officer of the company (s, ...
Judges have tended to speak of creditors as a homogeneous group but have failed to state clearly whether directors owe a duty to creditors generally, to individual creditors, or to a class of creditors. Attempts have been made to distinguish the interests of existing creditors from those of future creditors but, even in this endeavour, inconsistent approaches are to be encountered. Thus, in *Nicholson v. Permakraft*\(^{203}\) Cooke J indicated that future creditors might normally be expected to “take the company as it is” and guard their own interests, whereas in *Winkworth v. Edward Baron*\(^{204}\) Lord Templeman urged that “duties were owed to creditors present and future to keep its property inviolate and available for the payment of debts”.

As for existing creditors, these may possess highly conflicting interests; the unsecured trade creditor is in a quite different position from the bank with a floating charge over the company’s property. The courts have yet to offer clear guidance to the director who has to choose between such competing interests\(^{205}\) and an undifferentiated approach may reduce the force of such a duty quite considerably: “Where duties are owed to persons with potentially opposed interests, the duty bifurcates and fragments so that it amounts ultimately to no more than a vague obligation to be fair [...]. If the law does this it abandons all effective control over the decision maker.

In *Re Pantone 485 Ltd*\(^{206}\) it was stated that “the creditors” meant the creditors as a whole, i.e. the general creditors. Consequently, if directors acted consistently with the interests of the general creditors but inconsistently with the interest of a creditor or a section of creditors with special rights in a winding up then the directors would not be in breach of their duty. Distinguishing between classes of creditor seems necessary, however, if nothing else, for the purposes of rendering duties potentially effective. If unsecured creditors are to be protected, the judges will have to construe the duty as owed to them either individually or as a specific class and the latter approach would

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\(^{205}\) For example, directors may have to choose between using remaining assets to pay off preferential creditors or continuing trading in the hope of benefiting unsecured creditors. Of course, choosing to trade on for the benefit of unsecured creditors rather than immediately paying preferential debts is not necessarily improper: see *Re CU Fitting Ltd* [1989] 5 BCC 210, which is a disqualification case, noted in V. Finch, *Disqualification of directors: a plea for competence*, 1990, MLR, 53, 385.

\(^{206}\) [2002] 1 BCLC 266.
seem more consistent with the notion of bankruptcy as a collective procedure concerned with \textit{pari passu} distribution according to pre-bankruptcy entitlements\textsuperscript{207}.

A further issue that the courts have yet to resolve concerns the exclusivity of the attention that directors should give to creditor interests when those interests fall to be considered\textsuperscript{208}. In the case of \textit{Whalley v. Doney}\textsuperscript{209} Park J said that, at the pre-insolvency stage of financial difficulties, the duties owed to the company extended to encompass the interests of the creditors as a whole as well as those of a shareholder\textsuperscript{210}. It is noteworthy here that \textit{Whalley} talks of creditor interests joining those of the shareholder. Some authorities, however, come close to making creditor interests an exclusive focus – at least at the stage when insolvency is questionable or imminent. Thus, in \textit{Brady v. Brady}\textsuperscript{211}, Nourse LJ, in the Court of Appeal, indicated that after the advent of insolvency (or doubtful insolvency) the interests of the company are in reality the interests of existing creditors alone\textsuperscript{212}. This implies that the directors have a duty to pursue the advantage of creditors, an approach consistent with the comments of Street CJ in \textit{Kinsela} to the effect that in an insolvent company it is the creditors’ and not the shareholders’ assets that are under the management of the directors. More recently, in the \textit{Colin Gwyer} case, it was emphasised that, where the company was on the verge of insolvency, the interests of the creditors must be considered \textit{paramount}\textsuperscript{213}.

A contrasting approach allows directors to act post-insolvency in the interests of the company as a whole, provided that actions do not prejudice creditors. Thus, in \textit{Re Welfab Enginers Ltd}\textsuperscript{214}, Hoffmann J considered the position where a company was insolvent but had not been placed in the hands of a receiver. He stated that although the directors were not, at such a stage, entitled to act in a manner leaving the creditors in a worse position than on a liquidation, they had not failed in their duty to the company when they had borne in mind the effect on employees of different courses of action\textsuperscript{215}.

\textsuperscript{207} To give unsecured creditors a class action would guide directors rather than leave them to attempt to be fair to all creditors and would not seem prejudicial to secured creditors who would be able to realize their security or appoint a receiver to act on their behalf. Furthermore, such an approach could align with the view that directors owe their duty to the company’s residual owners, who stand to lose the most in corporate insolvency, the unsecured creditors.


\textsuperscript{209} \textit{Whalley v. Doney} [2004] BPIR 75.

\textsuperscript{209} See also \textit{Re Cityspan Ltd} [2008] BCC 60; D. Hopkins, \textit{A company’s interest- a question of balance}, in \textit{Insolvency Intelligence}, 2004, 17, 103.

\textsuperscript{211} \textit{Brady v. Brady} [1989] 3 BCC 535.

\textsuperscript{212} This appears unaffected by the House of Lords’ decision in \textit{Brady} and indeed is impliedly accepted by Lord Oliver: see [1988] 2 All ER 617 at 632.

\textsuperscript{213} See also \textit{Re Pantone 485 Ltd} [2002] 1 BCLC 266.

\textsuperscript{214} \textit{Re Welfab Enginers Ltd} [1990] BCC 600.

\textsuperscript{215} See Grantham, \textit{Directors’ duty and insolvent compagnie}, p. 578.
A way to resolve such tension is to read dicta in *Brady* and *Kinsela* as being concerned with the reorientation of focus from shareholders to creditor interests that occurs around the point of insolvency rather than being concern to address the issue of exclusivity of interest. The judges could endorse *Welfab* and stress that creditor interests fall to be considered on insolvency (or doubtful insolvency) but that such interests do not have to be the exclusive concerns of directors. Just as directors are entitled to look beyond shareholder interests before insolvency they should be given a degree of flexibility in relation to the interests of the creditors, who, on insolvency, have stepped into the shoes of the shareholders\(^\text{216}\).

Even if it is accepted that the duty to creditors flows from the traditional duty to act in the company’s interests, the courts have been tentative in stating when creditors’ interests fall to be considered by directors as part of those company interests. Three positions on the issue can be distinguished: a.) when a company becomes insolvent the interests of creditors are company interests; b.) creditors’ interests transform into company interests as the company approaches insolvency or when insolvency is threatened, in a single term, when company is “in troubles”; c.) the interests of the company include those of creditors and directors should bear in mind creditors’ interests at all times.

The judges have hovered, sometimes uneasily, between these three positions. In support of the position a.) is the *West Mercia*\(^\text{217}\) decision of the Court of Appeal in which a director effected a fraudulent preference and was found to be guilty of a breach of duty (the director had, for his own purposes, made a transfer between accounts in disregard of the interests of the general creditors of the insolvent company). *West Mercia* indicated that where a company is insolvent, a director’s duty to act in the best interests of the company includes a duty to protect the interests of the company’s creditors. Dillon LJ noted with approval Street CJ’s statement in the Australian case of *Kinsela v. Russel Kinsela property Ltd*\(^\text{218}\) that in a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise, but “where a company is insolvent the interests of creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to

\(^{216}\) See Sealy, *Directors’ “wider” responsibilities*; Company Act 2006 s. 172(1).

\(^{217}\) See *West Mercia* [1988] 4 BCC 30.

\(^{218}\) See *Kinsela v. Russel Kinsela property Ltd* [1986] 4 ACLC 215 at 401.
deal with the company’s assets”. Whether insolvency is a precondition of creditor interests being subsumed within company interests is, however, a matter not beyond doubt. A number of cases extend the principle to incipient insolvency or even threatened insolvency. Thus the Court of Appeal in Re Horsley and Weight Ltd\(^{219}\) stated that insolvency, or near insolvency, was a precondition, and a similar stance appeared to be taken by the New Zealand Court of Appeal in Nicholson v. Permakraft\(^{220}\). In Nicholson the company was solvent at the relevant time but Cooke J considered situations in which directors should consider creditors’ interests. These included circumstances of insolvency or near insolvency or doubtful insolvency or if the “contemplated payment or other course of action could jeopardise its solvency”. Such reasoning may accord to some extent with position \(b\.) and the idea that creditor interests fall to be considered in so far as insolvency looms. This is echoed in, for example, Nourse LJ’s dicta in Brady v. Brady\(^{221}\) where His Lordship considered the meaning of “given in good faith in the interest of the company” in section 153 of the Companies Act 1985\(^{222}\) and stated that where the company is insolvent or even doubtfully solvent, the interests of the company are in reality the interests of the existing creditors alone. In Whalley v. Doney\(^{223}\) Park J urged that a company did not have to be insolvent for a director to have breached his duties to the company by being motivated only by the interests of shareholders and employees. In Whalley there was a preliquidation sale to an entity in which the principal and the liquidator argued that the price represented an undervaluation. The judge found for the liquidator on a misfeasance claim and said that the company might have a good claim against a director when the company “whether technically insolvent or not, is in financial difficulties to the extent that its creditors are at risk”\(^{224}\).

Certain cases go further, however, and adopt a stance close to position \(c\.) by suggesting that insolvency \textit{per se} is no precondition to consideration of creditors’

\footnotesize{\begin{itemize}
\item [] \(^{219}\) See Re Horsley and Weight Ltd [1982] 3 All ER 1045.
\item [] \(^{220}\) See Nicholson v. Permakraft [1985] 1 NZLR 242. See also Grove v. Flavel (1986) 4 ACLC 654, where the court rejected the argument that there was a general duty owed by directors to protect creditors’ interests irrespective of the company’s financial position.
\item [] \(^{221}\) See Brady v. Brady [1989] 3 BCC 535 at 552.
\item [] \(^{222}\) In this sense, Nourse LJ assumed that the words in the (then) Companies Act 1985 s. 153(1) (b) had the same meaning in that context as when considering directors’ fiduciary duties.
\item [] \(^{223}\) See Whalley v. Doney [2004] BPIR 75 and also Re Cityspan Ltd [2008] BCC 60.
\item [] \(^{224}\) See Hopkins, \textit{A company’s interests – a question of balance}. See also Colin Gwyer & Associated Ltd v. London Wharf (Limehouse) Ltd [2003] 2 BCLC 153, [2003] BCC 885, where the deputy judge expressed the principle as follows:” where a company is insolvent or of doubtful insolvency or on the verge of insolvency and it is the creditors’ money that is at risk, the directors, when carrying out their duties to the company, must consider the interests of the creditors as paramount and take those into account when exercising their discretion”.
\end{itemize}
interests. In the High Court of Australia in *Walker v. Wimborne*, Mason J indicated that creditors’ interests should be considered even before insolvency because “those interests may be prejudiced by the movement of funds between companies in the event that the companies become insolvent”. Thus, creditors’ interests could always be relevant given the theoretical possibility of future insolvency. *Nicholson v. Permakraft* is not far short of this position in referring to circumstances in which a contemplated payment or other course of action might jeopardise solvency. There are dicta, moreover, in two House of Lords decisions in which duties to creditors are mooted and the issue of insolvency is not even referred to. The courts have thus adopted a variety of positions on directors’ duties to creditors but, post-*Gwyer* and *Whalley* , there does seem to be a shift by the English judiciary towards position b.) above. The *West Mercia* and *Gwyer* cases, however, did not address the issue of whether the directors’ state of appreciation of the company’s solvency was to be judged objectively or subjectively.

4.2. Regulatory remedy to protect creditors: compensate strategies

4.2.1. Fraudulent trading

It is fundamental and peculiar of U.K. jurisdiction the provision of fraudulent trading, making directors personally liable in the context of companies in troubles. This is a strategy which requires directors to compensate for the damage caused. More precisely, the offence of fraudulent trading is committed by every person who

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226 See Barrett (1977) 40 MLR 229.


228 See in *Lonrho v. Shell Petroleum* [1980] 1 WLR 627, Lord Diplock, where speaking of the best interests of the company not necessarily being those of shareholders alone but possibly including those of creditors, made no mention of solvency or insolvency. Neither did Lord Templeman in *Winkworth v. Edward Baron Developments Co. Ltd* [1986] 1 WLR 1512, when he was speaking of the duty apparently directly owed to creditors.

229 Per Giles J A in *Linton v. Telnet Pty Ltd* (1999) 30 ACSR 465 at 473; there is significant difficulty in deciding when directors should have regard to creditors’ interests and it depends on the particular facts.


231 *Whalley v. Doney*, op. cit.

232 In *Whalley v. Doney*, op. cit Park J seems, indeed, to adhere to both assessments: “whether IM Ltd was technically insolvent before the transaction or not (and in my view it was anyway) it was on any view in a dangerous financial position, and Mr Doney knew it”.

233 Since 1928, the U.K. legislation provided that a civil remedy could be sought where fraudulent trading, as it was called, could be proved. But the Report of the Insolvency Law Review Committee, *Insolvency Law and Practice* (known as the “Cork Report”) put forward the opinion that the fraudulent trading provision possessed significant inadequacies in dealing with irresponsible trading, such as the fact that the criminal burden of proof applied to civil actions and, also, applicants were required to establish actual dishonesty and real moral blame (*Re Patrick and Lyion Ltd* [1993] Ch 786). The recommendation of the Cork Committee was that the provision
knowingly is a party to the carrying on of a business of a company with intent to defraud creditors of the company or creditors of any other person, or for a fraudulent purpose. The provision can be invoked even where the intention is to defraud future creditors of the company.\(^\text{234}\)

Section 213 (1) sets out the conduct that constitutes the action of fraudulent trading, i.e. intent to defraud creditors or having a fraudulent purpose. The following section 213 (2) then states who is liable in civil action and for what they can be liable.\(^\text{235}\) The persons who are liable to be proceeded against are those who knowingly are parties to the carrying on of a business of a company with intent to defraud creditors. Such persons are liable to make such contributions to the company as the court thinks proper.\(^\text{236}\) Commonly those persons will be the company’s directors, but they are not the

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\(^{234}\) See Re Smith [1996] 2 BCLC 109. In fact customers of a company may be regarded as creditors of the company for the purposes of section 213, cfr. R. v. Imman [1967] 1 QB 140, CCA; [1996] 3 All ER 414; Re Sarflax Ltd [1979] 1 Ch 592, on the basis that they are prospective or contingent creditors, although this does not include all customers, see In re Gerald Cooper Chemicals Ltd [1978] Ch 262.

\(^{235}\) According to statutory provision creating personal liability, directors may be liable to compensate creditors where they have been party to fraudulent trading by the company. Section 213 of the Insolvency Act 1986 provides:

1. If in the course of the winding up of the company it appears that any business of the company has been carried on with intent to defraud creditors of the company, or creditors of any other person, or for any fraudulent purpose, the following has effect.
2. The court, on the application of the liquidator, may declare that any persons who were knowingly parties to the carrying on of the business in the manner above mentioned are liable to make such contributions (if any) to the company assets as the court thinks proper.

\(^{236}\) It has been said that there must be a connection between the losses caused by the fraudulent trading and the quantum of compensation and that the court has no power under section 213 to impose a punitive element in the compensation order made. The section has a long history and, indeed, was introduced particularly to protect unsecured creditors from the abuse of “filling up” floating charges. Now, however, it is recognized that the aim of fraudulent trading provisions – to discourage directors from carrying on business at the expense of creditors – is severely restricted by the requirement of dishonest intent and the courts’ insistence on strict standards of pleading and proof. Such an approach may be understandable for criminal liability under section 993 of the Companies Act 2006, but its imposition on the civil liability provided for in section 213 of the 1986 Act has led to the latter section’s virtual obsolescence. This obsolescence is now even more apparent with the advent of
only ones who may, theoretically, be sued. For instance, Neuberger J\textsuperscript{237} held that section 213 (2) was not limited to those who managed or controlled the company that had failed. The learned judge said that a company that was involved in and assisted and benefited from the business of the failed company and did so knowingly, could fall within section 213. This assumption opens the view to another discussion, about the possibility to evocate this remedy also to other subjects connected with the company, such as banks or creditors in general who had had the control of the company of, however, had made some business decisions with the intention to defraud (other) creditors of the same company (or group of the company).

Only liquidators are able to apply for an order under section 213, and in taking action the liquidator is seeking compensation on behalf of the general body of creditors\textsuperscript{238}.

There are, therefore, three elements that need to be established by a liquidator. These are: the business of the company in liquidation has been carried on with intent to

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\textsuperscript{237} See in Re BCCI; Banque Arabie Internationale D’Investissement SA v. Morris [2002] BCC 407, Neuberger J.

\textsuperscript{238} The upshot is that courts are unable to direct that specific creditors be compensated for losses that they have suffered as a result of fraudulent trading, see: Re Esal (Commodities) Ltd; London and Overseas (Sugar) Co Ltd v. Punjab National Bank [1993] BCLC 872 and affirmed on appeal at [1997] 1 BCLC 705, CA.
defraud creditors\textsuperscript{239} or for any other fraudulent purpose\textsuperscript{240}; the respondent participated in the carrying of business; the respondent did so knowingly\textsuperscript{241}.

To keep within the limitation period, proceedings, being for the recovery of a sum of money, must be commenced within six years of either the resolution to wind up, in voluntary liquidation, or the making of a court order, in compulsory winding up\textsuperscript{242}.

Where a court makes a declaration, it is, at its discretion and as under section 214, empowered to make further directions to give effect to its declaration, \textit{ex} section 215 (2)\textsuperscript{243}.

As with wrongful trading claims, it would seem that any recoveries are not available to a chargeholder who has a charge over the present and future assets of the company. This is because the liquidator is proceeding in his or her own capacity for the benefit of creditors and not on the company’s behalf\textsuperscript{244}.

\textbf{4.2.2. Wrongful trading}

In terms of increasing directors’ duties to unsecured creditors, section 214 provides that where a company is in liquidation, a liquidator can apply to the court to have a person who is or has been a director declared personally liable to make such contribution to the company’s assets as the court thinks proper\textsuperscript{245}. The liquidator must establish that, at some time before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation and that the respondent was either a director or a shadow director\textsuperscript{246} of the company at that time.


\textsuperscript{241} See generally: \textit{Re BCCI}; \textit{Morris v. Bank of India} [2004], \textit{op. cit.}, 236.

\textsuperscript{242} See \textit{Re Farmizer (Products) Ltd} [1995] BCC 926.

\textsuperscript{243} For instance, a court might direct that the amount which it has ordered against the director be a charge on any debt or obligation due from the company to the respondent, or on any mortgage or charge or any interest in a mortgage or charge on assets of the company held by or vested in the respondent, or any person on behalf of the respondent, or any person claiming as assignee from or through the respondent (section 215 (2) a.). Also, the court may, from time to time, make such further or other order as may be necessary for enforcing any charge imposed under section 215 (section 215 (2) b.).

\textsuperscript{244} \textit{See Re Oasis Merchandising Services Ltd} [1995] BCC 911 and affirmed on appeal by the Court of Appeal at [1997] 1 All ER 1009,[1997] BCC 282.

\textsuperscript{245} Section 214 of the Insolvency Act 1986 owes its birthright to the Cork Committee (Cork Report, ch. 44), and, as stated previously, was the White Paper’s great hope for the unsecured creditor. See Prentice, Creditors’ Interest; F. Oditah, Wrongful Trading, [1990] LMCLQ 205.

\textsuperscript{246} On shadow directors see \textit{Insolvency Act 1986} s. 251; \textit{Company Directors’ Disqualification Act 1986} s. 22(5); \textit{Company Act 2006} s. 251(2).
Here it is noteworthy that a point may arise, during a cumulation of failures to produce funds, when directors must realise that insolvency is unavoidable. Thus, in *Rubin v. Gunner and another*, the court found directors to be liable for wrongfully trading after the date at which they ought to have concluded that promised funds would not be forthcoming from an investor who had given numerous assurances but had repeatedly failed to produce the moneys needed to avoid insolvent liquidation. From the said date, said the court, the directors should have concluded that there was no reasonable prospect of the company avoiding going into insolvent liquidation. A defence is, however, available if the respondent director shows that, having reached the state of knowledge referred to, he took *every step* with a view to minimising potential loss to the company’s creditors that he ought to have taken. Here there is a movement away from the subjective test of skill and care applied to directors in the common law cases such as *Re City Equitable Fire Insurance Co*. Under section 214, a director is judged not only by the knowledge, skill and experience that he actually has (section 214(4)(b), but also by the “general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions” (section 214(4)(a)). A director can, therefore, under this limb be judged by standards of the “reasonable director” even though he may be well below those standards himself.

The wrongful trading section has, however, proved to be a disappointment in terms of numbers of reported cases. The reason may be that it is often seen as easier to make out a case of misfeasance, preference or transaction at undervalue than to chart  

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247 See also Katz and Mumford, *Making creditor protection effective*, part. 5, who, in discussing what form of evidence is needed to establish that “a director knew or ought to have concluded [stated that] the key evidence includes cash flow forecasts, prepared at intervals, that reflect the perceived seriousness of the company’s financial situation”.  
248 See Section 214(3). For suggestions on steps and strategies which directors could adopt (including, *inter alia*, taking appropriate outside professional advice, holding weekly board meetings, keeping major creditors and all directors in the loop and recording all recommendations for remedial action made by the directors) see C.. Swain, *Light at the end of the tunnel - operating in the twilight zone*, in *Insolvency Intelligence*, 2006, 19, pp. 33-35.  
249 This sets a minimum standard and, in deciding whether this minimum has been obtained, regard can be had to the particular company and its business: see *Re produce marketing consortium* [1989] 5 BCC 569 per Knox J at 594. For a further discussion see also Prentice, *Creditors’ interests*, op. cit.; L. S. Sealy [1989] CLJ 375; see also Park J in *Re continental assurance co of London plc* [2001] BPIR 733 for a judicial analysis of the nature of individual directors’ potential liabilities, quantum and issues of several liability versus joint and several liability under s. 214; see further A. Walters, *Wrongful trading: two recent cases*, [2001] Ins. Law, 211.  
250 *Re City Equitable Fire Insurance Co* [1925] Ch 407.  
251 See *Re D’Jan* [1993] BCC 646 comparing with Companies Act 2006 s. 174.
the difficult waters of wrongful trading. Central to those difficulties is often the liquidator’s challenge in identifying the “relevant date or time”, when the director should have been aware that there was no reasonable prospect that the company would avoid going into insolvent liquidation. Establishing this time will often be problematic, especially if the company’s records are incomplete. Also, as Keay has commented, the courts have been reluctant to second-guess directors’ commercial decisions. They usually recognize that directors have to make tough decisions, often in difficult circumstances, and “have generally come down on the side of the directors. Problems in the funding of wrongful trading actions clearly have not helped to develop wrongful trading as a strong force for directorial accountability. Judicial approaches to section 214 have, furthermore, not added to the efficacy of the provision. This is an area where there has been an unhelpful confusion about the role and purpose of the law. Cork had envisaged that civil liability for wrongful trading would effect a balance between encouraging the growth of enterprises and discouraging “downright irresponsibility.” This balancing as involved in section 214, has allowed different judges to adopt different approaches to wrongful trading and degree of uncertainty has resulted. In *Re produce marketing consortium ltd* Knox J treated the section 214 jurisdiction as “primarily compensatory rather than penal.” It is clear, however, from other cases...

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253 The courts require compelling evidence to be convinced of wrongful trading and often prefer to impose liability through other mechanisms. As Milman notes: “This is because wrongful trading rarely occurs in a vacuum and usually in a context of other managerial shortcomings which are easier to prove through legal action.” D. Milman, *Improper trading: can it be effectively regulated?*, Sweet & Maxwell’s Company Law Newsletter, 2004, 4, 3. A cited example of a wrongful trading action that failed to impress the court was *Liquidator of Marini Ltd v. Dickenson* [2004] BCC 172 in which the claim foundered because there was no evidence of an increase in the net deficiency of the company during the relevant period of alleged wrongful trading (an application of *Re Continental Assurance plc* [2001] All ER 229, where Park J had stated that there had to be more than a “mere ‘but for’ nexus [...] to connect the wrongfulness of the director’s conduct with the company’s losses” : see Milman, *Improper trading, op. cit.;* N. Spence, *Personal liability for wrongful trading,* in *Insolvency Intelligence,* 2004, 17, 11.

254 The liquidator, in seeking to maximize assets for the general creditors, may, understandably, be tempted to select the time period which would provide the possibility of the highest attainable contribution. On the courts’ approaches as to whether the liquidator’s exact selection of time is fundamental see A Keay, *Wrongful trading and the point of liability,* in *Insolvency Intelligence,* 2006, 19, 132. See also *Rubin v. Gunner and another* [2004] BCC 686, [2004] 2 BCLC 110, where the liquidator appeared to rely on several dates during the course of the litigation and trial and where a specific time was then settled upon by the court itself.


256 The Insolvency (Amendment) Rules 2008 (SI 2008/737) amend the Insolvency Rules 1986 by replacing r. 4.218(a) with a new r. 4.218(1), (2) and (3) and by inserting new rr. 4.218 A-4.218E. The amendments, *inter alia,* provide expressly for the expenses of liquidation to be payable out of the proceeds of any legal proceedings which the liquidator has power to bring and also for the recovery of expenses and costs relating not only to the conduct but also to the preparation of any such legal proceedings.

257 Cork Report, par. 1805.

258 *Re produce marketing consortium ltd* [1989] 5 BCC 569.

259 On the public law function of s. 214 in prescribing standards of directorial behavior see R. Walker J in *Re Oasis Merchandising services Ltd* [1995] BCC 911-918.
such as Re Sherborne Associates ltd, that the wrongful trading provisions are being seen by some judges not so much as a civil remedy to raise standards among directors and to compensate creditors, but as a way to punish directors whose actions are seen immoral. Such a punitive conception may also sit more comfortably with a “pro-enterprise” / “pro-rescue” stance rather than a “pro-creditor” position. In Sherborne, the actions were dismissed and the judge was sympathetic to the honest, hard-working, well-respected businessmen who acted as directors in times of difficulty. Even on a finding of liability under section 214, the court may exercise its discretion under section 214(1) when deciding the appropriate amount of compensation to be paid by director and may take account of the degree of culpability exhibited by the director. The court can, therefore, note whether the director’s conduct resulted from a failure to appreciate rather than from a deliberate course of wrongdoing: whether or not there were heeded or unheeded warnings from the auditors; and whether there was any misappropriation of assets by the directors for their own benefit. In Re Purpoint Ltd, however, Vinelott J did not look kindly on directors who failed to monitor their company’s financial affairs and in Re DKG Contractors Ltd there was a similar approach to directors who failed to abide by the basic requirements of company law. In Re Continental Assurance of London plc it was emphasised, moreover, that it was directors who had “closed their eyes to the reality of the company’s position [...] had been irresponsible and had not made any genuine attempt to grapple with the company’s real position” who had something to fear apropos liability under section 214.

Thus, in exercising their discretions to order directorial contributions, the courts may, as noted, vary their responses according to their espousal of different approaches.

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261 See I. F. Fletcher, *Wrongful trading: reasonable prospect of insolvency*, in *Insolvency Intelligence*, 1995, 8, p. 14. The dangers of acting on hindsight (noted in *Re Sherborne* itself), and of assuming that what has happened was always bound to happen and was apparent, were noted in *Re Brian D. Pierson (Contractors) Ltd* [1999] BCC 26 when Hazel Williamson QC, in the Chancery Division, declined to be “wise with hindsight” and gave respect to the directors’ judgment as to the company’s prospects. Nevertheless, on the facts, she was satisfied that the directors ought to have concluded that there was no reasonable prospect of avoiding insolvent liquidation and they were liable under s. 214. In *Re Continental Assurance Co. of London plc* [2001] All ER 229, however, a sympathetic view of directors appears to have been taken again when Park J rejected a wrongful trading action, noting that the directors had not acted unreasonably in difficult circumstances when they sought expert advice and, reasonably, traded on.


265 See *Re Purpoint Ltd* [1991] BCLC 491.

266 See *Re DKG Contractors Ltd* [1990] BCC 903.

267 See *Re Continental Assurance of London plc* [2001] All ER 229.
to section 214, be these compensatory (as in *Re Produce marketing*) or inclined to advert to issues of culpability (as discernible, for instance, in such cases as *Re Sherborne, re Purpoint, Re DKG Contractors* and *Re Continental Assurance*). The bite of the wrongful trading provisions is, therefore, diminished not merely by the legal uncertainties that liquidators face on seeing widely varying judicial ruling, but also by the propensity of the judiciary to look to culpability (rather than pure compensation) as a factor of relevance in deciding both whether to declare a liability to contribute and subsequent issues of quantum.

**4.2.3. Enforcement strategies: some considerations**

After setting out the main rules governing the potential liability of directors in cases of corporate troubles, matters of enforcement need, however, to be considered in order to understand if the real accountability of directors is to be assessed. In relation to the common law duties that directors owe to creditors, there are considerable enforcement difficulties. The judges have tended to see directors’ duties to creditors in exhortatory terms and so have failed to grasp the enforcement nettle. If creditors’ interests derive from general duties owed to the company then breaches should properly be dealt with by the company as contemplated in *Nicholson*[^268] and *Walker v. Wimborne*[^269]. The problem is that enforcement of the duty is likely to be difficult before the company goes into administration, receivership or liquidation since creditors cannot rely on the existing board or the shareholders to complain about the ill-treatment of creditors’ interests. On liquidation, the possibility arises of a misfeasance action under section 212 of the Insolvency Act 1986, which allows proceedings where a director has been guilty of “any misfeasance or breach of any fiduciary or other duty in relation to the company”[^270]. Duties to creditors may thus arise at the stage of doubtful solvency but creditors *per se* are given a right of action only on winding up[^271].

[^270]: The Insolvency Act 1986 extended the ambit of misfeasance to “include breach of any duty including the duty of care”: per Hoffmann LJ in *Re D’Jan of London Ltd* [1994] 1 BCLC 561 at 562. On misfeasance see further *Re Eurocrut Europe Ltd* [2007] BCC 916, claims under s. 212 do not have a limitation period distinct from that applicable to the underlying claim; *Whitehouse v. Wilson* [2007] BPIR 230, which clarifies liquidators’ responsibilities to the various stakeholders apropos offers to settle misfeasance claims; *Mullarkey v. Board* [2008] 1 BCLC 638, where the onus of proof in misfeasance rests on the claimant; *Walker v. Walker and Another* [2005] All ER 277, according to which liquidator ordered to pay the director’s costs as the action was commercially worthless from the start in that the director had limited assets; *Re Brian D. Pierson (Contractors) Ltd* [1999] BCC 26; *Re Westlowe Storage & Distribution Ltd* [2000] BCC 851; *Re Continental Assurance Co*
[^271]: Such enforcement would, of course, offer little assistance to unsecured creditors since any recovered funds
In order to verify whether creditors are in a good position to enforce duties against directors, it can be argued that effective enforcement demands an ability to acquire and use information; expertise or understanding of the relevant activity; a commitment to act; and an ability to bring pressure or sanctions to bear on the party to be controlled. On the first issue, creditors may have not inconsiderable access to information. The disclosure rules operating throughout company legislation generally reflect the principle that these operate for creditors’ as well as shareholders’ benefit. Creditors, like shareholders, can obtain information on the financial state of the company at the Company Registry in the form of copies of certain class of resolution, annual accounts and directors’ and auditors’ reports. Copies of these documents have, moreover, to be sent to “all debenture holders”. When a company enters or nears insolvency, further sources of information arise. Administrators must be furnished with information from the company’s directors to enable the preparation of a notice of the administrator’s appointment and, on the commencement of the procedure, the administrator must provide a statement of affairs to creditors. Where voluntary arrangements are made in order to conclude an agreement with creditors, the directors’ proposal and statement of the company’s affairs will become available to creditors, and when liquidator act they will provide creditors’ meeting with a body of information. Data concerning directorial behaviour may also flow from the creation of contractual rights to information. The terms of debentures may provide for the supply of information and financial data and detailed figures, for example, may be requested on a periodic basis by financial creditors.

As with shareholders, informal sources of information may assist creditors, and major financial creditors will often use their influence to obtain a steady flow of information from senior managers. Major creditors may also obtain representation on the company’s board and subsequently will again access to new sources of information.

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272 See Insolvency Act 1986 Sch. B1, par. 47.

273 Insolvency Act 1986 s. 2(2) and (3); Insolvency Act 2000 Sch. A1, par. 30; Insolvency Rules 1986 rr. 1.3(1) and (2), 1.5(19 and (2), 1.12(3); Insolvency Act 1986 s. 3(2) and (3).

Trade creditors will be less likely to use such sources but if a continuing trading relationship has been formed, they may acquire information informally.

Whether more can be done to inform creditors, it is possible to say that one potential response to the “phoenix syndrome” has been put forward by the Federation of Small Businesses (FSB), which has argued that the BERR should designate certain individuals as provisional directors where they have been at the helm of several failed companies. Such directors would then be required to disclose their track records so that trade creditors, for instance, would be aware of these. Monthly financial returns for the companies of such directors might also be demanded so that creditor monitoring of financial health could be facilitated. The FSB argument here is that such steps offer smaller creditors lower-cost information sources and help them to assess risks. There seems an arguable case for such requirements also on grounds of fairness to unsecured creditors.

Even when creditors possess information, however, they may have problems in using it to good effect. The value of information deriving from insolvency-related regimes may be questioned. Creditors may well gain much information only at a very late stage in corporate troubles and this tardiness will often rule out actions designed to forestall directorial failures or negligence. Creditor expertise, indeed, may vary considerably. Financial creditors might be expected to be expert in assessing risks and managerial performance, but trade creditors may possess expertise in a particular business sector only and may be less able to evaluate directorial performance beyond those areas.

About the commitment to act to enforcing directorial duties, creditors may be where they foresee any threat to their prospects of repayment but, in general, they are not disposed to review the actions of managers. Factors that might, nevertheless, affect the propensity to enforce might be the size of the investment, the nature of any security, the type of business and the levels of directorial discretion that are usual in the sector. For small trade creditors, such factors may well not come into play unless the debtor is a major purchaser of the creditor’s product. Such creditors will tend to look for supply elsewhere rather than to continue a relationship in the hope of recovering from directors on the basis of a breach of duty.

Indeed, a different behaviour should be mentioned: on the one hand, secured creditors will focus on realising their security and only if such realisation fails to meet the sum outstanding will such creditors have anything to gain from the contributions of
directors. In the case of creditors secured with floating charges, incentives may similarly operate only to cover shortfalls (directorial contributions will form part of the company’s assets). On the other hand, ordinary unsecured trade creditors will possess questionable incentives to pursue errant directors since they will be paid after floating charge holders.

After a liquidation has been initiated by qualifying creditors, actions may be brought by creditors against directors under a number of heads: for example, misfeasance actions for breaches of fiduciary or other duties in relation to the company. Such duties, however, are owed to the company and contributions obtained from directors, as a result, will go to the company assets for the benefit of all creditors. Individual creditors may be discouraged from bringing such actions, moreover, because the liquidator may proceed similarly on behalf of all creditors and will have investigative powers that individual creditors do not possess. As for liquidators’ actions, creditors may have to indemnify costs where it is anticipated that there may be sufficient assets to support litigation. Section 176ZA of the Insolvency Act 1986 and the amended Insolvency Rules have now, however, provided that litigation expenses are expenses of the winding up.

The common law duty offers little to the unsecured creditor since it is owed to the general body of creditors rather than unsecured creditors individually or as a class. A duty owed directly to individual creditors seems, as already noted, to have been denied by Yukong and would conflict with insolvency’s collectivist principles, might lead to a multiplicity of suits, and could lead individual creditors to place improper pressure on directors to settle their particular claims. The alternative may be to place directors under a duty to unsecured creditors as a class. Such a class action could exceptionally allow unsecured creditors collectively to seek injunctions where necessary.

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275 Though some incentive may be provided by the “prescribed part” of funds made available to unsecured creditors which would otherwise have been paid to holders of floating charges: see Insolvency Act 1986 s. 176A. If creditors consent the liquidator could use these moneys as a fighting fund to bring actions.
276 Insolvency Act 1986 ss. 131-4, 235.
277 This is a negation of the Court of Appeal’s decision in Re Floor Fourteen [2001] 3 All ER 499, [2001] 2 BCLC 392. Company Act 2006 s. 1282(1) and the Insolvency (Amendment) Rules 2008 (SI 2008/737) amending the Insolvency Rules 1986 by replacing r.4.218(1) (a) with new r. 4.218(1), (2) and (3) (a) and by inserting new rr. 4.218A-4.218E (expenses of liquidation can also be payable out of proceeds of litigation brought by the liquidator; and expenses and costs relating to the conduct and preparation of any such legal proceedings can be recovered).
to prevent directors from acting in a manner jeopardising the company’s solvency or to ensure the consideration of unsecured creditors’ interests in circumstances of marginal solvency.\textsuperscript{281}

The position of creditors generally might be strengthened by another reform: one to allow creditors to take action in the company’s name in enforcement of directorial duties. The Companies Act 2006 sections 260-4 provided a statutory derivative action for members but not for creditors\textsuperscript{282}. Are there, nevertheless, good reasons for a creditors’ counterpart?\textsuperscript{283} One reason advanced for the inclusion of creditors has been that, in some circumstances, creditors might be in receipt of better relevant information than is available to “other outsiders”. The opportunity of using creditors as monitors of corporate management seems, however, a less convincing argument than the need to protect creditor interests. If, as was indicated in \textit{Whalley} and \textit{Gwyer}\textsuperscript{284}, creditor interests become company interests not merely post-insolvency, but also when insolvency threatens, then it may be appropriate to allow creditors to act before the liquidator comes onto the scene (so as to protect their interests) by injunctioning any directorial actions that are likely to prejudice solvency severely.\textsuperscript{285}

Enforcement of the statutory controls over such matters as fraudulent or wrongful trading, transactions at undervalue and preferences depends on action, not by a creditor, but by an office holder of the company. However, liquidators have traditionally faced severe funding problems in resorting to law in order to enforce directors’ duties. Although such practical difficulties have to some extent been ameliorated by legislative reform, problems of funding allocation and legal uncertainty still remain, particularly in the case of wrongful trading, and to date we have seen an accountability regime of seemingly low impact.

\textsuperscript{281} For their part, directors might have few grounds to fear that unsecured creditors would interfere in the workings of the company. Such creditors would have to demonstrate to a court reasonable cause to anticipate that insolvency would result from the action in question and this would be an onerous burden to discharge.

\textsuperscript{282} See Keay, \textit{Can derivative proceedings be commenced when a company is in liquidation?}, op. cit.

\textsuperscript{283} See Australian Companies and Securities Law Review Committee, \textit{Enforcement of the duties of directors and officers of a company by means of a statutory derivative action}, in CSLRC, 1990, 12.


\textsuperscript{285} Section 1234 of the Australian Corporations Law of 1991 enabled the court to grant injunctive relief to “any person” affected by contraventions of the Corporations Law. The Australian Corporations Law 2001 (Part 2F.1A) provided for a derivative action on the part of current and former members and officers of a company but not creditors: see I. Ramsay and B. Saunders, \textit{Litigation by shareholders and directors: an empirical study of the statutory derivative action} [2006] 2 JCLS 397.
4.2.4. Liquidator’s duties

The liquidator may be appointed by the creditors, the company or the court. The liquidator is not a trustee for creditors but rather an agent for the company with statutory duties which may be enforced by application to the court. He does not in general owe any duty to an individual creditor. There are, however, exceptions. The liquidator may incur a liability to an individual creditor for loss caused by fraud or other personal misconduct, such as breach of fiduciary duty or misfeasance, or for breach of contract, or for negligently distributing the company’s assets without taking account of a debt which has been or should have been admitted to proof, but in this case only where the company has been dissolved, so that the creditor is deprived of his ordinary remedy of application to the court.

On behalf of the creditors the liquidator can bring proceedings in the name of the company in respect of causes of action vested in the company but he has no locus standi to pursue claims vested in persons qua creditors. So if, for example, a company established a subsidiary to carry on the business of deposit-taking and the parent runs the subsidiary as its alter ego, effectively depriving the subsidiary’s directors of any management function and using the subsidiary as a façade through which deposited funds are transferred to the parent, then if in consequence the subsidiary is driven into insolvent liquidation, the liquidator may be able to pursue a claim in the name of the subsidiary against its parent but has no standing to assert claims on behalf of the subsidiary’s depositors, who must pursue their own proceedings.

The liquidator’s powers vary depending on the type of winding up. Whereas in a compulsory winding-up the winding-up order operates to terminate the director’s powers and dismiss them from office, on a voluntary liquidation the powers of the directors come to an end only on the appointment of the liquidator, though between the

286 Another possibility is, on the application of the official receiver when acting as liquidator and desiring a private liquidator to be appointed in his place, by the Secretary of State. The usual practice is, however, to convene a meeting of creditors and contributories to choose another liquidator under s. 136 (4) of the Insolvency Act
292 The winding-up of an insolvent company may take one of two forms, a creditors’ voluntary winding-up and a compulsory winding-up. Insolvency practitioners tend to favor voluntary winding-up in order to avoid the need to utilize the Insolvency Service Account, which is obligatory in the other one and has the disadvantage that while the rate of interest it pays has moved nearer toward market rates a substantial ad valorem fee is charged in connection with the operation of the account.
time of passing of the resolution for voluntary winding-up and the appointment of the liquidator these powers are severely restricted.

Moreover, in a creditors’ voluntary winding-up the liquidator is primarily under the control of the creditors rather than of the court and the liquidator can exercise without sanction certain powers which in a compulsory winding-up would require the sanction of the court or of the liquidation committee.

4.3. Different approaches to protect creditors in troubles companies

Commentators, inspired by the law and economics movement, have argued that the proper function of legal strategies in troubles companies can be seen in terms of a single objective: to maximize the collective return to creditors (that is the so called Creditor wealth maximization and the creditors’ bargain). Thus, according to this thought, every legal mechanism is best seen as a “collectivized debt collection device” and as a response to the “common pool” problem created when diverse “co-owners” assert rights against a common pool of assets. Moreover, it has been stated that this context should be seen as a system designed to mirror the agreements one would expect creditors to arrive at where they able to negotiate such agreements ex ante from behind a “veil of ignorance”. This “creditors’ bargains” theory is argued to justify the compulsory, collectivism regime of insolvency law on the grounds that were company creditors free to agree forms of enforcement of their claims on insolvency they would agree to collectivist arrangements rather than procedures of individual action or partial collectivism. As a consequence, the collectivist, compulsory system is seen as attractive to creditors in reducing strategic costs, increasing the aggregate pool of assets, and as

293 Insolvency Act 1986, ss. 165 and 167 and Sch. 4, paras 4 and 5. There is no equivalent to the retrospective effect of a winding-up order: the winding-up by creditors’ commences on the passing of the resolution to wind up. In consequence there is also no equivalent of s. 127 of the Act, which invalidates dispositions of the company’s property between winding-up petition and order unless sanctioned by the court. Whereas a winding-up order automatically stays all proceedings against the company except by leave of the court, there is no automatic stay in the case of a voluntary winding-up. It is for the liquidator to apply for a stay, which will normally be granted as a matter of course if the plaintiff’s claim is admitted, but not if it is disputed. See Insolvency Act ss. 112.


296 Jackson, Logic and Limits of Bankruptcy Law, op. cit., chs. 1-2.

administratively efficient. It follows from the above argument that the protection of the non-creditor interests of other victims of corporate decline, such as employees, managers and members of the community, is not the role of legal strategies. In this regard, keeping firms in operation is thus not seen as an independent goal of legislator. In the creditor wealth maximization approach all policies and rules are designed to ensure that the return to creditors as a group is maximized. Every legal device is thus concerned with maximizing the value of a given pool of assets, not with how the law should allocate entitlements to the pool. Accordingly, effect should only be given to existing pre-insolvency rights, and new rights should not be created. Variation of existing rights is only justified when those rights interfere with group advantages associated with creditors acting in concert.

However, the creditor wealth maximization vision has been subject to extensive criticism, some of which has been phrased in the strongest terms298. Major concerns have focused, firstly, on “troubles state” being seen as a debt collection process for the benefit of creditors. This, it has been said299, fails to recognize the legitimate interests of many who are not defined as contract creditors: for instance, managers, suppliers, employees, their dependants and the community at large300. Creditor wealth maximization, moreover, fails to focus on the non-efficiency objectives that are often recognized in legislation301. To see companies in troubles as in essence a sale of assets for creditors (what might be termed a “fire sale” image), moreover, fails both to treat it as a problem of business failure and to place value on assisting firms to stay in business. Thus, it has been argued that to explain why the law might give firms breathing space or reorganize them in order to preserve jobs requires resort to other values in addition to economic ones. The economic approach, as exemplified by the same commentators, is alleged to demonstrate only that its own economic value is incapable of recognizing non-economic values, such as moral, political, social and personal considerations302.


The idea, moreover, that a troubled company constitutes a mere pool of assets can also be criticized. Such a firm can be seen not purely as a lost cause but as an organic enterprise with a degree of residual potential; the rehabilitation of the firm is a legitimate factor to take on board in insolvency decision-making\textsuperscript{303}.

The thought that a trouble situation can justify a contractarian fashion with reference to a creditors’ bargain has also come under heavy fire. The creditors’ bargain restricts participation to contract creditors. In this sense, the “veil of ignorance” is transparent since the agreeing parties know their status. It is not surprising that in an \textit{ex ante} position such creditors would agree to maximize the value of assets available for distribution to themselves. This approach, furthermore, focuses exclusively on voluntary and bargaining creditors, while assuming a perfect market, and leaves out of account other types of creditor, for whom there is no market at all. The circular nature of the bargain has been exposed by critics. Creditors in the bargain are assumed to be de-historicized and equal. In real life, in contrast, creditors differ in their knowledge, skill, leverage and costs of litigating. As a consequence, what parties will agree to will inevitably mirror those disparities in rights, authority and practical leverage that shape their perspectives. A further major weakness of the creditor wealth maximization vision is its alleged lack of honesty on distributional issues. The collectivism advocated by Jackson is treated as neutral but it begs distributional questions\textsuperscript{304}.

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{303} See D. R. Korobkin, \textit{Rehabilitating values, op. cit.}, p. 749; see also S. Hill, \textit{Company Voluntary Arrangement and Administration Orders: a consultative document} (DTI, 1993); \textit{Revised proposals for a new Company Voluntary Arrangement Procedure} (DTI, 1995); \textit{A Review of company rescue and business reconstruction mechanism} (DTI, 1999); \textit{A review of company rescue and business reconstruction mechanism: report by the review group} (DTI, 2000).
\item \textsuperscript{304} It can be said, in the first instance, that insolvency does and should recognise the interests of parties who lack formal legal rights in the pre-insolvency scenario, not least because parties with formal legal rights never bear the complete costs of a business failure. Thus, creditors may suffer in an insolvency but those without formal legal rights may also be prejudiced: not only employees who will lose jobs and suppliers who will lose customers, but also tax authorities whose prospective entitlements may be diminished and neighbouring traders whose business environments may be devalued. A danger of the creditor wealth maximization vision is that it fails adequately to value the continuation of business relationships that have not been formalised in contracts and may, indeed, omit from consideration those who suffer the greatest hardships in the context of financial distress. A second point concerns those parties with various pre-insolvency legal rights. The argument that insolvency strategies should only give effect to these pre-insolvency rights can be countered by asserting that a core and proper function of insolvency measures is to pursue different distributional objectives than are implied in the body of the pre-insolvency rights; that insolvency law does so by adopting a base-line rule on equality –\textit{pari passu}- and by then making considered exceptions to that rule. It is insolvency law’s application to the turbulence of financial crisis, as distinct form the calm waters that mark pre-insolvency contracts, that can be said to justify the intrusion of a number of value judgements concerning relative priorities of various liabilities and the order in which groups of liabilities should be discharged. In this regard, see Warren, \textit{Bankruptcy policy, op. cit.}, p. 778.
\end{enumerate}
\end{footnotesize}
A vision of legal strategies for troubles companies that attempts to overcome the restrictions of creditor wealth maximization is a broader contractarianism. All those person who are potentially affected by a company’s decline, including employees, managers, owners, tort claimants, members of the community, etc., choose the principles of insolvency law from behind a strict veil, ignorant of their legal status, position within the company or other factors that might lead them to advance personal interests. They would, however, foresee that the financial distress of companies would affect a wide variety of individuals and groups occupying various positions and differing in their ability to affect the actions and decisions of the companies in distress. According to this points, the parties in such a position of choice would opt for two principles to govern insolvencies. First, a “principle of inclusion” would provide that all parties affected by financial distress would be eligible to press their demands. Second, a principle of “rational planning” would determine whether and to what extent persons would be able to enforce legal rights and exert leverage. It would seek to promote the greatest part of the most important aims and would involve formulating the most rational, long-term plan as a means of realizing the “good” for the business enterprise. This approach, however, is open to question on a number of fronts. First, the particular choices of principle made from behind the veil of ignorance depend on a particular concept of the person. Risk-averse and risk-neutral individuals might produce very different principles of justice. It is not clear why an individual behind the veil might not prefer a regime marked by low-cost credit and low protection for vulnerable parties to one with high costs of credit and high levels of protection. Advocates of creditor wealth maximization might object on the grounds that principles of insolvency law designed by a veiled and highly inclusive group are liable to be so protective of so many interests, and as a result so uncertain, that the effects on the costs of credit would be catastrophic. It might be further objected that the contractarian approach fails to explain how agreements can be reached behind the veil as to who in a potential insolvency is most


306 It is not possible to strip the individual completely yet conclude that he or she would choose, for instance, the differente principle. See in F. H. Bradley’s words, a theoretical attempt to isolate what cannot be isolated, quoted in M. Loughlin, Public Law and political theory, Clarendon Press, Oxford, 1992, p. 96. See also M. J. Sandel, Liberalism and the limits of Justice, Cambridge University Press, Cambridge, 1982, pp. 93s.
vulnerable and thus should enjoy priority of protection over those occupying less threatened positions.

In contrast with the emphasis on private rights contained within the creditor wealth maximization approach, the communitarian countervision sees insolvency processes as weighing the interests of a broad range of different constituents. It, accordingly, countenances the redistribution of values so that, on pre-insolvency and insolvency, high-priority claimants may to some extent give way to others, including the community at large, in sharing the value of an insolvent firm\textsuperscript{307}. A concern to protect community interests may, furthermore, militate in favor of insolvency laws that compel companies and their creditors to bear the costs of financial failure (for example, environmental cleaning costs) rather than shift those to third parties or taxpayers. Communitarianism thus challenges the premise that serves as the basis for the traditional economic model, namely that individuals should be seen as selfish, rational calculators. An important aspect of communitarianism is the centrality that is given to distributional concerns. Redistribution is seen, not as an aberration from the protection of creditors’ rights, but as a core and unavoidable function of insolvency law\textsuperscript{308}. It follows from these concerns that insolvency legal remedies should look to the survival of organizations as well as to their orderly liquidation. In this respect, the insolvency process should preserve viable commercial enterprises capable of contributing to the economic life of the country\textsuperscript{309}. To creditor wealth maximizers the communitarian vision is objectionable in so far as it clouds insolvency law by departing from creditor right enforcement and taking on issues which more properly should be dealt with by allocating pre-insolvency rights – for example, rights to employment security, fair dismissal and compensation on redundancy. In response, communitarians might urge, first, that there is no reason why issues arising in insolvency should be governed by rules or agreements formulated without regard to insolvency and, second, that it is perfectly proper to advert to communitarian issues in both pre-insolvency and insolvency law. It may also be objected that corporatist visions of the company have difficulty in defining the public good and offer “simply a mask behind which corporate


\textsuperscript{308} According to Warren, \textit{op. cit.}, “…bankruptcy is simply a scheme designed to distribute the costs amongst those at risk”.

\textsuperscript{309} See Cork Report, para. 198(i) and (j).
managers exercise unrestrained social and economic power”310. Similarly, communitarianism can be said to lack the degree of focus necessary for the design of insolvency law because of the breadth of interests to which it refers.

Rather than seeing the insolvency process in terms of substantive objectives it may be conceptualized in procedural terms, its essence being to establish a forum within which all interests affected by business failure, whether directly monetary or not, can be voiced311. However, such a vision may throw light on an important role to be played by legal strategies but it necessarily falls short of offering guidance on matters of substance. As, moreover, with other theories of legitimation through providing means of representation, difficult issues remain concerning the amount of representation to be offered to different parties; the right balance between provisions for representation and efficiency in decision- and policy-making; and the extent to which representation should be reinforced with legal rights.

In stark contrast to approaches offering a single, economic rationale, as exemplified by the creditor wealth maximization vision, is the notion that remedies for troubles companies serve a series of values that cannot be organized into neat priorities. Whereas the economic account can explain insolvency law only as a device to maximize creditor wealth, not distribute fairly, a value-based account is said to understand insolvency law’s economic and non-economic dimensions and the principle of fairness as a moral, political, personal and social value. Multiple values/eclectic approaches see insolvency processes as attempting to achieve such ends as distributing the consequences of financial failure among a wide range of actors; establishing priorities between creditors; protecting the interests of future claimants; offering opportunities for continuation, reorganization, rehabilitation; providing time for adjustments; serving the interests of those who are not technically creditors but who have an interest in continuation of the business; and protecting the investing public, jobs, the public and community interests. Such approaches incorporate communitarian philosophies and take on board distributive rationales, placing value, for instance, on relative ability to bear costs; the incentive effect on pre-insolvency transactions; the

311 The enterprise is seen as comprising not merely the physical assets and stock of business but the focus of interests and concerns of all participants in the company’s financial distress. The law’s function, in turn, is seen as establishing space; it creates conditions for an ongoing debate in which, by expressing conflicting and incommensurable values, participants work towards defining and re-defining the fundamental aims of the enterprise.
need to treat like creditors alike; and the aim of compelling shareholders to bear the
lion’s share of the costs of failure.

In conclusion, the above visions or approaches to companies in troubles emphasize different facets of corporate insolvency strategies’ role. What fails to emerge from the review undertaken, however, is any complete view of the appropriate legal measures. Creditor wealth maximization was narrow in its exclusive concerns with creditors’ interests and pre-insolvency rights and in its conception of the insolvent company as a pool of assets. The broad-based contractarian approach begged questions concerning the nature of persons behind the veil of ignorance and failed to explain trade-offs of fairness or justice versus efficiency or between different kinds of interests worthy of protection. The communitarian vision escaped the narrowness of creditor wealth maximization but encountered problems of indeterminacy. The forum vision made much of procedural concerns but shed little light on the substantive ends to be pursued by insolvency law or processes. The ethical vision gave rise to difficulties concerning the possibility of locating agreement as to ethical content and to establishing the boundaries of relevant ethical concerns. How ethical aspects of decisions on insolvency interacted with other, say legal, principles remained in doubt. Finally, the eclectic approach, again, gave rise to problems of indeterminacy and of contradictions and tensions between different ends.

Company legal strategies in a physiological situation were said to be about the legitimation of corporate managerial power in the hands of directors. The phenomenon of companies in troubles is more complex because, according to the economic theory of distribution of power connected with agency problem solutions, the power is taken out of the hands of management and is placed, depending on various circumstances, with different parties such as creditors, insolvency practitioners and the courts themselves. It is thus broad regulatory insolvency process in all its dimensions and with its variety of actors that requires legitimation. A second issue concerns the basis for requiring legitimation. It cannot be assumed that since corporate managerial power in a going concern requires legitimation, insolvency regimes and powers

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312 According to P. Shuchman, insolvency laws fail to rest on an adequate philosophical foundation in so far as the formal rules of insolvency disregard issues of greatest moral concern. See, P. Shuchman, An attempt at a “philosophy of bankruptcy”, 1973, 21 UCLA L Rev. 403; the author argues that the situation of the debtor, the moral worthiness of the debt and the size, situation and intent of the creditor should be taken into account in laying the foundations for insolvency law. Judgments in such matters would not be based upon intuitions but on utilitarian principles; see also J. Kilpi, The ethics of bankruptcy, Routledge, London, 1998.

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automatically require legitimation. Regulatory processes do, however, impinge strongly upon the public interest in so far as decisions are made about the lives or deaths of enterprises and those decisions affect livelihoods and communities. Insolvency processes also have dramatic import for private rights in so far as, for instance, pre-insolvency property rights and securities can be frozen and individual efforts to enforce other legal rights constrained. On both public and private interest grounds, accordingly, the powers involved in insolvency processes can be seen as calling for strong justification. How tension and trade-offs between different legitimating rationales can be resolved remains, of course, an issue connected with the different strategies adopted in the U.K.

As for the array of rationales that can be used to legitimate powers impinging upon public interests and private rights, these can be described as: firstly, formalist, which justifies with reference to the efficient implementation of a statutory or shareholders’ mandate; secondly, expertise-based, which sees managers as worthy of trust due to their expertise and professionalism; thirdly, control-based, which looks to the restrictions imposed on discretions by courts, markets and others; and, fourthly, pluralist, which adverts to the degree of amenability of processes to representations from the public about how corporate affairs should be conducted\textsuperscript{314}.

The justifications of legal insolvency processes can similarly be seen as dependent not merely on the efficient pursuit of mandates but also on the degree of expertise exercised by relevant actors, the adequacy of control and accountability schemes and the procedural fairness that is shown in dealing with affected parties’ interests.

It is possible to outline four key values: thus efficiency looks to the securing of democratically mandated ends at lowest cost; expertise refers to the allocation of decision and policy functions to properly competent persons; accountability looks to the control of insolvency participants by democratic bodies or courts or though the openness of processes and their amenability to representations; and fairness considers issues of justice and propensities to respect the interests of affected parties by allowing such parties access to, and respect within, decision and policy processes. This approach may produce no fine-tuned answers on either procedural or substantive issues;

\textsuperscript{314} See Baldwin & McCrudden, \textit{Regulation and Public law}, ch. 3.
nevertheless, it does have force in identifying the values and rationales that can be accorded currency in debates on insolvency law.\(^{315}\)

4.4. Anticipatory strategies

The legal responses to companies in troubles are under U.K. jurisdiction the so called “rescue strategies”, which deal with informal mechanisms and formal processes. In order to assess the role of rescue procedures, it will begin by considering what rescue involves, the reason why rescue may be worth attempting, the different routes to rescue and the UK’s new focus on rescue as an ever-earlier responses to corporate troubles.

It is useful, therefore, to see rescue as ‘a major intervention necessary to avert eventual failure of the company’\(^{316}\). This allows the exceptional nature of rescue action to be captured and it takes on board both governance and regulatory rescue strategies.

Central to the notion of rescue is, accordingly, the idea that drastic remedial action is taken at a time of corporate troubles\(^{317}\). The company, at such a point, may be in a state of distress or it may have entered a formal insolvency procedure. Whether or not a rescue can be deemed a success raises a further set of issues. Complete success might be thought to involve a restoration of the company to its former healthy state but in practice this scenario is unlikely. The drastic actions that rescue necessarily involves will almost inevitably entail changes in the management, financing, staffing or modus operandi of the company and there are likely to be winners and losers in this process\(^{318}\).

Some visions of insolvency processes and laws are highly unsympathetic to the whole notion of corporate rescue\(^{319}\). The so called ‘creditor wealth maximisation’ vision, which sees insolvency as a process of collecting debts for creditors, is in tension with the notion that keeping firms in operation (and protecting interests beyond those of creditors) is an independent goal of insolvency law. It may be the case, in some

\(^{315}\) A. Keay and P. Walton, Insolvency Law, corporate and personal, Jordans, Bristol, 2008, pp. 21ss.


\(^{317}\) A. Belcher, Corporate Rescue, cit., p. 12;


\(^{319}\) If regimes are largely creditor-driven it is likely that prospects for rescue will be less than where regimes are debtor-driven: see R. Harmer, ‘Comparison of Trends’, p. 147s. On classifying jurisdictions as pro-creditor or pro-debtor regarding, inter alia, the general position on insolvency, see P. Wood, Allen & Overy Global Law Maps: World Financial Law (3rd edn, Allen & Overy, London, 1997).
circumstances, that maximising potential returns to creditors will demand some sort of rescue activity but this will not always be the case and a failed rescue may reduce creditors’ returns materially.\textsuperscript{320} On most occasions, those economic theories that focus on creditor interests will hold that the collective actions of liquidation will reduce transaction costs for individual creditors and make for administratively efficient processes. It is efficient, on such a view, to decline to save ‘hopeless’ companies and to allow the market to redeploys resources swiftly, and at least cost, to more productive uses.\textsuperscript{321} However, it can be argued that the creditor wealth maximisation vision is excessively narrow and (that), in looking at insolvency processes, attention should be paid to interests beyond those of creditors: to social and distributional goals; to public as well private interests; and to values such as expertise, fairness and accountability. Whether existing English rescue procedures perform adequately with regard to these factors it will not be considered in details in this discussion. At this stage it is worth noting that an approach going beyond creditor wealth maximisation – in short a ‘social’ as opposed to an ‘economic’ approach – leaves scope for rescue and justifies rescue activity with reference to a number of objectives and values. In relation to the technically efficient achievement of social and distributional goals, regard can thus be had to the potential of a rescue procedure to achieve a number of results. These may include the preservation of a business that, in the longer term, is worth saving or is worth more as a going concern than if sold piecemeal; the protection of the jobs of a workforce; the avoidance of harms to suppliers, customers and state tax collectors; and the prevention of damage to the general economy or to business confidence in a sector.\textsuperscript{322}

For its part, the Cork Committee\textsuperscript{323} laid the foundations for a ‘rescue culture’ and was clear on the legitimacy of considering the broader picture. A good, modern system of insolvency law, said Cork, should provide a means for preserving viable commercial enterprises capable of making a useful contribution to the economic life of

\textsuperscript{320}Rescue is likely to increase returns to creditors where there is a good prospect of turning corporate fortunes around (for example, by coping with a short-term dip in the market) or where the company is worth more as a going concern than as assets sold off piecemeal.


\textsuperscript{323}Report of the Review Committee on Insolvency Law and Practice (Cmnd 8558, 1982) (‘Cork Report’).
the country. In the period since the Cork Report, the rescue culture has strengthened and been endorsed by the judiciary as well as bankers and politicians.\textsuperscript{324}

A key issue in any process that purports to be rescue-orientated is whether it provides for intervention at a sufficiently early stage in proceedings and action of a sufficiently speedy nature to allow the above ends to be achieved.\textsuperscript{325} The trade-offs between achieving ‘social’ ends and the costs imposed on various parties have, moreover, to be taken into account. Many rescue activities will involve the forestalling of enforcement actions by certain parties and the use of periods of grace in which realignment efforts are made. During these period, certain interests will suffer. Creditors, for example, may be prevented from realising their securities. Distributional and social goals may demand that creditors make certain concessions for the purpose of rescue but considerations of both efficiency and fairness impose limits on the sacrifices that can be justified.\textsuperscript{326} In assessing such trade-offs, balances have to be drawn between

In \textit{Powdrill v. Watson (Re Paramount Airways Ltd (No.3) sub nom. Powdrill v. Watson} [1995] 2 AC 394, [1995] 2 WLR 312, [1995] 2 All ER 65) Lord Browne-Wilkinson stated in the House of Lords: “The rescue culture, which seeks to preserve viable businesses, was, and is, fundamental to much of the Act of 1986. Its significance in the present case is that, given the importance attached to receivers and administrators being able to continue to run a business, it is unlikely that Parliament would have intended to produce a regime as to employees’ rights which renders any attempt at such rescue either extremely hazardous or impossible”. For further judicial references to the rescue culture see e.g. \textit{Re Demaglass Holding Ltd} [2001] 2 BCLC 633 (Neuberger J); \textit{On Demand Information plc (in administrative receivership) and another v. Michael Gerson (Finance) plc and another} [2000] 4 All ER 734 (Robert Walker LJ).
The British Bankers’ Association publicly endorsed a rescue culture in its 1997 paper, \textit{Banks and Businesses Working Together}\textsuperscript{324}. British Bankers’s Association, \textit{Banks and Business Working Together} (London, 1997) para. 3: ‘Banks have long supported a rescue culture and thousands of customers are in business today because of the support of their bank through difficult times’. See also British Bankers’ Association, \textit{A Statement of Principles: Banks and Businesses – Working Together When You Borrow} (BBA, London, 2005). The Blair governments also sought to encourage a movement towards a more US-style philosophy of enterprise that was less censorious of business failures and more encouraging of rescue. Peter Mandelson, when Trade Secretary in 1998, made a number of speeches that advocated a reassessment of attitudes to business failure and need to encourage entrepreneurs to take risks. He announced the need to reconsider the position of the Crown as preferential creditor so that hard-pressed companies were not driven into insolvency by demands relating to tax debts. The 1998 White Paper, \textit{Our Competitive Future: Building the Knowledge Driven Economy}, echoed such sentiments and, in 1999, a joint DTI and Treasury initiative was mounted in order to further the rescue culture and examine how it could be made to work more efficiently. More recently, the Enterprise Act 2002 removed the Crown’s preferential rights to recover unpaid taxes ahead of other creditors and reduced the role of administrative receivership. This initiative resulted in September 1999 Consultation Document and a May 2000 Report: Insolvency Service, \textit{A Review of Company Rescue and Business Reconstruction Mechanism}, Interim Report (DTI, September 1999); IS 2000.

\textsuperscript{325} In R3’s Survey of Business Recovery of 2001, the rescue professionals who responded indicated that in 77 per cent of cases there was, by the time they were appointed, no possible action that could be taken to avert company failure.

\textsuperscript{326} See Dal Pont and Griggs, ‘Principled Justification’, p. 47.
the probabilities of achieving certain desirable ends and the (usually far higher) probabilities of imposing costs on parties who are asked to make sacrifices.\textsuperscript{327}

A final issue to consider under the heading of technical efficiency is whether a rescue regime is conducive to low cost and effective coordination between the different actors that may be involved in working towards a turnaround.\textsuperscript{328} A rescue generally involves a number of parties who carry out a variety of roles and tasks and the challenges of co-ordinating roles and actions vary across such tasks. What is clear is that if such involved parties do not work together harmoniously, a considerable amount of unproductive friction will result and this will stand in the way of completing such tasks as collecting the data relevant to the rescue and the taking of timely actions and decisions. These matters are taken in special consideration in looking at the administrative procedure.

Moreover, attention should also be paid to the propensity of any given rescue procedure to allow business judgements to be taken by experts. The argument for expert decision-making may, like those for fairness and accountability, be the more important where democratically established goals for rescue are difficult to identify.\textsuperscript{329}

Rescue procedures also stand to be judged according to their fairness. Issues here are whether those processes allow equal weight to be given to the voices of various affected parties; whether the processes are open to self-interested manipulation by certain individuals or groups; and whether those administering the processes are (and can be seen to be) operating even-handedly.

Finally, considerations of accountability are relevant. Acceptable levels of supervision and approval should be instituted so that opportunities for opportunist

\footnotesize{\textsuperscript{327} Ibid., pp. 61-71 and see the discussion of the policies of (1) redistribution determined by relative ability to bear costs and (2) allocating the costs of business failure to those who stand to benefit most from business success.  

\textsuperscript{328} See V. Finch, ‘Control and Co-ordination in Corporate Rescue’ (2005) 25 Legal Studies 374; J. Westbrook, ‘The control of Wealth in Bankruptcy’  

\textsuperscript{329} Where, for instance, a rescue procedure involves a handover of control form a specialist insider (for example, a director) to a generalist outsider (for example, an insolvency practitioner), this may involve the expenses of parties coming up to speed with the particular company’s financial, operational and market positions but also dangers that judgements will be made by persons who are not fully familiar with the relevant market sectors and business circumstances. In this regard, see M. Phillips, The Administration Procedure and Creditors’ Voluntary Arrangements (Centre for Commercial Law Studies, QMW, London, 1996); N. Segal, ‘An Overview of Recent Developments and Future Prospects in the UK’ in J. Ziegel (ed.), Current Developments in International and Comparative Corporate Insolvency Law (Clarendon Press, Oxford, 1994) p. 10.  

Experts should also be allowed to exercise their expertise. A consideration in judging a rescue regime is, accordingly, whether it gives the expert sufficient information and time to be able to effect a rational, balanced judgement. ‘Expert’ decisions may amount to little if those taking them are, by force of circumstances, ill-informed and subjected to unduly tight deadlines. See Belcher, Corporate Rescue, op. cit., pp. 240ss.}
behaviour are curtailed and regimes are not only fair but also capable of generating the
degree of consent that is necessary for effective rescues to be achieved. This, in turn,
demands that supervisory functions are not allocated in a way that itself allows
manipulation. The transparency and accessibility of processes must also be sufficient to
allow affected parties to apprise themselves of relevant facts and to ensure that such
parties’ representations are considered. Again, however, the costs of supervision and
access have to be borne in mind and the pitfalls of excessively legalistic procedures and
undue levels of court supervision should be avoided\textsuperscript{330}.

In relation to issues of both fairness and accountability it should be emphasised
that different groupings may possess widely divergent interests and incentives when the
company meets troubled times\textsuperscript{331}. Shareholders and directors will tend to favour
ensuring that the company continues to operate for as long as possible. The former are
residual claimants in insolvency and have little to lose by trading on. The directors may
wish to prolong operations in order to eke out or stabilise their employment. They may
not bear the financial risks of continued trading but their inclination to trade on should
be constrained by fears of personal liability for wrongful trading, fraudulent trading,
breach of duty or of disqualification. Both shareholders and directors will thus tend to
 gamble on further business activity since they will enjoy whatever gains result.
Corporate creditors, in contrast, will tend to favour ceasing operations sooner rather
than later since they will bear the losses that result from any continued trading\textsuperscript{332}.
Employees, again, will tend to favour continuing trading in the hope of securing their
jobs and in the knowledge that further losses will be borne by other parties. Insolvency
practitioners may possess incentives to encourage companies to move towards formal
insolvency procedures because these are likely to generate fee income. Such acute
dergences of interests make it especially important that rescue regimes are not only
fair and accountable but seen to be so.

4.4.1. Informal and formal routes to rescue

Troubled companies and their directors, creditors or shareholders are able, as
noted, to take informal as well formal steps in order to effect rescues. Most rescues are,

\begin{footnotesize}
\textsuperscript{330} See M. Phillips, \textit{cit.}, pp. 11-12.
\textsuperscript{332} Ibid., pp. 244.
\end{footnotesize}
indeed, achieved through informal action\(^{333}\).

Informal actions do not demand any resort to statutory insolvency procedures but are contractually based. They are usually instituted by directors or creditors and they may involve the use of professional help: where, for instance, a “company doctor” or firm of accountants is appointed (usually on a creditor’s insistence) to investigate the company’s affairs and to make recommendations. Such informal steps may result in the kinds of remedial action already referred to, for example: changes in management, corporate reorganizations or refinancing.

Alternatively, under the “London Approach”, co-ordination of a creditors’ agreement in accordance with informal guidelines may be achieved with the Bank of England acting as an honest broker in making efforts to persuade reluctant parties to pursue such informal settlements\(^{334}\).

Formal arrangements under which rescue may be attempted are provided for the Insolvency Act 1986\(^{335}\) and include company voluntary arrangements (CVAs)\(^{336}\), receiverships and administrative receiverships\(^{337}\) and administration\(^{338}\).

From the company management and shareholders’ point of view, a general advantage of informal rescue is that publicity concerning corporate troubles may be minimal, the stigma of formal insolvency may be avoided and the goodwill and reputation of the company preserved. Avoiding the adverse publicity that would often follow the commencement of a formal insolvency proceeding can have a significant impact on the ability of a company to survive and on the realizable value of its assets\(^{339}\). The cost of informal procedures is also likely to be lower than where court proceedings are involved. Delays and attendant costs may, furthermore, be reduced where rescues are managed without hostile litigation. Informally also ensures flexibility.

From the point of view of company directors, a further considerable advantage of informality is that this avoid the intervention of an insolvency practitioner in the role of a formal scrutiniser of directorial actions, who possess extensive power to investigate


\(^{334}\) In 1998 the Financial Services Authority took over from the Bank of England as banking regulator.

\(^{335}\) See also Company Act 2006 s. 895.

\(^{336}\) Insolvency Act 1986 ss. 1-7.

\(^{337}\) Insolvency Act 1986 ss. 28-69 and 72°-H.


corporate affairs together with the duty to report on the conduct of directors\textsuperscript{340}. Another incentive for management to see that the company remains outside formal insolvency is that the latter carry with the stigma of failure, that is particularly relevant in terms of external perceptions, such as in employment markets.

From the point of view of many banks and secured lenders, informal rescue may be attractive in ways that can outweigh attendant risks. It not only offers the prospect of repayment in full, if ultimately successful, but also provides an opportunity to acquire a fresh injection of funds from other sources (such as shareholders or other banks) and allows such well-positioned creditors to extract enhanced or new security, or priority, as the price for supplying further funds to the company. A bank, for instance, may improve its position by taking a floating charge as security and, even if an informal rescue ultimately fails, the bank will often have improved its security position and may then be able to appoint an administrator of its choosing out of court\textsuperscript{341}.

A disadvantage of informal rescue, however, is its potential to prejudice the interests of less-well-placed creditors. Informality may be attractive to directors, but, from the point of view of certain creditors, a deficiency of informality may be the absence of investigative powers and the lack of an inquiry into the role of directors in bringing a company to the brink of disaster. A fundamental weakness of informal rescue is, furthermore, that the agreement of all parties whose rights are affected will generally be required if the rescue is to succeed. Informal rescues demand that parties with contractual rights agree to compromise, waive or defer debts, or alter priorities. Dissenting creditors, accordingly, have the power to halt informal rescues by triggering formal insolvency procedures, including liquidation. This renders the informal rescue a fragile device that is dependent on a high degree of co-operation from a range of parties. In contrast, a formal procedure such as administration involves a moratorium on the enforcement of a wide range of creditors’ rights and so create a more sustainable space within which a rescue can be organized.

\textsuperscript{340} See Insolvency Act 1986 ss. 234-7; once an administrative receiver has been appointed, an administration order made, or the company has gone into liquidation, the relevant IP is under a duty to submit to the Secretary of State a report on the conduct of the directors of the company; in this regard, see Company Directors’ Disqualification Act 1986 s. 7 (3) and the Insolvent Companies (Report on Conduct of Directors) n. 2 Rules 1986.

\textsuperscript{341} See Insolvency Act 1986 Sch. B1, para. 14. The administrator may then even be implementing a “pre-packaged” administration.
4.4.2. Formal rescue strategies

There are four forms of formal insolvency and restructuring procedures for English companies: administration, receivership, company voluntary arrangement and liquidation (or winding up). In addition a company may propose a scheme of arrangement with its creditors and/or members. This procedure is available to companies regardless of their solvency under the Companies Act 2006 and is, therefore, not a formal insolvency procedure as such.342

Of the above procedures, administration is nowadays the most commonly used. English legislation aimed at promoting a corporate rescue culture has sought to phase out receivership and make liquidation a last resort. Company voluntary arrangements obviously fit within the rescue framework but, other than for a limited period for small companies, they lack the flexibility afforded by a moratorium on creditors enforcing their contractual rights although, as can be seen below, they may be used in conjunction with administration to provide that moratorium protection. These factors mean that administration is generally the preferred route for insolvent companies regardless of size.343 Therefore it will look at in greater detail, even with no exhaustive, than the alternative procedures.

Administration involves the appointment of an insolvency practitioner as administrator to take control of the company from the directors, while at the same time imposing a moratorium on creditors enforcing their rights against the company. This moratorium provides the business with a breathing space within which to address its

342 In very general terms, if a company is insolvent according to the U.K. system it has a range of choices: attempt to re-finance, try to come to some informal arrangement with some or all the creditors, enter administration, put forward a proposal for the debtor to enter, under the Insolvency Act 1986, a company voluntary arrangement (CVA) whereby all creditors will be bound by the arrangement if the required vote is obtained from creditors; approach a secured creditor about appointing a receiver where the secured creditor holds a floating charge over the whole, or substantially the whole, of the company’s property; resolve to enter voluntary liquidation; wait to see if a creditor presents a petition for compulsory liquidation.

343 Before considering the different regimes available under English Law, it is necessary to note the context provided by European law and in particular Council Regulation (EC) No 1346/2000 of 28 May 2000 on Insolvency Proceedings (the “EC Regulation”), that governs, among other matters, in which EU Member State’s jurisdiction insolvency and restructuring procedures can be commenced. The insolvency procedures available, their effects and creditors’ rights vary greatly between different jurisdictions within the EU, reflecting differing attitudes to companies that become insolvent. The “rescue culture” that dominates English law is not prevalent in all EU Member States, although there is a growing trend for reforms to insolvency and restructuring laws in EU Member States which reflect an underlying rescue culture. The insolvency procedures of each state that are recognized by the EC Regulation are set out in annexes to it: Annex A for main proceedings, that in the U.K. are liquidation, administration and voluntary arrangement; and Annex B for secondary and territorial proceeding, that in the U.K. are liquidation and winding up through administration. Receivership is not recognized as a qualifying insolvency procedure as it is considered a self-help remedy for secured creditors rather than a collective process. Schemes of arrangement under the Companies Act are also excluded as they are not a process created by England’s insolvency legislation and do not necessarily involve the appointment of an overseeing office-holder.
problems. A tight timetable is set down by statute within the administrator must assess the company’s position, formulate a plan and put it to the company’s creditors for approval.\(^{344}\)

The primary purpose of administration is to rescue the company as a going concern as this should provide the best outcome for its creditors as a whole. Where the company itself cannot be rescued, the administrator may pursue the second objective of this procedure, which is to achieve a better outcome for its creditors than if it was simply liquidated (for example, by saving the business). Administration may therefore be appropriate where a business can be sold as a going concern and this would lead to a greater value being available to the company’s creditors than simply selling its assets. The third objective, which will only apply if neither of the other two options is possible, is to realize property in order to make a distribution to one or more of the secured or preferential creditors but without unnecessarily harming the interests of the unsecured creditors. Since the Enterprise Act 2002 came into force\(^{345}\), it has become easier for either the company itself or a creditor holding a floating charge to appoint an administrator and it is no longer always necessary to involve the court in the appointment. So an administrator can be appointed without a court order by the company, its directors or a creditor who holds a qualifying floating charge. Any of these parties may also apply to court for an administration order, and in certain circumstances it may be necessary to use the court route, but the cost and delay of a court appointment means the out-of-court route will normally be preferable. In comparison, creditors (other than those with the benefit of a qualifying floating charge) can only place a company in administration by applying to the court. In practice, it is usually the directors or a major creditor with a long term business relationship with the company that will seek to place it into administration. Creditors who are owed smaller amounts will rarely view placing control of the company into the hands of an administrator as their best option as it offers no short term prospect of payment.

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\(^{345}\) The relevant sections of the Enterprise Act 2002 came into force on 15 September 2003. Certain types of companies, primarily those performing a quasi-public function or operating in former state-run sectors, are subject to separate or modified administration regimes. These include building societies and companies involved in water supply and sewerage, air traffic control, railways and Public-Private Partnerships (PPPs), as was the case with the administration of Metronet in 2007. The Banking Act that came into force on 21 February 2009 introduced a further insolvency regime in relation to banks, that is a specialized regime which is not beyond the scope of this discussion.
The objective requirement is that the company must be in troubles in terms of “unable, or likely to become unable, to pay its debts as they fall due” and there must have been no administrator appointed to the company by the directors or company in the last 12 months.

The out-of-court route was introduced to avoid the costs and time associated with the court procedure, allowing a company that is in financial difficulties to obtain quickly and cheaply the protection of an administration when the directors (or company if done by resolution of shareholders) will be able to select the administrator. In reality if the board has been functioning properly, it will have engaged advisors to consult on the company’s financial condition and trading prospects long before an administration is in prospect. As conditions become more serious, a licensed insolvency practitioner should be brought into this process and when the decision to appoint an administrator is reached, that practitioner is therefore already engaged and brings with him prior knowledge of the company’s affairs.

The company or the directors (as appropriate) must first pass a resolution proposing to put the company into administration. The holder of a qualifying floating charge may appoint an administrator as long as no administrator, administrative receiver, liquidator or provisional liquidator is already appointed. No notice of intention to appoint needs to be given to the company or its directors, so the first formal notice received by the company and its directors will be of the appointment itself. However, in practice, the qualifying floating charge holder will invariably have been in discussion with the company about its financial affairs and the possible appointment of an administrator, so it is unlikely the appointment will

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346 Five business days’ notice, in the prescribed form, that is Form 2.8B, Rule 2.28, of the intention to appoint an administrator must then be given to: (a) anyone entitled to appoint an administrative receiver; (b) any holder of a qualifying floating charge; (c) anyone who has distrained or is charged with executing a judgment against the company; (d) the supervisor of any pre-existing CVA; and (e) the company itself (if the appointment is to be made by the directors as opposed to the company). This notice of intention to appoint must also be filed at court as soon as possible, together with the board minutes or a resolution of the company, as appropriate, resolving to put the company into administration. Once the five days’ notice has expired, or sooner if each person served with the notice gives his written consent to the appointment, the administrator may be appointed. The appointment must be made within 10 business days of filing the notice of intention to appoint in court. Notice of the actual appointment of the administrator must also be filed at court.

347 Floating charge is a a form of security used primarily by banks to take security over a company’s assets without preventing those assets from being used by the company in the ordinary course of business. They can therefore cover items such as stock, regardless of the fact that this is a constantly changing pool of assets and book debts/receivables. A “qualifying” floating charge is one that covers the whole or substantially the whole of the company’s assets and which states that the holder has the right to appoint an administrator or administrative receiver. The floating charge must obviously have become enforceable due to an event of default.
come out of the blue. The appointment is affected by filing the actual notice of appointment in court along with the other documents referred to above. Because the holder of a qualifying floating charge must be given five day’s notice of any intention to appoint an administrator by the company or its directors, it will be able to pre-empt any such proposed appointment with its own. Unlike the directors or the company itself, the holder of a floating charge can also appoint an administrator even if a petition to wind the company up has been filed, provided no winding up order has yet been made by the court. Any petition to wind the company up is then suspended.348

Where someone other than the holder of a qualifying floating charge applies to the court to appoint an administrator, the holder of a qualifying floating charge can apply to nominate its choice of administrator. The court is required to accede to the charge holder’s request unless the particular circumstances of the case dictate otherwise, though as with the appointment of all administrators, the administrator must still act in the interest of the creditors as a whole, and not just in the interests of the floating charge holder.349

Facing on the scope of this strategy, the court must be satisfied that the administration is likely to achieve its aims of rescuing the company or giving a better outcome to creditors than liquidation. If the court is not satisfied of this, it can make any order it sees fit. The court has the power to treat the application as a winding up application and order that the company be placed into liquidation.

The central provision of the administration regime is that a moratorium is imposed, preventing creditors from taking steps to enforce security or repossess goods and property.350

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348 The court can still appoint an administrator upon the application of any creditor (including a qualifying charge holder), the company or its directors provided the company is insolvent or is likely to become so. If the application is by the directors, it must be by all the directors acting together or by the board acting on a majority resolution. The application must nominate the proposed administrator and should be supported by a statement from that insolvency practitioner in the prescribed form, stating that the aims of the administration are likely to be achieved. An affidavit must also be provided by a director or the company secretary (on behalf of the company or the directors, as appropriate) setting out the financial position of the company, a summary of its assets and liabilities and a description of any security that exists over its assets. There is also a court filing fee to pay. Notice (five days) of the court hearing must be given to, amongst other, any person who has a right to appoint an administrative receiver or an administrator under a qualifying floating charge.

349 The application will ordinarily be considered at a public hearing where a judge will refer to the statements filed and any submissions made by those represented. This will normally be the applicant, the proposed administrator and anyone with a relevant interest who wishes to be heard, such as the holder of a qualifying floating charge, anybody seeking to have the company wound up or the supervisor of any voluntary arrangement to which the company is subject.

350 This allows the company breathing space for the best solution to be found, preventing a disorderly series of actions by individual creditors that might otherwise destroy any prospect of the company surviving. An interim moratorium takes effect as soon as either an administration application has been made or a notice of intention to appoint an administrator has been filed at court. The interim moratorium has largely the same effect as the
Once a moratorium is in place, no creditor may commence legal proceedings against the company without the permission of the administrator or the court. Creditors are also prevented from enforcing security over the company’s property and repossessing goods or premises (including forfeiture by peaceable re-entry) without permission. No administrative receiver may be appointed. A secured creditor may apply to court to enforce its security, but permission to do so will normally only be given where it is clear that the asset over which security is held is not necessary for the ongoing business of the company. Allowing security to be exercised, for example, over a trading company’s fleet of delivery vans would obviously thwart the purpose of the administration and would not ordinarily be permitted by the court.

The moratorium does not prevent certain actions by creditors (self-help remedies which do not involve a court process), including exercising rights of set-off and declaring an event of default under a contract triggered by the appointment of the administrator.

As soon as an administrator is appointed, he takes over the management of the company. The directors can only exercise management powers with the consent of the administrator and, although the directors remain in office, the administrator effectively displaces the directors in running the company.  

Given that creditors’ substantive rights are put on hold by the company entering administration, it is important that the process has a defined and short timetable.

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351 All correspondence for the company, including invoices and orders, must bear the administrator’s name, stating that the affairs, business and property of the company are being managed by him. The administrator will inevitably have to delegate certain tasks in order to keep the business in operation, but may set value thresholds on any decisions taken without his direct input. The role of the directors now becomes one of assisting the administrator; certain specific duties are imposed on directors as a result of the appointment of an administrator such as getting in the company’s statement of affairs and co-operation with the administrator generally.

352 An administrator’s appointment has an initial duration of one year, though this can be extended by consent of the creditors or on application to the court. Once an administrator is appointed, he must draw up a list of all the company’s creditors as soon as is practicable and write to each notifying them of his appointment. The administrator will also advertise his appointment in the London Gazette and other suitable publications, often being the trade press and sometimes local press in areas where the company has a presence. The administrator will request that one or more suitable officers or directors of the company draw up a statement of the company’s affairs. The latter must be completed and produced within 11 days of the administrator’s request and needs to be verified by a statement of affairs as is used on a witness statement in court proceedings. The statement of affairs is filed with the court and with the Registrar of Companies. It forms part of the basis of the administrator’s analysis of the company’s problems, though if he has been involved prior to his appointment he is likely to have already formed a view as to what can be done with the company. Having reviewed the books and records and consulted with the company’s management, as well as perhaps its key creditors and employee representatives, the administrator will then prepare his formal statement of proposals. This statement must be...
The proposals commonly made by administrators include one or more of the following: (a) a period of trading under the moratorium to enable the company to trade its way out of difficulties; (b) a restructuring of the company’s debt financing to make its debt burden feasible, possibly involving a debt for equity swap under which the lenders will acquire a stake in the company in exchange for writing off debt; (c) the injection of new capital to restore the company’s balance sheet; (d) the sale of the business, or part of it, as a going concern; (d) the sale of key assets that may take time to sell, while maintaining the moratorium in the interim; and (f) commencing a company voluntary arrangement or scheme of arrangement.\(^{353}\)

The vote is passed by a simple majority of those voting, by value of debt rather than number of creditors. To prevent collusion by parties connected to the company (such companies in the same group or directors who have made loans to the company), a resolution cannot be validly passed unless more than half, by value of debt, of those creditors unconnected to the company vote for it.

It is open to creditors to propose amendments to the administrator’s proposals at the meeting and these will be put to the vote in the same way at the meeting.

An administrator enjoys very wide powers in his running of the company and may do anything necessary or expedient to manage the company’s affairs. His full powers are set out in the IA 1986. He can, for example, remove existing directors and appoint new ones. He is empowered to bring legal proceedings on behalf of the company and to compromise the company’s claims against others in order to realize its assets. He may sell property that is subject to a floating charge as though it were not and can apply to court for permission to dispose or property subject to other forms of security or proprietary agreements, including retention of title provisions, if the beneficiary of such rights does not consent. It is normal for an administrator to make major changes to the way in which the business is run, for he cannot allow the business to continue to incur losses. To allow this to happen would obviously not further the aim

\(^{353}\) The statement of proposals may offer alternative courses of action for creditors to consider, but it must include proposals for how the administration will be conducted and how it is proposed it will be brought to a close. The statement of proposals sent to creditors is accompanied by an invitation to a meeting of creditors, to be held not less than two weeks’ later, but no more than ten weeks after the company entered administration. Only where the administration has concluded that there are sufficient assets to pay all creditors in full, or that there are insufficient assets for there to be any distribution to unsecured creditors, is no creditors’ meeting needed. The purpose of the meeting of creditors is to consider and to vote upon the administrator’s proposals for the company. The administrator chairs the creditors’ meeting and he may be accompanied by directors of the company and legal advisors to assist in answering any questions from creditors.
of improving the creditors’ position compared to a liquidation of the company. The administrator nonetheless works within a strict framework. He must adhere to his stated proposals for the company and he must preserve the hierarchy of creditors which allows preferential and secured creditors to recover their debts in priority to unsecured creditors.

There are a number of different ways in which an administration may come to an end, which will largely depend on the nature of the company’s business and financial affairs and the proposals which the administrator puts to creditors, and whether or not those proposals are successful. It may be that the company can, with the protection of the moratorium, trade out of its difficulties or, more likely, that the administrator having restructured its finances (perhaps under the umbrella of a company voluntary arrangement or a scheme or arrangement), can return control of the rescued company to the directors. If the business or assets of the company have been sold, the administrator may seek the leave of the court to make a distribution to creditors, in which case it is likely that the company would simply be dissolved thereafter. Alternatively, the company may proceed from administration into liquidation thereby enabling the liquidator instead to make a distribution to creditors. A simplified process for converting from administration into a creditors’ voluntary liquidation was introduced by the Enterprise Act 2002. However, the precise manner in which an exit from

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354 However, as the person charged with seeing through the proposals, the administrator must approve any amendments. If the proposals are voted down, the administrator may either adjourn the meeting for up to 14 days to come up with revised proposals, or otherwise report this to the court, which will ordinarily order that his appointment be terminated and that the company be liquidated. The creditors can appoint a creditors’ committee at the meeting of between three and five creditors, including companies but these must be represented by a named individual. Members of the creditors’ committee must be elected at the meeting. The purpose of the creditors’ committee is to assist the administrator in discharging his functions and act in relation to him in such manner as may be agreed from time to time. The administrator is required to call a first meeting of the committee not later than six weeks after its establishment; thereafter the committee can require the administrator to meet with it in order to provide information about the administration. Perhaps the real power the creditors’ committee has is setting the remuneration of the administrator, either as a percentage of assets dealt with, or on an hourly fee basis. The administrator may apply to the court to increase his remuneration if he is not satisfied with the creditors’ committee’s decision. It is by no means inevitable that a creditors’ committee will be formed, as there may be insufficient creditors willing to undertake the role.

355 If the administrator wishes to revise his proposals for the company in a substantial way due to developments in the course of the administration, he must convene a further creditors’ meeting to vote upon the revised plan. Where property is sold that was subject to a floating charge or, with the creditor or court’s permission, other security, the sale proceeds must be paid to the creditor holding that security. Any shortfall between the price achieved and market price must also be made up, through in reality an administrator would rarely sell an asset for less than market value. While this may appear to substantially protect the rights of a holder of security, in reality it transfers control of the process to the administrator. If the value of the asset in question is volatile or cyclical, for example, the holder of the security would ordinarily have the ability to repossess the asset but not sell it until its value had risen. Such decisions are not the creditor’s to take in an administration and the administrator is only required to pay over to the creditor the asset’s market value at the time he sells it.
administration may be achieved is still quite technical and will depend very much on the facts and circumstances of the case.

One consequence of the removal of the requirement for court involvement in the appointment of an administrator has been the rise of the “pre-pack” administration, which has attracted some controversy. A pre-pack administration is one where a deal to sell the company’s business, or part of it, is arranged before an administrator is appointed, though in consultation with the insolvency practitioner who will take this role. The administrator is then appointed by the directors and immediately signs the pre-agreed contract to sell the business or a part of it.

The advantages of a pre-pack are obvious. There is no drawn out process during which the business is subject to doubt as to its future, with the attendant loss of confidence for its staff, customers and suppliers. The surviving part of the business is therefore handed over to its new owners in a better state than would be possible after an open-ended period of administration. This should enable it to attract a better price for the company’s creditors, while hopefully minimizing the size of any part of the business that cannot continue.

The flipside of there being no drawn out process, however, is that pre-pack administrations necessarily involve less transparency for creditors. Where creditors are exposed to only certain parts of the business, such as one branch, they are also likely to find a stark divide between winners and losers. It is common for the business that is to be sold to be a “cherry-picked” version of the insolvent company, with less successful sites left behind to be closed. Those creditors with contracts relating to a surviving part of the business will be in a much better position than those supplying a part of the business that is closed down, as contracts will usually be novated to the new company. Concerns have been expressed in particular where the buyer of the business is in fact related to the owner of the company placed into administration. Many pre-packs take this form because it is obviously easier to covertly negotiate a deal to sell part of the business to someone who knows it already, such as in the case of a management buy-out. While this should still represent the best available deal for creditors (otherwise the administrator should not sign the contract), questions are inevitably asked as to whether sufficient alternatives were investigated. At their worst, pre-packs can appear

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356 The sale is conducted before any meeting of creditors and, from the creditors’ perspective, there is inevitably the sense of being presented with a *fait accompli*, although the administrator could still be pursued for causing unfair harm to creditors or for misfeasance if the sale was demonstrably not in the best interests of creditors.
somewhat like “phoenix” companies, leaving creditors to be paid only in part while re-establishing the same business anew under the same or similar management.\(^{357}\)

Focusing on some aspect of the rescue procedures recalled above, it can be said that receivership is the most peculiar for several reasons. Firstly, it is not a collective insolvency procedure, but rather a strategy by which a secured creditor can enforce its security and obtain payment of sums owing to it. It is for this reason that certain restrictions have been placed relatively recently on the ability to appoint receivers and hence the reason why receivership is not as common as it once was.\(^{358}\)

Receivership was once the most common form of insolvency procedure and involves the appointment of a receiver by a creditor (often a bank) to take control of the company’s assets, or part of them, usually pursuant to a contractual right contained in the creditor’s security documentation. The security will generally provide for the right to appoint a receiver upon an event of default by the company. When a receiver is appointed over all or substantially all the assets of a company under security which includes a floating charge, he is deemed an administrative receiver. Hence, only a floating charge holder can appoint an administrative receiver, who must be an insolvency practitioner. Non-administrative receivers tend to be known as fixed charges receivers.

\(^{357}\) While the courts have considered the issue of an administrator selling a company’s assets before the creditors’ meeting and found this to be legally acceptable, concern amongst insolvency professionals has led to guidance being issued by R3, the Association of Business Recovery Professionals, which became effective on 1 January 2009. This guidance, Statement of Insolvency Practice 16 (SIP16), is not law, but has been adopted by all relevant professional bodies, including the Law Society, the Institute of Chartered Accountants and the Insolvency Practitioners’ Association. Emphasis in SIP16 is on full disclosure to creditors, albeit after the sale of the business. It requires disclosure of matters such as how the administrator was introduced to the company and any connections between the purchaser and the directors or shareholders of the company in administration. Full details should also be given of the reasoning behind the deal and alternative courses of action that were considered. Information should be provided on valuations obtained for the company’s business and assets, attempts to seek further financing, marketing of the business to other parties and all details of the actual transaction. All this information should be distributed to creditors as soon as possible to allow it to be considered in advance of the first creditors’ meeting. It remains to be seen whether this guidance will quell uneasiness about pre-packs. It should assist and certainly should serve as a reminder to insolvency practitioners of the need to satisfy themselves that a proposed pre-pack genuinely serves the interests of creditors as a whole.

\(^{358}\) Administrative receivership is no longer so common, as in 2002 the Government curtailed the circumstances in which this procedure may be appointed, in an attempt to encourage administrations and generally promote the corporate rescue culture. Hence in the Enterprise Act 2002, the Government removed the right of the holder of any floating charge created on or after 15 September 2003 (see s. 72A of Insolvency Act 1986) to appoint an administrative receiver other than in limited circumstances relating to large capital markets transactions or project finance agreements. Administrative receivers can still be appointed pursuant to security created prior to 15 September 2003, but, as many of these security agreements have now been superseded, the number of administrative receiverships is even-diminishing. Moreover, an administrative receiver cannot be appointed if an administrator is appointed first (IA 1986 Sch B1 43 (6A) ), though an administrative receiver cannot be displaced by a court appointed administrator without the consent of the creditor who appointed the administrative receiver (IA 1986 Sch B1 39 (1) ).
Characteristic of this strategy is that the administrative receiver should only sell off those assets required to satisfy the debt, after which he will vacate office and a liquidator will usually be appointed to deal with any residual assets of the company for the benefit of creditors generally and to wind up the company. The appointment of the administrative receiver is a quick and relatively straightforward process and prevent any intervention of administrators, who cannot be appointed without the consent of the administrative receiver.

The courts are not involved in the process nor is the consent of the directors of the company required although, in practice, it would be unusual for the directors not to know about the appointment before it is made. An administrative receiver has wide powers but they are not as extensive as those of an administrator. There is no moratorium on other creditors taking action to enforce their rights.

Finally, this proceeding is not recognized by EU law as a collective insolvency procedure, meaning that the appointment of an administrative receiver does not prevent other forms of insolvency proceedings commencing elsewhere in Europe where the company operates.\(^{359}\) The administrative receiver takes control of all assets subject to the security, so that he effectively controls the company and the assets remain in the ownership of the company. The directors are divested of their authority. The receiver has broad powers to run the company and will usually aim to sell the business or part of it as a going concern, as this has the best chance of realizing the whole amount of the debt secured. He does not generally deal with the claims of unsecured creditors save for the requirement to ring-fence a statutory “prescribed part” of floating charge assets reserved for unsecured creditors. When the secured assets have been realized and the proceeds paid to the appointing creditor, the company, deprived of the assets that would allow to continue to trade, will usually enter into liquidation.

A different type of receiver is that appointed under contractual rights granted since 15 September 2003 where the security has been granted over specific assets that do not constitute the whole or substantially the whole of the company’s assets. Such a receiver would not, by definition, be an administrative receiver, but a receiver appointed under a specific fixed. In practice, this figure is most likely to involve real estate, where

a fixed charge has been granted over a commercial property. The rights of a receiver appointed in these circumstances will depend entirely upon what powers he is granted by the security document. The default position for real estate is governed by the Law of Property Act 1925, which in simple terms allows a receiver only to take steps to secure and protect the property (e.g. provide insurance cover at the company’s expense) and receive the rents from the property. Any right to sell the property, carry out works on it, or in the case of a development, complete, must be granted in the security document, although this is common. A fixed charge receiver is not under a duty to report to other creditors and does not have to administer the statutory “prescribed part”\(^{360}\) of assets reserved for unsecured creditors, which relates only to assets covered by floating charges.

4.4.3. Modes of arrangement and compromise

Arrangements and compromises may be concluded in one of five ways:

1. As a compromise or arrangement under s. 425 of the Company Act;
2. as a company voluntary arrangement (CVA) under Part I of the Insolvency Act;
3. as an arrangement by way of reconstruction pursuant to s. 110 of the Insolvency Act;
4. as a compromise or arrangement by a liquidator under the Insolvency Act, ss. 165-167 and Sch. 4, para. 2;
5. as a non-statutory arrangement or compromise concluded by contract or informal arrangement (“restructuring” or “work-out”).

Section 425 of the Company Act, which can be invoked whether or not the company is in liquidation, involves obtaining the sanction of the court to a scheme approved by the requisite majority of creditors of each class at wherever possible. The procedure is cumbersome and most things that can be done under s. 425 can be more simply and expeditiously achieved by a CVA under Part I of the Insolvency Act, particularly since this can (and often will) be effected in the course of administration of the company under an administration order, where the administrator has the benefit of a statutory freeze on the enforcement of creditors’ rights. There is, however, one great advantage enjoyed by the s. 425 procedure over the CVA, in that once the scheme under

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\(^{360}\) See IA 1986 176.
s. 425 has been approved all creditors are bound\textsuperscript{361}, whereas a CVA binds only those creditors who in accordance with the rules had notice of and were entitled to vote at the meeting approving the arrangement\textsuperscript{362}. So s. 425, despite its drawbacks, continues to be used in a number of cases. Where the compromise or arrangement has been proposed for the purposes of or in connection with a scheme for reconstruction of any company or companies or any amalgamation the court is given specific powers when sanctioning the compromise or arrangement\textsuperscript{363}.

Section 110 deals with a specific form of arrangement by which the liquidator in a voluntary winding up may, with the sanction of the court or the liquidator committee, dispose of the company’s business to another company in exchange of shares, policies or other like interests in the Transferee company. Sections 165-167 and Sch. 4 to the Insolvency Act deal with the liquidator power to make compromises or arrangements with creditors, subject to his obtaining the requisite sanction. It has been held that this procedure is not appropriate as a means of distributing assets otherwise than in accordance with creditors’ strict legal rights, since the procedure lacks the safeguards for prospective dissentient creditors provided by s. 425\textsuperscript{364}. Compromises and arrangements under ss. 165-167 and Sch. 4 are quite distinct from CVAs, which are governed by Part I of the Insolvency Act 1986 and Part I of the Insolvency Rules 1986 and may be made even if the company is not in liquidation or administration. By contrast, arrangements under ss. 165-167 and para. 2 of Sch. 4 are confined to companies in liquidation and may be sanctioned either by the liquidation committee or by the court. The provisions relating to such arrangements are of long standing\textsuperscript{365} and they are particularly useful in cases where it is impracticable to convene meetings of creditors\textsuperscript{366}.

Finally, if creditors are willing a scheme of arrangements, including a reconstruction, can be effected by a workout outside the statutory provisions altogether, by contract or, in some cases, informal arrangement. The workout has several advantages; it avoids the formality, expense and delay of the statutory modes of arrangement, is much more flexible and generally leaves a greater degree of control.

\textsuperscript{362} IA 1986, s. 5 (2) (b).
\textsuperscript{363} Company Act 1985, s. 427.
\textsuperscript{364} See Re Trix Ltd [1970] 3 All ER 397.
\textsuperscript{365} They go back to s. 159 of the Companies Act 1862.
\textsuperscript{366} See Re Bank of Credit and Commerce International SA (n. 3) [1993] BLCL 1490.
with the management. In addition, it may enable the company to avoid an event of
default under its loan agreements, and the fact that it is being supported by its major
creditors helps to reduce in some measure the effect of the damage to its reputation of
becoming insolvent. The success of a workout does, however, depend on the
cooperation of all the creditors, which may be difficult to achieve unless they constitute
a relatively homogeneous group, such as a syndicate of banks.\footnote{367}

\textbf{Italy}

4.5. Creditors’ interests under Italian jurisdiction: three types of creditor control

As it has been try to justify, the pathologic situation of indebtedness, which
define a company in troubles (with no regard to the nature of the crisis) provides the
basis for a limitation of the shareholders’ control power. This connection has been
demonstrated in economic terms. The starting point is a reading of the insolvency state
as a \textit{discrimen} between two different corporate governance distribution of power. Following this economic thought, which is an application of the agency problems
theory, it can be argued that the imbalance between debt and equity may determine an
imbalance between the distribution of power which characterize a company with an
equity/debt balance. As a consequence, this pathological situation may also arise pre-
insolvency, that is, when a company is in troubles.

Having said that, even if it is far from easy to define these issues in law, it will be try to
understand whether that limitation of shareholder control in troubles companies may
find justifications also under law. For this purpose, it will be focused on Italian legal
strategies which, in solving potential agency conflicts between the actors who risk in the
business, will protect creditors, giving them (some) control power, and, maybe, some
power control liability.

\footnote{367}{Neverthe-
less, a study conducted by Professor J. Franks and O. Sussman, based on the private records of
three clearing banks, revealed a surprising high percentage of rescue based on informal work-outs. See \textit{The
Cycle of corporate distress, rescue and dissolution: a study of small and medium sized UK companies}, London,
2000, pp. 3ss. where it is said that “about 75\% of firms emerge from rescue and avoid formal insolvency
procedures altogether (after 7.5 months, on average). Either they are turned-around or they repay their debt by
finding alternative banking resources. The remaining 25\% of cases enter some form of insolvency procedure,
usually administrative receivership or winding up, Turnarounds are often accompanied by management
changes, asset sales, and new finance or directors’ guarantees. There is evidence that these changes
significantly influence the bank’s response and the likelihood of a successful outcome”.}
In speaking about the issues above, it will not be described specifically the strategies and remedies whose it will refers to, being the aim of this discussion far from making an exact and precise presentation of any legal strategies. As a result, it will be highlighted only some aspects which may be useful to understand to what extent and in what way, that is which legal remedies, creditors protection can be find under Italian law of company in troubles.

According to the severity of the troubles of the company and the consequently ability to absorb, internally or externally, the crisis, it is possible identify three main categories of out-of-court strategies. These are: control managements, controlled liquidations and contractual definitions; remedies which are connected with the almost three degrees of the troubles in continuing the activities of the company, that are danger of insolvency, insolvency transient, final state of the insolvency.

In relation to this subdivision, it has been outlined that the necessary condition for the adoption of management control is that the company has good prospects for income and that its financial equilibrium, though unstable, can be recovered by means coming from outside or self-financing. In economic field, it can be said that the control must be implemented by the creditors and this is deemed possible only if the company has a profitable, albeit modest, but capable of gradual improvements. Moreover, it can be noted that these forms of control unlikely affect the general creditors, since they are often concerned about the most important creditors or those with particular skills in the administrative or technical staff to monitor the progress of the company to control.

Controlled liquidation, instead, requires the decision to terminate the company and, therefore, it deviates from the forms taken by the company for the maintenance of business. It is argued that, in practice, the usefulness of this type of arrangement is to ensure effective control to creditors under the liquidation, by inspection, verification, and in the frequent statements of checking the final destination of the proceeds. In this case

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368 In severe cases then, when it is no longer a contractual rescue possible, the only way forward is the stage of formal proceedings under the Court.

case, consequently, creditors do not participate in decisions concerning the winding up operations, but check that the results correspond to those planned\textsuperscript{370}.

Finally, the out-of-court solutions can deal with company in insolvency. The peculiarity of this type of remedy, which may be identified in the out-of-court agreed, is that the success of the arrangement depends on agreements with each creditor. This does not necessarily mean that the arrangement is based on separate negotiations with individual creditors. Indeed, it is noted in this connection that a greater guarantee of success is found where negotiations will be concluded on the basis of conditions applied unitary to everyone, offering a comprehensive description to creditors supported by adequate documentation of the reasons and extent of losses, with the means available by which to fulfill its commitments to creditors\textsuperscript{371}.

As a result, it is necessary to establish a program for the realization of the assets, as well as an updated situation for guidance in assessing the liquidity of assets. The payment terms can then be differentiated with respect to certain categories of creditors. This event has given rise to discussions by those who believe that the negotiations out of court should respect the principle of \textit{par condicio creditorum}\textsuperscript{372}.

The brief analysis in economic terms as described above is the confirmation that, in relation to the means adopted, the legal effects differ for the debtor company and the creditors, depending on the severity of the troubles which involves the company. Where, in fact, the company is in a state of temporary crisis, the freedom of the debtor to negotiate with his creditors seems to suffer no limitations. Following this though, companies who are not insolvent do not necessarily have to take those precautions which the law imposes to an insolvent subject. Indeed, despite having to bear in mind the duty not to aggravate its state of distress to avoid the penalties provided under art. 217, n. 4 and 216, n. 3, l. fall., which should be applied after a bankrupt declaration, the debtor-company cannot be bound also to avoid that acts which will be potentially submitted to revoke under art. 64ss. or bottlenecks under article 72 l. fall. Consequently, the possible differential treatment carried out to creditors, when the company is in


\textsuperscript{372} Generally, see: Guatri, \textit{ult. op. cit.}, p. 1041; Perrone, \textit{Insolvenza, factum de non petendo e creditori pretermessi}, in \textit{Fall.}, 1992, p. 661.
troubles but in substantial solvency, has no legal consequences, in contrast to what happens when there is a declared insolvency. It follows that, when there is a situation of insolvency, it rises the most sensitive issues on how make agreements with creditors, lighting particularly the need to respect the discipline of the insolvency law principles, that are due to the pari passu. So there are discussions on the validity of that contractual remedies, as well as to the lawfulness of the same issues in terms of effectiveness against third parties outside that agreements. The starting point for some reflections on these issues may be that the loss of the legislative remedy provided for and regulated in respect of insolvency can be justified only as a contractual instrument is chosen such as to eliminate the state of insolvency.\textsuperscript{373}

Having pointed out that the real boundary (even if not easy to define) of the transfer of control power from shareholders to creditors is the “in troubles” company, the next step of discussion will be whether in this pathological situation the contractual remedies of distribution of power have to respect the principles which come from insolvency law, that are connected, in particular, with the par condicio creditorum principle.

4.6. Out-of-Court remedies

4.6.1. Pacta de non petendo

One of this contractual remedies is the so called pactum de non petendo.\textsuperscript{374} Generally, whether the organizational dysfunction or conditions of financial, economic or balance sheet instability, as described above, have affected the ability of the company (or of the entrepreneur in general), to fulfill her commitments with third parties, she will try to avoid the consequences provided by law for the case of full-blown crisis, concluding agreements with all or some of her creditors to obtain an extension of deadlines or a cut debts.

\textsuperscript{373} This is a point of great discussion which will not be treated here. See: Fauceglia, Panzani.

Under this pactum, creditors undertake not to require payment before a certain time; moreover, it can be the case of negotiating a reduction in interest rates, or conversion of loans into other property or rights. The company in troubles may also obtain new financing from her existing creditors who reserve, in some cases, to agree with the entrepreneur's strategic plan to help restore solvency. This is what happens, for example, in the complex agreements between the creditor bank and the contractor-company in crisis to support the attempt to restructure the company itself. Through this remedy the contractor may try to restore the lost equilibrium or even close down the business without incurring liability to the insolvency proceedings. These remedies are recognized in law provided that they do not violate the creditor interests. In this regard, the Insolvency Law also provides specific agreed solutions to the company troubles, that is, according to the provision under Italian Insolvency Law, when the company enter in a crisis. It is the case of art.182-bis l. fall., which states debt restructuring agreements, and art. 67, c. 3, let. d), l. fall., which sets up recovery plans.

However, when the crisis is not overcome by these strategies, or when there has been no attempt in this direction, the conditions for the application of specific obligations and legal duties arise, providing the protection of the interests involved in the company. Even in this case, the system favors solutions that enable the preservation of the business activities. The focus on the contractual remedies to the crisis of the company is one of four main directives provided by the reformer Legislator that are: to protect the interests of creditors by giving them more powers; to provide sanctions for failure proportionate and sustainable for the debtor; finally, to evaluate the company itself, understood as a business organization with its intrinsic value.

In this context it is possible to understand the importance of alternative remedies (alternative to winding up) which one designed to allow agreed definitions between company and creditors, such as the already mentioned art. 182-bis l. fall. The initiative is entirely up to the debtor. Creditors have no voice at this step, while the agreement, under the supervision of the judicial authority, will be concluded whether creditors approve the content of the debtor proposal. As I have already specified, it is out of the purpose of this discussion a description of the proceeding. Here it can be outlined, in order to understand the distribution of power between shareholders and creditors, that under art. 160ss (and the same for concordato fallimentare), if on the one hand, in

375 It is the same also under art. 160, which provides the so called concordato preventivo.
accordance with the *pari passu* principle, creditors have the veto power, on the other hand, creditors power can be limited by a court decision. Indeed, the latter will prevail on dissenting creditors if, in making a business decision on behalf of them, the test of “the best interest for creditors” is respected. This is a discretionary decision, albeit constrained to choose the alternative that best meets creditors’ interest. The *pari passu* principle seems have less power also according to other provisions. In particular, having regards to the contents of the agreement, linked to a possible subdivision of creditors into classes with different treatment; moreover it seems outline importance of other interests, such as the rescue of the business and the value of the firms as a business organization. The same recue issue can be find under art. 182-*bis* and under the special proceeding reserved for special and with large dimension (in terms of employees and level of indebtedness), that are L. 270/99 and 39/2004 as modified in 2009 to overcome the “Alitalia crisis”.

Finally, the law provides plans to enable consolidation, reorganization or restructuring in the context of established procedure, groped to make an accommodation crisis that gives the maximum possible survival of the business organization. The importance of the latter is outlined in the fact that, also whether there are no reasonable perspectives to save the company, neither the contractual remedies have any successful results, the (only) liquidation solution is a mechanism which try to evaluate the business organization, for instance, facilitating by the default rule under art. 104, c. 4, l. fall.\^{376} the continuation of the temporary business activities even when there is the state of insolvency.

4.6.2. The role of the bank creditor

Regarding the adoption of contractual solutions, the role of the banks is extremely important in terms of the manner of participation in the “rescue” of the business of company and also in the identification of a possible liability in the financing transaction of the company, then declared bankrupt. The bank is defined sometimes as a “victim” and sometimes as a “partner” with reference to the insolvency. Indeed, on the one hand, there are known the adverse effects linked to some aspects of

\[376\] The continuation of the temporary business activities when a company is bankrupted depend on the creditors’ decision (that is the creditors’ committee). Under art. 104 Insolvency Law, that continuation can be provided in two moments: in the decision by which the Court declares the bankruptcy of the company or then, by the delegated judge, who provides on proposal of the practitioner, with the necessary approval of the creditors’ committee.d1
the role of the bank. This is the case of the granting credit in two respects: that of illegal granting and that the sudden and unjustified termination or restriction of the exposure.\textsuperscript{377}

As to the second profile, detrimental situations to the firm in troubles may arise even in the event of breach by the bank of an out-of-court agreement between the company and the bank. This is the case, generally, of covenants tending to delay the performances of the parties or of a contract with clauses providing the funds needed to satisfy creditors not participating in the agreement. The effect that is linked to such agreements, classified according to the law as a real form of lending, is the removal of the state of insolvency by restoring liquidity. Consequently, non-compliance of the agreement may be an unexpected and unjustified termination of the credit. As a result, the possible discharge by breach of the bank overwhelms any possible effects of restoring liquidity positively evaluated for removing insolvency\textsuperscript{378}.

In addition to the above assumptions that traditionally constitute criminal liability of banks, it can be also made considerations regarding civil liability profiles. The theme is closely linked to the bank's role in “managing” the company. This occurs both through consultancy on financial strategies, both with the opportunity to participate within the limits set by law in the assets of the company. Consequently, banks become joint operators of companies in troubles\textsuperscript{379}.

Regarding the first type of bank participation in the management of the company\textsuperscript{380}, that is a control strategy, usually the company appoints an advisor who can be a single professional connected to the bank or a bank holding company or a bank financial company\textsuperscript{381}.


\textsuperscript{378} Guerra, Ristrutturazione del debito ed assistenza finanziaria all’impresa: il cd. consolidamento dei crediti bancari, in Banca, borsa, tit. cred., 1995, I, p. 806.

\textsuperscript{379} See T.U.B, d. lgs. 1.9.1993, n. 385

\textsuperscript{380} See art. 1, c. 2, let. g), n. 9, d. lgs. 1.9.1995, n. 385

In alternative, there can be an agreement concluded between the company and one or more banks in order to establish a plan to rescue the company\textsuperscript{382}. These agreements are structured in various ways, which may include the sale of the whole assets to another company, or to the members (separately or together), or finally, the access to an insolvency procedure. The agreement may also regulate the relationship of other subjects, such as subsidiary companies, members and creditors in various ways\textsuperscript{383}.

While not addressing here the problem of the nature of these conventions, it can be shown the variety of the content of these. It is the case, for instance, of the situations in which the intervention of banks provides for the waiver of credit (that is, part of the interest or part of the capital); or for a reassessment of the terms of debt (lengthening of repayment terms and interest payment); or moreover and peculiarly, for a recapitalization, which consists of a subscription by banks of all or part of the capital of the company in troubles, through conversion of loans into equity or fresh funds.

Furthermore, in this context, it is necessary a distinction between situations in which the ratio can be interpreted as an expression of general advice, for which eligibility is also provided between the extra credit activities, from other situations where, instead, banks control the funding for the recovery of their claims. In this last case, commentators have been set up banks as de facto managers of companies in troubles\textsuperscript{384}.

4.7. Standard strategies: managers’ duties to creditors

When liquidators are unable to pay creditors it should be distinguished: if the company is in the state of insolvency, the liquidator has the duty to conduct a procedure according to the pari passu principle. By contrast, if there is not a situation of insolvency, the liquidator has the freedom to “manage” the company. The point in the latter case is to what extent the liquidator can continue “to do the liquidator” according to the discipline under art. 2487 ss. c.c.. In particular, the question is whether he can or has to apply the pari passu rules if he has considered not possible to satisfy all creditors. From an abstract point of view, it can be argued that the liquidator does not have the


\textsuperscript{384} Fauceglia, op. cit, pp. 435.
mandatory duty to follow the insolvency rules at least when insolvency procedures cannot be opened, that is, those assumptions which can be derived under art. 1 l. fall. One solution could be found trying to extrapolate from the Italian law a principle that seems to have a general application.

Indeed, the Legislator when there is a distribution of the control under contract strategies between company (her members) in troubles and its creditors, when management is legally entrusted to a third party, namely the liquidator, the solution seems to be one for which that subject has the freedom to manage and choose the remedies which he considers appropriate, providing that, concretely, there are no more favorable alternatives to creditors protection. This ratio, as it has been mentioned above, is expressed in different provisions, for example, under art. 180 l. fall., in connection with the power of courts to make business decision opposed to (a class of) creditors, if she considers that in this way, these creditors can be satisfied at not less than the other concrete possible alternatives. It can be called the “best interest of creditor test”.

Directors, as well as being potentially liable for the same offenses as described above (Sections 224 and 223 l. fall.), when the risk of default is rising, become subject to new obligations and additional to those which they are normally subject to. The law makes them civilly liable for the damage caused to creditors through an administration that in the new context, does not take into account also the creditors’ interests. The techniques by which this result is achieved are indirect remedies, such as art. 2394 c.c., which sets up directors' liability to creditors for the social obligations regarding the preservation of assets and art. 2485 c.c., which states liability for compliance failure caused by the occurrence of a ground for dissolution; finally art. 2486, c. 2, concerning the liability for non-conservative managing in the assets after the dissolution of the company. Although the first and the second rules cover the violation of specific obligations and the third is connected with the violation of the obligation to preserve

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385 The same standard, that is the same principle, is provided in the case of “concordato fallimentare” under art. 129, c. 5, Insolvency Law.


387 On the contrary, UK jurisdiction provides for direct remedies. It is the case of Sec 213 and 214 of the Insolvency Act 1986 respectively on fraudulent trading and wrongful trading. Here the lack of assets is the only assumption of the liability, that, even if not explicitly, cover the damage caused to creditors by the continuation of activities. It can be observed that liability on the part of directors states if the company, although not insolvent, has no prospect of avoiding insolvency proceedings. See Continental Assurance Co of London Plc (27.4.2001).
heritage waiting for the appointment of liquidators, the result is that directors, when the asset is not enough and the business activities are continued, answerable for the caused losses.

Creditors’ protection cannot stop at this step. If the standards of criminal liability and liability actions are a deterrent, especially an *ex post* remedy, it is not indeed conceivable that creditors have to settle for the fact that the same directors, appointed by the shareholders and often closely linked, change their role and become now the “managers” of the company in the creditors’ interest. The company law rules are in fact operating, and the members are still entitled of the appointment and removal rights of directors.

The simplest and general solution would be to stop the further activities of the company. Consequently, the assets and the debt situation will be crystallized, and creditors would satisfy themselves with what is left in the debtor's assets. This solution, however, could be very detrimental to creditors too. The same result would vacate the individual creditors to recover what they are entitled. Their precautionary or executive actions would have the same destructive effect on the values of the company.

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388 This can be achieved before 2004 through the art in 2449 which prohibits the directors to carry out new activities, making them accountable to the company and the creditors for the losses that they have caused. It remains open today, the lack of relevance of insolvency which is not accompanied by even a loss of capital. While these are issues that may arise rarely, because the insolvency normally is connected with serious losses which can affect the capital, it denotes not a perfect equivalence with the system described above. A liability of this kind may arise under general principles of tort (art. 2043 and 2395 cc), or because of the delay in the request of having access to an insolvency proceeding (criminal prosecution under art. 217, n. 4 and 224). Therefore, the damage produced by this situation is compensable in chief to creditors who have suffered. Precisely for this reason it seems arise the need for the adoption of manager liability rules for the continuation of activities in a state of insolvency. Also some solutions adopted by the U.K. Courts are relevant to these purposes. In this regard, in *Credit Lyonnais bank Netherland, N. V. v. Pathe Communication Inc.*, it was argued, albeit in passing, that when the company is approaching insolvency, the board must make the interests of the company as a whole as “At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent for the residual risk bearers, but owes a duty to the corporate enterprise”. The common result is in the sense that when the company is insolvent the bond between directors’ board and shareholders should be cut. See *Credit Lyonnais bank Netherland, N. V. v. Pathe Communication Inc.* Del. Ch. C.A. N. 12150, 1991 W.L. 277613 (Del. Ch. 1991); A. Chaver, J. M. Fried, *Managers' Fiduciary Duty upon the Firm's Insolvency: Accounting for performance creditors*, in *Vanderbilt Law Review*, 2002 (55), 1813 ss., nt. 4.


390 See T. H. Jackson, *The logic and limits of Bankruptcy Law*, Harwald University Press, Cambridge, Mass.-London, 1986, according to which the main purpose of insolvency law is to prevent a destructive race to the debtor’s assets. See also Jorio, *Le crisi di impresa. Il Fallimento*, Giuffrè, Milano, 2000, 7, which emphasizes the preservation of the business unit during the procedure can sometimes be a tool for the most profitable realization of the assets. Understanding the “value” of the company as an organization, an entity capable of productive assessment, as distinct from the assets of the entrepreneur entity, depends on its ability to produce more wealth than that which it employs. It therefore has the same value regardless the financial structure of the company. So a company may be worth the same $ 100 is that the entrepreneur has failed to debts, or he has debts amounting to $ 200. The possibility that the assets has a positive value even if the company is in troubles can occur for several reasons.
So, firstly, the firm may have a positive value.\footnote{This is the scholar example reported in D. Baird, The element of Bankruptcy, III ed., The Foundation Press, Westbury NY, 2001, 63. Polaroid co. was in a serious crisis in the summer of 2001 partly because of accumulated debt for having pursued an unsuccessful attempt to expand the field of image for medical use. This does not mean that all assets were worthless. However, it is lower than was expected when the investment was made. For example, if the company filed for investments, stranded, for 1.000.000 euro and provides a steady MOL equal to Euro 20,000(ie formance annual rate of 2 percent of invested capital, clearly less than the cost of debt), it is likely that it is in crisis. This does not mean that it has a value of zero. In other words, it has cost too much, but still it has a positive value that is in the interest of creditors to keep. A very similar case and perhaps more frequent is that in which the company is burdened by the financial burden due to a mistaken investment (for example, attempts at expansion or diversification which are not going to succeed), which left the company with the same margins gain, but with many more debts.} Secondly, the company may miss today as a result of bad business decisions, but may be able to return to producing value through disposals of non-strategic assets, changes in strategies, etc., that is, using the cd. turnaround. Obviously, if there is a possibility that the firm now in crisis “return to the value”, the assessment will take account of that point. The assessments are in fact prospective and it is in the interest of the creditors recover a today lost business which tomorrow can go back to produce. Third, the crisis may be due to bad financial choices. For example, there are sectors of market (such as high technology) where it can take years of investment before they produce a useful result. A good contractor should plan the flow of funds to make sure you can build a bridge between monetization of costs and revenues, but the fact that there is an incorrect programming activities does not mean that the company is worthless and that, therefore, creditors have no interest in continuing activities.\footnote{See R. C. Higgins, Analysis for Financial Management, 5 Irwin McGraw-Hill, Boston, 1998, 120.} Finally, the assets of the entrepreneur may be composed of business units that create wealth on the one hand and, on the other, of business units which are destroying and not restructured. The latter may have produced losses that might kill the first, and it is evidently in the interest of creditors to separate the good from the bad ones.

As a consequence, it can be deduced that the existence of troubles for a company is not a sign of health of the company, but neither it is a clear signal of the opportunity to discontinue the business activities. It would be equally wrong, however, say that the failing enterprise must always be saved. There are companies unrestructurable except with costs that exceed the benefits, there are whole areas in decline due to the emergence of alternative technologies or changing consumer preferences, and so on. The aggressive treatment to the company in crisis can be devastating to the interests of creditors.
The onset of the crisis therefore requires a choice about the fate of the company. From a creditors point of view, a flexible procedure should be necessary. Central importance in this context is the distinction between the “value of the company” as a business organization and the “value of the assets” of that company. Creditors may have an interest in the continuation of the activities, because only through the latter operation, they may realize their value, recovering at least part of their credits. The death of the company so is not necessarily a solution that serves the interests of creditors. After all, no tool replacement ordinarily provided by law - such as a subrogation action under Art. 2900 cc, clearly unsuited to the case of defendant who neglects to manage a company well - allows them to avoid the debtor destroy wealth on which they could satisfy.

As a result it is showed that the transfer of control to creditors does not solve all problems because it needs to be supported by structures and rules which organize the control head to creditors and which have regard also to “other interests” (with no valuation about which one may be the prevalent), in particular the value of the continuation of the business activities.

4.8. Different interests and approaches to protect creditors in troubles companies

In this regard, some reflections should be useful. First it may be noted that creditors as a whole have a clear common objective: the greatest value of their (common) debtor assets, in whatever way it can be implemented and to the extent permitted total amount of their claims. So whether the company produces wealth or otherwise has a positive value (also with a view to restructuring), it is in the interest of the creditor group (not necessarily the individual creditor) in continuing business, but, whether the business destroys wealth and it is not susceptible to back to produce, it is in their interest ceases any activities. In general terms, they have an interest in each asset that is valued at the best way: e.g. credits should be monetized quickly and to the maximum extent achievable, non-productive property should be disposed of to the best buyer, and so on. One can say that the creditors have the interest that each asset is as useful as possible, that is specified in the continuation or termination of the business of the company depending on whether it is worth more as a going concern (complex of

393 If the company is worth 100 and the assets are burdened with debts that absorb (or negative exceed) the asset value, there is no longer interest in continuing the activities (except for groped a stroke of fortune at the expense of creditors ), because, anyway the owner of the company can no longer deal with the positive results of the activities which, on the contrary, will end up in the pockets of the creditors. So it is possible that a company that has a positive value, however, entirely absorbed by the debts, is left to die by her members, that is a quite rational decision for them, but that destroys wealth.
assets in assets) or as a set of disaggregated goods. However, the commonality of interests between creditors is not enough to make a cohesive group and able to exercise effective control. So, for instance, the large creditor secured by a mortgage is completely indifferent to the fate of the rest of the assets as its sole purpose is the rapid clearance of the object of his guarantee, even if this could damage others creditors. Moreover, the rules on business struggling firms are not certain in advance.

As a result, creditors, sharing the same aim, that is the maximum achievable satisfaction of their claims, are not part of an organized and well-functioning group or class, which are members, as they are weak controllers.

The systems provide different remedies in order to give answers to the problems described above when there is an insolvency. A first measure is that the debtor is deprived of the possession of his assets, an effect linked to the prohibition of individual enforcement actions on the part of creditors (art. 51, 168 Insolvency Law). The pari passu principle arises in the formal sense and substantial. It is created between the creditors a commonality of interests that did not exist. It is created between the creditors a trade association providing for the appointment of one or more individuals representing them (although with different functions and variously referred to as “curator”, as Italian practitioner or “commissario straordinario” as a kind of administrative receiver) by providing various forms of direct consultation and voting on certain types of decisions. It provides a framework of legal certainty, resolving conflicts between different creditors with different interests, for example, attributing the decision to approve a contractual solution of the crisis (concordato fallimentare) only to greater and / or class of creditors (127 and 177) or by attributing to the pledge, for example, the right to sell the thing given as security, unless the right to regain possession of the liquidator pays the creditor (53 l. fall.). The relation between the transfer of control and the organization of creditors vary in different insolvency procedures: sometimes decisions are made not by the creditors, but by third parties in the interest of creditors in other respects the decisions are taken directly from them. For instance, the special administration of large firms in crisis (amministrazione straordinaria delle grandi imprese in crisi, ex d. lgs. 8.7.1999, n. 270) produces an almost complete transfer of control to creditors, but it does not organize the category. Vice versa, the arrangement called “concordato preventivo” ex art. 160 ss., l. fall., produces a transfer attenuated but it is provided for a stronger organization.
The transfer of control meets several major obstacle\(^{394}\). When troubles arise, companies need a wealth of knowledge and information which are not always easily transferable (eg relating to the know-out, the market situation, etc.). Moreover, management is in possession of this information and should disclose to creditors, that are their “successor” in managing the crisis of the company. This step necessarily involves the emergence of agency problems. So, on the one hand, managers or members may not be able to properly manage the enterprise, since the crisis led to or may not have sufficient incentives; on the other hand, they may have incentives other than maximizing the satisfaction of creditors (for instance, they may prefer to transfer information outside of the company in view of their own direct or indirect benefit.

There is uncertainty on the decisions to be taken (what can be done with the assets of the debtor), on who should make such decisions (only creditors, and which of them, or even the borrower), and whether reallocate the rights to the debtor's assets (only among the creditors, all or a portion, or even by the debtor). Thus, for example, asset values are often uncertain and the present values of flows decisions making during a procedure may benefit one group or another. Moreover, it is necessary then to decide whether and how is it financed the cost of the business activities. Even if it is clear that there is goodwill to be saved, may be needed in the immediate liquidity of which the company does not hold. The same guidelines that must be followed in this twilight phase are partly uncertain: although in theory, it is scheduled to be assured that the art. 2740 and art. 2741 c.c., it seems inevitable raises the possibility for the debtor to save something, and this in the creditors’ interest. The main goal is to manage the uncertainty in step to the achievement of the interest protected by law. It is however not unique as it is that interest or, more precisely, if the protected interest is only the creditors’ one or whether the latter is just one of the protected interests.

4.9. “Other different interests”

There are several clues which can show that “others” than creditors’ interests arise and whose the law give some protection. For instance, assuming that the negotiation is the starting point for defining the powers of the creditors, in this discussion I will try to understand to what extent can one speak of effective constructive in the sense of operating a power add-in-chief to the creditors in order to ensure an

\(^{394}\) As it has been already said, the first one is to define clearly when the “troubles” of a company become crisis situations.
distribuite the powers of the shareholders. The art. 2409 c.c. seems to be a possibility in this regard, providing the business administration of the company by a person appointed by the court where, under the provision referred to, there has been a complaint for serious misconduct. It is considered that the scope of this rule also covers problems connected with capital operations.

In another context, it can be mentioned art. 90 Insolvency Law, which seems a clear index of the importance that the Legislator gives to the continuity of the business activities and, consequently, to the value of the company as an organization.

Moreover, art. 63 d.l.gs. 270/1999 deals with the necessity to take into account, as reductive part of the sale price, the negative profitability due to the maintenance of jobs partly or wholly unproductive. As a consequence, it can be argued that the creditor interests are postponed by a mandatory rule which states a specific behavior they have to attempt.

For this analysis it is essential to ascertain what are the appropriate goals. Based on the model of control of a solvent company, the law, as it has been seen, allows shareholders to establish general guidelines for the management and to choose those who will actually implement such guidelines. This is on account of their status as providers of risk capital, or residual claimants, justifying the allocation of power. It is on this system that is based, for better or for worse, the market economy that is a constituent element of private enterprise and constitutionally recognized (Article 41 Constitution). This does not mean that there is no room for different interests to those of shareholders and directors must pursue them to the detriment of any other interests: research interests other than profit are presented as the outer limit to that of shareholders in the sense that there is no profit without good relations with employees, suppliers, customer, ie the so-called stakeholders, or to persons who have an interest to the smooth operation of the enterprise. There are also those who believe that directors should be pushed further, mediating the interests of various stakeholders. Again, other people talk about corporate social responsibility, the subject of increasing attention in the EU framework, where he emphasizes the impact with the company395.

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395 Commission Communication COM/2002/347. The potential of the so called “CSR” (that is company social responsibility) policies to strengthen the symbiotic relationship between enterprises and society has already been demonstrated in areas such as sustainable growth, education and social cohesion. CSR can support the creation of an atmosphere of trust within companies, which leads to a stronger commitment of employees and higher innovation performance. A similar atmosphere of trust in cooperation among other stakeholders (business partners, suppliers, and consumers) can increase the external innovation performance. Consumer confidence fostered through CSR can be a major contributor to
This framework of values for the company in normal operation and solvent cannot be arbitrarily altered when the company becomes insolvent. According to legislation, under articles 2484, n. 6, 2485, 2486, 2487 and 2489, members may at any time decide to put the company into liquidation, with the associated effect of the rise of a limitation on the powers of directors, which is required to preserve the heritage, and the rise of the bonds appointment of liquidators, which is required to liquidate. If therefore the decision to stop a business which can no longer survive belongs to those who have voluntarily provide risk capital, it is unthinkable that this decision is precluded from creditors, that are involuntary suppliers of venture capital.

System consistency wants therefore creditors as operators. However, as in most cases they are not an organized group in advance (it may be a consortium of banks, but not representative of all creditors), it is necessary to appoint a “manager”. The appointment in the UK lies with the creditors themselves. In Italy to a judicial or administrative authority (receivers or other manager).

Insolvency state certifies that the financial market no longer believes the ability of the debtor to repay the debt already accumulated, and then refuses to provide new credit. The insolvency manifestation in terms of financial flows is a clue, imperfect but significant, of the existence of a lack of assets, connected to which the legislator made an external intervention in the management of the company. The insolvent company is therefore a company whose real shareholders, as residual claimants, are the creditors. The consistency of the system, as mentioned above, requires that, where possible, the same rights and the same protections enjoyed by the shareholders of a solvent company may be given to the creditors of a company in troubles and that they are subject to the same constraints restricting the action of the first one.

Concluding remarks

Italian insolvency procedures do not fully respond to this model, indeed:

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economic growth. CSR policies can also boost the societal benefit that enterprises create with regard to innovation. Indeed, the desire of enterprises to improve their risk management is a powerful factor behind CSR. Enterprises generally agree that CSR helps them in managing their risks, their intangible assets, their internal processes, and their relations with internal and external stakeholders. It has also been argued that opportunities and advantages for enterprises stemming from complying with international social and environmental conventions, norms or "soft law “ instruments can outweigh costs. Although most businesses support the assumption of a positive impact of CSR on competitiveness, particularly in the long term, they are however not able to quantify this effect”.
- in some cases the protection of creditors is weakened by the protection of other interests (such as those of employees or the value of the business activities), whose cost is attributed to the creditors, rather than the community as a social safety net;
- creditors have no power to choose and appoint their representative, that is the one who shall manage the assets of the insolvent debtor in their interest (consider the appointment of the liquidator or the practitioner), neither have the power to appoint other experts who may be useful during the insolvency proceeding;
- creditors have no voice in deciding alternative views to the liquidation of assets if no agreements with the debtor are made (moreover also see the limits of 182-bis Insolvency Law and the agreement under art. 160 ss., called “concordato preventivo”, where the initiative is entirely up to the debtor, not to the creditors). An exception to this principle can be found in the discipline under art. 78 l. 270/1999, which provides the possibility for a third party to present the proposal for the agreement (this is the case of a transfer of the assets to a third party, that is an alternative, even if more efficient, to the winding up); finally, under art. 4-bis, c. 1, l. 39/2004 the practitioner may propose an agreed solution in terms of debt restructuring or satisfaction of claims by any forms. In this context, it can be also outlined that the content of the covenant may provide the allocation of shares to creditors, or bonds or convertible bonds to shares or other securities. As a result, by law it is allowed to propose to creditors to convert debt into equity of the debtor company;
- creditors have no possibility to influence the management of the property even when they represent a majority of the claims, except the weak instrument of claim against the acts of the practitioner and the special practitioner (art 36 l. fall. and 65, d. lgs. 270 / 99); during an insolvency procedure every expert or practitioner is appointed and chosen by the court or by other juridical authority or by an administrative authority;

397 This is a legal strategy which requires the cancellation of previous shares and the issuance of new shares in favor of the creditors, assuming the allocation of powers to the practitioner instead of the shareholders in special meeting. That is why this remedy was discussed and, according to some commentators, reserved to s.r.l. and avoided for s.p.a. This last assertion was supported by the fact that this capital increase without a previous shareholder decision should be inconsistent with the EC Guideline requires, according to which the capital increases have to be deliberated by the shareholders; see: Paftitis v. Banca Trapeza Kentriks Ellandos AE, CE Court of Justice, 12.3.1993, C-4491/93, in Società, 1996, p. 977; in Giust. civ., 1996, I, p. 2773; in Foro it., 1997, IV, p. 131, in accordance with the art. 25 of the 2nd Commercial Law Directive 77/91/CEE.
398 D. lgs. 8.7.1999, n. 270 – Nuova disciplina dell’amministrazione straordinaria delle grandi imprese in stato di insolvenza, a norma dell’articolo 1 della legge 30 luglio 1998, n. 274, in G.U. 9.9.1999, n. 185, called “Prodi bis”, which has repealed the “Prodi” law, that is D.L. 30.5.1979, n. 26- Provvedimenti urgenti per
- a positive side is that creditors bound by the editor for selected determinants (Article 90ss.), but there are also several areas in which their opinion is not binding; it is the new Insolvency Law, as has been reformed, that has reformed the previous approach in favor, nowadays, of a stronger power of the Creditor committee to make the main important decisions during an insolvency procedure.

- Creditors cannot bring the action of proportional liability to remove the practitioner, chance that is only allowed to the new practitioner appointed by the court, and only at the end of this procedure individual creditors can take that action, with problems of rational apathy for small creditors (who would spend to take more than they can expected);

- receiver’s point of view does not necessarily coincide with those of creditors. Creditor rights in different areas are recessive with respect to the conservation of business as a means of wealth for the community. A peculiar example in this sense is the l. 39/2004 already as modified in 2008\(^399\), which gives evidence to the new approach of the Legislator. That intent is no longer to maintain the integrity of the assets as a source of employment and wealth for the community, but the aim is to allow the continuation of the activities considered in the public interest, which has held the company in that procedure of special administration and which will take place by the newco using only the purchaser of goods and contracts to enrich those already held\(^400\).

As a result, if one of the purposes of company law is to reduce the agency costs arising from potential non-coincidence of research interests between shareholders and directors, when troubles arise, reading creditors as residual claimants (bearers of risk capital) constitutes the triumph of those costs. These are costs of control (supported by the principal), warranty costs (supported by the agent, who shall return them to the principal) and residual loss not avoided\(^401\). At the time of onset of insolvency the directors appointed by the shareholders (which, even if in an imperfect way, have the tools of corporate governance which protect them) there is the transition of management on the part of the manager appointed by an external authority. Creditors, who are in the

middle, have no power in appointing the liquidator, and they are held just as passive recipients and away during the time in which he works.

- Directors may have specific duties to protect creditors when a threat is looming for the satisfaction of their reasons, regardless of a loss of social capital, so as to strengthen their control on the basis of guidance from the English model, and above all, prevent the damage that creditors may suffer in the twilight phase of the undertaking (Articles 2484 as we have seen are inadequate for that purpose). The goal should be, on the one hand, to avoid insolvency solutions do not agree with the creditors, by the other to give certainty and stability of these solutions even in case of possible failure in the rescue attempt.

Having said that, some remedies should be proposed, which deal with the U.K. experience, that are; firstly, it should be indicated clearer under law that creditors can replace the shareholders in the event of the insolvency of the company. The benefit of limited liability has, as a necessary pendant, the fact that the shareholder who (legitimately) decide not to recapitalize the insolvent firm, has changed hands to creditors. It is therefore quite proper to provide tools which, in substance, permit (but not compulsory) the creditors to replace the old shareholders compulsively, acquiring shares of a company's financed rebalanced capital structure precisely because all the credit, or a substantial part, has been converted into shares (l. 39/2004).

Moreover, another strategy should be to allow creditors to choose and control their representative. In this sense the U.K. procedures are an example worthy of great attention. Indeed even after the Enterprise Act 2002 which reduced the administrative receivership, creditor usually directly appoint their representative (sometimes it is the company or the court to appoint an interim representative, being increasingly replaced by creditors, usually selected after informal consultation with major creditors). For instance, in the administration proceeding (in which the activities of businesses continue without permitting any actions of creditors, in order to seek an agreement with its creditors), the creditors' meeting has the power to replace an administrator appointed by the company (ex par. 97 (1) of Schedule B1 of the Insolvency Act 1986, introduced by the Act Enterprise 2002), and in fact often the power to appoint directly accruing to the creditor holding a general privilege on the property of the company or floating charge (section 14 (1) of Schedule B1 above), as finally the power to appoint a liquidator under Art. 100 Insolvency Act 1986.
Finally, it should be useful to provide an organic restructurated financial process. In the few cases where there is an asset to manage (cases which are nevertheless often economically and socially relevant) should be given to creditors chance to participate in a real restructuring program. This requires the establishment of market mechanisms aimed at the alienation of assets and the company in business without the pressure of liquidation.\textsuperscript{402}

\textsuperscript{402} In this regard, M. J. Roe, Chapter 11 and the Market, 7.6.2002 discussion in Florence.


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