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Roberta S. Karmel

Brooklyn Law School, roberta.karmel@brooklaw.edu

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THE DUTY OF DIRECTORS TO NON-SHAREHOLDER CONSTITUENCIES IN CONTROL TRANSACTIONS—A COMPARISON OF U.S. AND U.K. LAW

*Roberta S. Karmel**

INTRODUCTION

Directors of corporations in the United States and the United Kingdom owe fiduciary duties to their shareholders which are based on the same common law tradition.¹ The scope and nature of these duties are being tested by the market for corporate control being waged on both sides of the Atlantic.² Among other developments, non-shareholder constituencies, especially employees³ and bondholders,⁴ are asserting that their interests as well as shareholders' interests should be considered by directors deliberating a control transaction. The claims of non-shareholder constituencies have drawn mixed response.

This article will compare the law relating to non-shareholder claims in the United States and the United Kingdom. Very generally, U.S. law is evolving to the view that directors may, but are not required, to consider non-shareholder interests. In the United Kingdom, the duty to shareholders is formulated as a duty to future as well as current shareholders, which, as a practical matter, may involve taking non-shareholder constituencies into account. Further, U.K. directors owe a general duty to em-

*Roberta S. Karmel, B.A. Radcliffe 1959; LL.B. New York University 1962, is a Professor of Law and Co-Director of the Center for the Study of International Business Law, Brooklyn Law School. She is also a Partner of Kelley Drye & Warren and was a Commissioner of the Securities and Exchange Commission from 1977-80. During the Fall 1989 term, she was a Visiting Professor at the University of Notre Dame London Law Centre, where she performed some of the research for this article. A research stipend from Brooklyn Law School was helpful in the preparation of this article. The research assistance of Brooklyn Law School students Lee Michael Huttner and Lawrence R. Plotkin is gratefully acknowledged. The comments of John L.T. Newbegin and Ann Giles of Cameron Markby Hewitt and of Professor Arthur Pinto of Brooklyn Law School were helpful and appreciated. The date of this article is November 1, 1989.

1. See *Charitable Corp. v. Sutton*, 2 Atk. 400 (1742).

2. Although hostile takeovers are a relatively recent phenomenon in Europe, U.S. techniques are being exported to Britain. See Lublin & Forman, *Europe's Merger Boom Triggers an Invasion by U.S. Deal Makers*, Wall St. J., Aug. 23, 1989, at A1, col. 6. See generally Brayne, *Tender Offers Involving U.K. Companies*, 21 REV. OF SEC. & COMM. REG. (Standard & Poor's) 67 (Apr. 27, 1988). The Gold Fields and B.A.T. battles have been transatlantic corporate control contests. See *A Tale of Two Takeovers*, Wall St. J., July 17, 1989, at A10, col. 1. See also *Consolidated Gold Fields PLC v. Minorco, S.A.*, 871 F.2d 252 (2d Cir. 1989), *app. pending*. Management buy-outs also have become popular. See *Larger Management Buy-Outs 1981/1989*, Fin. Times, Oct. 11, 1989, at §§ III, XII.

3. For a discussion of employee claims, see *infra* notes 29-57 and accompanying text.

4. For a discussion of bondholder claims, see *infra* notes 58-81 and accompanying text.

ployees. Yet, any direct duty to employees or creditors in a takeover is inchoate in both countries.

Nevertheless, U.S. corporations have seized upon the idea of non-shareholder interests as a way to shift decision making about a corporation's future from shareholders to management. Whether U.K. boards could do the same thing is an interesting question. A potential threat to the flexibility of board decision making is that a change in the political environment could transform the freedom to consider non-shareholder constituencies into a legal obligation.

I. DUTIES OF DIRECTORS UNDER U.S. LAW

A. *Duties to Shareholders*

1. *Care and loyalty*

Although federal regulation, in particular the federal securities laws,⁵ impose various duties on directors of U.S. corporations to stockholders and others, the basic duties of care and loyalty are governed by state law. The duty of care which directors owe to their corporation and its shareholders is generally expressed as that degree of skill, diligence and care that an ordinary prudent person would exercise in similar circumstances.⁶ The duty of loyalty, sometimes expressed as a duty of fair dealing,⁷ requires directors who have a conflict of interest to demonstrate the fairness of a transaction in which they are interested.⁸

The burdens imposed upon directors by the duties of care and loyalty are threshold requirements that must be met before a court will apply the business judgment rule, which shields directors from liability for disinterested business decisions made with due care, in good faith, and without an abuse of discretion.⁹ Classic corporation law principles concerning the duties of care and loyalty and the business judgment rule have been severely strained by the takeover battles of the past decade.

In reaction to the highly publicized *Smith v. Van Gorkom* case¹⁰ imposing liability on directors for failure to exercise due care in a change of control situation, Delaware and numerous other states passed legislation

5. Disclosure obligations in public offerings are imposed by the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1988). Shareholders are accorded additional informational rights under the proxy provisions, tender offer provisions and antifraud provisions of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-771l (1988). As a general matter, breaches of fiduciary duty are not actionable under the federal securities laws. *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 477 (1977).

6. REVISED MODEL BUSINESS CORPORATION ACT § 8.30 (1984). See D. BLOCK, N. BARTON & S. RADIN, *THE BUSINESS JUDGMENT RULE* 28 (2d ed. 1988).

7. See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983).

8. W. FLETCHER, *CYCLOPEDIA OF CORPORATIONS* § 931 (perm. ed. 1986). See ALI, *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS* § 5.08 at 107. (Tent. Draft No. 3, 1984) [hereinafter *ALI PRINCIPLES*].

9. D. BLOCK, N. BARTON & S. RADIN, *supra* note 6, at 12.

10. 488 A.2d 858 (Del. 1985). This case and its aftermath are discussed in A. FLEISCHER, G. HAZARD & M. KLIPPER, *BOARD GAMES* (1988).

permitting corporations to limit or eliminate the personal liability of directors for breach of the duty of care.¹¹ However, in cases involving target company defenses against hostile takeovers, the line between the duty of care and the duty of loyalty has sometimes become blurred because courts recognize that directors often are interested in remaining in office.¹²

In the context of a takeover, the business judgment rule grants the same protection to directors as in any other context. Directors can use their business judgment to keep a corporation independent. However, in *Unocal Corp. v. Mesa Petroleum Co.*,¹³ the Delaware Supreme Court developed two prerequisites for the application of the business judgment rule to anti-takeover measures. First, the board must demonstrate good faith and a reasonable investigation to prove that protection of the corporate enterprise and shareholders is necessary. Second, defensive measures must be reasonable in the face of the threat posed.

2. Long-term versus short-term values

There is no requirement that directors sell a company to the highest bidder unless the corporation is engaged in a sale of the firm or change of control transaction.¹⁴ Therefore, the duty of corporate directors does not become solely one of profit maximization unless and until sale of the company is inevitable.¹⁵ This important principle that directors may prefer long-term value over short-term shareholder gain, and need not sell a company to the highest bidder, was affirmed, at least for Delaware corporations, in *Paramount Communications, Inc. v. Time Inc.*¹⁶ The facts of the *Paramount* case are instructive because they suggest that long-term

11. In Delaware shareholders can adopt a charter provision limiting or even eliminating the personal liability of a director except for breach of the duty of loyalty or intentional misconduct. DEL. CODE ANN. tit. 8, § 102(b)(7) (1974 & Cum. Supp.1988). Many other states have followed this approach. See, e.g., N.Y. BUS. CORP. LAW § 717(b) (McKinney Supp. 1988). Other states have simply lowered the duty of care. See Hazen, *Corporate Directors' Accountability: The Race to the Bottom—The Second Lap*, 66 N.C. L. REV. 171, 174-77 (1984). Some have even suggested that directors be permitted to opt out of duty of loyalty obligations. See generally Branson, *Assault on Another Citadel: Attempts to Curtail the Fiduciary Standard of Loyalty Applicable to Corporate Directors*, 57 FORDHAM L. REV. 376 (1988).

12. When a board fights a takeover, there is the danger that it is "acting primarily in its own interests, rather than those of the corporation and its shareholders." *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985).

13. *Id.*

14. Reder, *The Obligation of a Director of a Delaware Corporation to Act as an Auctioneer*, 44 BUS. LAW. 275, 279 (1989).

15. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986). Even an exclusive duty to shareholders in an auction of the company allows directors to consider factors in addition to price such as the form of the consideration paid, timing and probability of consummation. *In re J.P. Stevens & Co., Inc. Shareholders Litigation*, 542 A.2d 770, 781 n.6 (Del. Ch. 1988).

16. [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514 at 93,264 (Del. Ch. July 14, 1989), *aff'd*, *Literary Partners, L.P. v. Time, Inc.*, (Del. 1989) (Lexis, States Library, Del. file).

value may not be exclusively economic. In July, 1988, the board of directors of Time Incorporated ("Time") authorized its management to negotiate a merger agreement with Warner Communications Inc. ("Warner"). From the outset, the merger was conditioned on a desire to maintain an independent Time culture. This included succession of Time management to senior positions in the merged entity. Of serious importance was the continued editorial independence of Time magazine. On March 3, 1989, the directors of Warner and Time, both Delaware corporations, agreed to a merger whereby Warner shareholders would receive .465 shares of Time for each share of Warner. At the conclusion of the merger, Warner shareholders would own approximately 62 per cent of the outstanding shares of the new combined entity.

The new combined entity would not have been highly leveraged. Since the merger agreement provided that only Warner shares would be converted, Delaware law required a vote only by Warner shareholders.¹⁷ However, the rules of the New York Stock Exchange, Inc. ("NYSE") required a vote by Time shareholders too,¹⁸ so the merger agreement provided for a vote by the shareholders of both companies. Time's shareholders were scheduled to vote on June 23, 1989.

On June 7, 1989, Paramount Communications, Inc. ("Paramount") made a cash tender offer for all outstanding Time common stock at \$175 a share. At a June 16, 1989, meeting, Time's board concluded that the Paramount offer was inadequate. The board also concluded that it was not in the long-term interest of Time or its shareholders to sell the corporation at that time. Accordingly, Time's board restructured the merger as a tender offer by Time for Warner stock at \$70 a share. The tender made shareholder approval unnecessary and also resulted in a significant leveraging of Time.¹⁹ Paramount, joined by both substantial individual Time shareholders and a purported shareholder class, sued to enjoin the Time tender offer for Warner.

Chancellor Allen was confronted with two issues: first, whether Time's directors were under an obligation to seek, in good faith, only to maximize current share value on June 16; second, whether the circumstances imposed upon the Time board a fiduciary obligation to afford to shareholders a choice with respect to whether the corporation should be sold or managed for the long term. Both questions were answered in the negative. The court held that the original merger agreement was not a change of control transaction because the shares of Time and Warner were so widely held that neither corporation could be said to be acquiring the other. "Control of both remained in a large, fluid, changeable and changing market."²⁰ Moreover, Chancellor Allen held that the Time

17. DEL. CODE ANN. tit. 8, § 251 (1974 & Cum. Supp. 1988).

18. N.Y.S.E. Rule 312, 2 N.Y.S.E. Guide (CCH) ¶ 2312 (1988).

19. See Kneale, *Time Warner Offers a Cashless Package of Stock for Remaining Warner Shares*, Wall St. J., Aug. 24, 1989, at A2, col. 2.

20. [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,280. The court recognized that Time shareholders would have suffered dilution. This is the basis of the

board was under no duty to let the Time shareholders decide whether the Paramount offer was better than the Time tender offer. This was because the Time board's restructuring was a reasonable response to the threat that its long term strategic plan would be thwarted.

The interesting question in this case is just what was the long-term value the directors were allowed to protect against the wishes of their shareholders. Although Chancellor Allen found that the Time directors were concerned "for the larger role of the enterprise in society," he decided that there was an "insufficient basis to suppose . . . that such concerns caused the directors to sacrifice or ignore their duty to seek to maximize in the long run financial returns to the corporation and its stockholders."²¹ Yet, the Chancellor acknowledged that in an efficient well-developed stock market there should be "no discount for long-term profit maximizing behavior except that reflected in the discount for the time value of money."²² Further, he recognized that the concept of long-term management includes charitable giving and similar endeavors.²³

Defensive recapitalizations have been upheld in prior cases.²⁴ Further, the principle that directors need not pursue immediate maximization of share value at the expense of long-term strategic plans had been articulated previously.²⁵ Indeed, in a prior case in which Chancellor Allen refused to compel a board of directors to redeem a shareholder rights ("poison pill") plan in the face of a tender offer conditioned on such redemption, the court recognized that the proposition that directors owe a duty "to the corporation and its shareholders" masks the fundamental issue. What interest does the board represent in resolving shareholder long-term interests, or corporate entity interests, or multi-constituency interests on the one hand, and shareholder short-term interests or current share value interests on the other hand?²⁶ Further, permitting directors to consider long-term interests allows them to support research and product development, personnel training and compensation, and charitable and community support.²⁷ Nevertheless, *Paramount* goes somewhat further than prior cases in permitting directors to consider constituencies beyond today's shareholders.²⁸

NYSE rule requiring a shareholder vote in such situations, *supra* note 18. The significance of this ruling to the case is that if there is no sale of control, there is no "Revlon" duty to maximize a sale price.

21. *Id.* at 93,269.

22. *Id.* at 93,277. In his view, directors may reject efficient market theory and operate on the theory that stock market valuation is "wrong."

23. *Id.* at n.15.

24. *E.g.*, *City Capital Assocs. Ltd. Partnership v. Interco, Inc.*, 551 A.2d 787 (Del. Ch. 1988), *appeal dismissed*, 556 A.2d 1070 (Del. 1988); *GAF Corp. v. Union Carbide Corp.*, 624 F. Supp. 1016 (S.D.N.Y. 1985).

25. *TW Services, Inc. v. SWT Acquisition Corp.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334 at 92,173 (Del. Ch. Mar. 2, 1989).

26. *Id.* at 92,178.

27. *Id.* at n.6.

28. "The mission of the firm is not seen by those involved with it as wholly economic, nor the continued existence of its distinctive identity as a matter of indifference." [1989

B. Duties to Employees

1. The stakeholder statutes

Under classic U.S. corporation law, the primary beneficiaries of the duties owed by directors are the shareholders,²⁹ because a basic objective of the corporation is to enhance shareholder value.³⁰ However, a developing suspicion of institutional investors who hold stock only for short-term gain³¹ and the perception that hostile takeovers result in the loss of employment³² have persuaded some state legislators to change the nature of a director's duty, substituting the concept of duty to various constituencies for the traditional duty to shareholders.³³ These "stakeholder" statutes are different from the change of control statutes which purport to protect shareholders,³⁴ but have been passed at the behest of similar non-shareholder constituencies and have the effect of thwarting hostile takeovers.³⁵

Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514 at 93,269.

29. See, e.g., *Dodge v. Ford Motor Co.*, 204 Mich. 459, 170 N.W. 668, 684 (1919); Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931). Directors owe their duties to the shareholders as a body, not to individual shareholders. 3 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 848 (rev. perm. ed. 1986). For a discussion of directors' duties to shareholders, see *infra* note 84 and accompanying text.

30. See Schwartz, *Defining the Corporate Objective: Section 2.01 of the ALI's Principles*, 52 GEO. WASH. L. REV. 511, 512, 528-29 (1984).

31. See Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 104 (1979).

32. See Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 70 (1986); Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 120-22 (1987).

33. See Coffee, *The Future of Corporate Federalism: State Competition and the New Trend Toward De Facto Federal Minimum Standards*, 8 CARDOZO L. REV. 759, 770 (1987); Karmel, *Duty to the Target: Is an Attorney's Duty to the Corporation a Paradigm for Directors?*, 39 HASTINGS L.J. 677, 695 (1988); Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1, 35-43 (1987).

34. N.Y. BUS. CORP. LAW § 912(b) (McKinney Supp. 1988) is typical. It prohibits an interested shareholder (20% holder) from effecting any business combination with the corporation for a period of 5 years unless there is approval by the board of directors of either the purchase of the 20% interest or the interested business combination. A similar Indiana statute was held constitutional in *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69, 94 (1987). For a discussion of the constitutional issues, see Pinto, *The Constitution and the Market for Corporate Control: State Takeover Statutes after CTS Corp.*, 29 WILLIAM & MARY L. REV. 699 (1988). This type of "control share" statute shifts power from the shareholders to the board of directors. After this case, the North American Securities Administrators Association and the American Bar Association proposed a Model Control Share Act, 20 Sec. Reg. & L. Rep. (BNA) 708 (May 6, 1988). The Delaware statute, DEL. CODE ANN. tit. 8, § 203 (Supp. 1989), which forces an interested business combination to a vote by disinterested shareholders, represents a less dramatic shift of power to the board. Since "control share" statutes are purportedly based on a duty to shareholders, they will not be discussed further in this article.

35. Johnson & Millon, *Missing the Point About State Takeover Statutes*, 87 MICH. L. REV. 846 (1989); Note, *Takeover Dangers and Non-Shareholders: Who Should Be Our Brothers' Keepers?*, 1 COLUM. BUS. L. REV. 301, 304-08 (1988). A similar anti-takeover interest group may be developing in the United Kingdom. See Waller, *Merger Mania Comes*

The first stakeholder statute was passed in Pennsylvania in 1986 and provides that in discharging their duties directors may, "in considering the best interests of the corporation, consider the effects of any action upon employees, upon suppliers and customers of the corporation, and upon communities in which offices or other establishments of the corporation are located, and all other pertinent factors."³⁶ More than a dozen states have passed similar laws.³⁷

Some of the statutes formulate the stakeholder concept in terms of long-term shareholder value and permit directors to consider the current value of the corporation in an orderly liquidation or sale versus the future value of the corporation over a period of years as an independent entity.³⁸ The recently enacted New York statute is broadly worded and addressed to a wide range of constituencies. It provides that in taking action as a director, including voting on any potential or actual change of control of the corporation,

. . . a director shall be entitled to consider, without limitation, (1) both the long-term and short-term interests of the corporation and its shareholders and (2) the effects that the corporation's actions may have in the short-term or in the long-term upon any of the following:

- (i) the prospects for potential growth, development, productivity and profitability of the corporation;
- (ii) the corporation's current employees;
- (iii) the corporation's retired employees and other beneficiaries receiving or entitled to receive retirement, welfare or similar benefits from or pursuant to any plan sponsored, or agreement entered into by the corporation;
- (iv) the corporation's customers and creditors; and
- (v) the ability of the corporation to provide, as a going concern goods, services, employment opportunities and employment benefits and otherwise contribute to the communities in which it does business.³⁹

Under the Microscope, Fin. Times, Oct. 23, 1989, at 14, col. 4.

36. 42 PA. CONS. STAT. ANN. § 8363(b) (Purdon Supp. 1988).

37. CAL. CORP. CODE § 309 (West 1987); 1989 FLA. SESS. LAW SERV. § 607.11(q) (West); ILL. REV. STAT. ch. 32 ¶ 8.85 (1985); IND. CODE ANN. § 23-1-29.2 (Burns 1987) (as amended by S.E.A. No. 255 § 2(d) (Burns Adv. Legis. Serv. 1989)); ME. REV. STAT. ANN. tit. 13-A, § 716 (Supp. 1985); Mass. Gen. L. ch. 172, § 13 (1987) (as amended by 1989 Mass. Adv. Legis. Serv. Ch. 242 § 15 (Law. Co-op)); MINN. STAT. ANN. § 302A.251 (West Supp. 1987); MO. ANN. STAT. § 351.347 (Vernon Supp. 1988); NEB. REV. STAT. § 21-2732 (Supp. 1988); N.J. STAT. ANN. § 14A:10A-2 (West 1986); N.Y. BUS. CORP. LAW § 717(b) (McKinney 1987) (as amended by 1989 N.Y. LAWS Ch. 228); OHIO REV. CODE ANN. § 1701.59(E) (Anderson Supp. 1988); TENN. CODE ANN. § 48-35-202 (1988); WISC. STAT. ANN. § 180.305 (West Supp. 1988). According to the Investor Responsibility Research Center, twenty-three states have adopted laws that allow or require directors faced with a hostile tender offer to consider non-monetary factors. *De Facto Federal Anti-Bidder Stance Exists Through State Laws*, IRRRC Says, 21 Sec. Reg. & L. Rep. (BNA) 1501 (Oct. 6, 1989).

38. *E.g.*, MO. ANN. STAT. § 351.347-1.(1) (Vernon Supp. 1987).

39. N.Y. BUS. CORP. LAW § 717(b) (McKinney 1987) (as amended by 1989 N.Y. LAWS Ch. 228).

Although differently phrased, the stakeholder statutes are based on a legislative determination that legitimate non-shareholder interests are harmed by takeovers and therefore the traditional principle that directors faced with a takeover owe their allegiance exclusively to shareholders is unsatisfactory. The statutes also endorse the value of maintaining corporate independence. Yet, giving directors the right to consider non-shareholder constituencies is different from imposing upon them the obligation to do so. As demonstrated by a case interpreting the Wisconsin stakeholder statute, these laws merely give directors the protection of the business judgment rule if they consider the interests of non-shareholder constituencies.⁴⁰

Whether and to what extent the stakeholder statutes change existing law is an interesting question. Delaware does not have a stakeholder statute. In *Grand Metropolitan Public Limited Company v. The Pillsbury Company*,⁴¹ the Delaware chancery court permitted directors engaged in defensive maneuvers to consider non-shareholder constituencies. Yet, in *Shamrock Holdings, Inc. v. Polaroid Corp.*,⁴² the court, in ruling on the legality of a defensive employee stock option plan, held that a director may only consider non-shareholder constituencies if the effect on such constituencies might ultimately have a positive economic impact on shareholders.

Although it has been argued that stakeholder statutes do not change the law on directors' duties,⁴³ they do work a shift in the power to effect the outcome of a takeover battle from shareholders to the board. Further, they particularly encourage directors to consider employee interests, and the employees with whom the directors have the greatest contact and affinity are a corporation's officers. If the interests of management can thus be juxtaposed with stockholder interests, the loyalties of directors become confused. The latitude to consider multiple constituencies is likely to become a legal fiction for the erosion of shareholder rights.

2. Affirmative duties

Under classic American political theory, the interests of labor and management are adversarial and the public interest is best protected by guaranteeing labor's collective bargaining rights. Duties owed by management or directors to employees are imposed by statutes rather than the common law.⁴⁴ Further, employee representation on boards of directors is

40. *Amanda Acquisition Corp. v. Universal Foods Corp.*, 708 F. Supp. 984 (E.D. Wisc. 1989).

41. 558 A.2d 1049 (Del. Ch. 1988).

42. 559 A.2d 278 (Del. Ch. 1989).

43. See Franklin, *Effect on 'Stakeholders' Is Factor to Consider in Takeovers*, N.Y.L.J. July 6, 1989, at 5, col. 3; *Securities Attorney Stresses Importance of Putting Poison Pills In Place Early*, 21 Sec. Reg. & L. Rep. (BNA) 696 (May 12, 1989).

44. See, e.g., National Labor Relations Act, 29 U.S.C. §§ 151-169 (1982). The view that federal labor legislation is premised on an adversarial labor-management relationship which precludes a duty by management to consider employee interests in major corporate deci-

rare and generally considered rife with conflicts of interest.⁴⁵ The idea that directors can even consider employee interests in a takeover is therefore novel and the idea that directors should owe a duty to employees in a takeover is contrary to long standing legal principles. Nevertheless, the traumatic impact on both labor and the public of takeovers and restructurings of U.S. businesses in recent years has given rise to at least the question of what priority employee interests should have when there is a change of corporate control.

There are serious differences of opinion about whether takeovers, on balance, are good or bad for the economy, and in particular employment.⁴⁶ Although the argument can be made that takeovers do not destroy jobs in the long run,⁴⁷ they frequently do in the short run,⁴⁸ and there is a perception that shareholder and employee interests in most takeovers or restructurings are antagonistic.⁴⁹

In some change of control situations, unions have played a key role in assisting management in either restructuring or resisting a hostile bid.⁵⁰ Employee stock ownership plans have been utilized as a takeover defense mechanism.⁵¹ Some unions have inserted anti-takeover devices in collective bargaining agreements.⁵²

The support which organized labor has given to the stakeholder statutes suggests that the power directors have been given to consider the interests of employees in responding to a takeover could be transformed into a duty. Such a duty may be presaged in the Massachusetts stakeholder statute which imposes on tender offerors the obligation to honor

sions is suggested by *First National Maintenance Corp. v. National Labor Relations Board*, 452 U.S. 666 (1981).

45. Lipton, *supra* note 33, at 43-46. See Buss, *UAW Chief Is In an Awkward Spot, Advising Restraint in Chrysler Talks*, Wall St. J., Aug. 12, 1982, at 21, col. 4; Doug Fraser's *Conflicts*, Wall St. J., Sept. 22, 1982, at 30, col. 1.

46. See *Leveraged Buyouts and Corporate Debt: Hearing Before the Senate Finance Comm.*, 101st Cong., 1st Sess. (1989) [hereinafter *Hearings*].

47. Statement of Joseph A. Grundfest, U. S. Commissioner, Securities and Exchange Commission, Before the Judiciary Committee of the Maryland House of Delegates, Concerning H.R. 1321, at 17 (Mar. 2, 1988).

48. *Hearings*, *supra* note 46, Pt. 3, at 20-26 (testimony of Lane Kirkland); *Id.* at 29-32 (testimony of Bruce Smart).

49. Remarks of David S. Ruder, Chairman, Securities and Exchange Commission, Before the American Banker Bond Buyer Conference on Strategic Corporate Restructuring and Financing 3, New York City (May 22, 1989) (SEC News Release).

50. See Ansberry & Valente, *UAL May Be Winging Its Way Toward Strife If Employee Buyout Succeeds, Some Warn*, Wall St. J. Europe, Sept. 27, 1989, at 5, col. 2; Fisher, *Safeway Buyout: A Success Story*, N.Y. Times, Oct. 21, 1988, at D1, col. 4; Valente & Smith, *United Air Pilots Face Cuts in Wages, Overtime Pay, Vacation to Finance Bid*, Wall St. J., Sept. 11, 1989, at A4, col. 2.

51. Trachtenberg, *Union Leader Enters the Buy-out Fray*, Wall St. J., June 1, 1989, at B8, col. 3. See *Shamrock Holdings, Inc. v. Polaroid Corp.*, 559 A.2d 278 (Del. Ch. 1989). See also Burr, *ESOPs Boom As A Defense*, Pensions & Investment Age, April 17, 1989, at 1; Farrell & Hoerr, *ESOPs: Are They Good For You?*, Business Week, May 15, 1989, at 116.

52. See *Airline Pilots Ass'n Int'l v. UAL Corp.*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 94,419 at 92,703 (7th Cir. May 4, 1989).

existing collective bargaining agreements and in addition to give two weeks severance pay per year of service to any employee who is laid off as the result of a takeover.⁵³ The federal law requiring corporations to give advance notice to employees concerning plant closings⁵⁴ was predicated on a similar anti-takeover policy. However, because this law restricted the ability of directors and management to deal with takeovers, it was vigorously opposed by the corporate community.⁵⁵ At least one academic authority has argued that employees should be compensated for the wealth transfer to shareholders which occurs in a takeover where employment is terminated.⁵⁶ Professor Coffee argues that employees are unable to protect themselves against such losses (but bondholders can.)⁵⁷ Such an argument is not tantamount to the idea that directors should have a direct duty to employees imposed upon them.

As a matter of logic and fairness, it is not intuitively obvious why shareholders (especially shareholders of short standing) should enjoy the benefits of the premium in a change of control transaction and employees (especially employees of long standing) should receive nothing but a termination notice. Although belief in markets can be utilized to justify takeovers on efficiency grounds, it does not follow that the control premium shareholders receive in such battles should not be shared with damaged constituencies. In effect, this is the result of "golden parachutes" for corporate managers, as well as the statutory obligation for severance pay in Massachusetts.

Whether the detriments employees suffer in change of control situations should be addressed by altering the duties directors owe shareholders is another question. Employees often have conflicts of interests in takeovers since they may be major stockholders, either directly through various employee purchase plans, or indirectly through pension plans or employee stock ownership plans held in trust. Compelling directors to consider employee interests in a change of control situation would only compound these conflicts. Further, unless labor were actually represented in the auction process, it would be difficult for boards, and reviewing courts, to devise a fair formula for weighing employee and shareholder interests.

53. 1989 Mass. Adv. Legis. Serv., Ch. 242 §§ 9-10 (Law Co-op.) (enacting Mass. Gen. L. ch. 149, § 20E and § 183(b)).

54. Worker Adjustment and Retraining Notification Act, 29 U.S.C. §§ 2102-2109 (West Supp. 1989).

55. See Roberts, *President Decides Not to Veto Bill Requiring Notice of Plant Closings*, N.Y. Times, Aug. 3, 1988, at A1, col. 2. Whether employees who receive such notice are entitled to bargain with management about the decision to close a plant is problematic. For a discussion of the labor-management relationship, see *supra* note 44 and accompanying text.

56. J. Coffee, *supra* note 32, at 78-81.

57. *Id.* at 68-71.

C. Duties to Bondholders

1. The contract/tort dichotomy

Many observers of the American economy have expressed concern about the leveraging of U.S. corporations involved in control transactions.⁵⁸ These concerns have been taken into account by the rating agencies which frequently downgrade bond ratings after a takeover or buyout, to the detriment of existing bondholders.⁵⁹ Although directors may owe duties to creditors under certain circumstances,⁶⁰ the general rule, recently reaffirmed in Delaware,⁶¹ is that directors do not owe bondholders a fiduciary duty except in extreme situations of fraud or insolvency because bondholders are not owners of the corporation, but only creditors.⁶² Therefore, the relationship between directors and bondholders is governed by contract law rather than tort law, and bondholders do not enjoy the same type of fiduciary duty protection as shareholders.

There are several logical and policy flaws in this general proposition as applied to control transactions. In general, the fiduciary duties of directors have arisen from analogies to the law of agency or trusts, in situations where one person manages another's property and has superior knowledge and power.⁶³ However, the landmark cases imposing a fiduciary duty on directors in novel situations have occurred where the director has abused his power gained from this superior knowledge for personal advantage.⁶⁴ In a control transaction where directors have negotiated for their own advantage, to the detriment of bondholders, it seems anomalous to raise shareholder interests as a complete defense, especially if shareholders have received a generous control premium. Utilizing the fact that this event risk was not prohibited in a bond indenture as a further

58. *Hearings, supra* note 46, at Pt. 3, at 4-12 (testimony of Alan Greenspan). See Forstmann, *Violating Our Rules of Prudence*, Wall St. J., Oct. 25, 1988, at A26, col. 5; Grant, *Will History Repeat Itself?*, Wall St. J., Oct. 25, 1988, at A26, col. 3; Hale, *How To Lower the Leverage Boom*, Wall St. J., Nov. 29, 1988, at A22, col. 3; *Corporate Debt Rises Despite Worries*, Wall St. J., June 26, 1989, at A1, col. 5.

59. McDaniel, *Bondholders and Stockholders*, 13 J. CORP. L. 205, 208-09 (1988); Mitchell, *Junk Bonds Fail to Recover From Recession Scare*, Wall St. J., Sept. 11, 1989, at C1, col. 3; *Junk Bond Defaults Are Expected to Increase, S&P Official Warns*, 20 Sec. Reg. & L. Rep. (BNA) 334 (Mar. 4, 1988).

60. *Pepper v. Litton*, 308 U.S. 295, 306-10 (1939).

61. *Simons v. Cogan*, 542 A.2d 785 (Del. Ch. 1987), *aff'd*, 549 A.2d 300 (Del. 1988). Another relevant case is *Revlon Inc. v. McAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

62. See e.g., Bratton, *Corporate Debt Relationships Legal Theory In a Time of Restructuring*, 1989 DUKE L.J. 92, 118.

63. See, e.g., Jacobson, *Capturing Fiduciary Obligation: Shepherd's Law of Fiduciaries*, 3 CARDOZO L. REV. 519, 524 (1982). Cases which impose fiduciary duties to creditors also have used the trust analogy. *Wood v. Dummer*, 30 F. Cas. 435, 436 (C.C.D. Me. 1824) (No. 17,944).

64. See *Perlman v. Feldman*, 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955); *Guth v. Loft*, 5 A.2d 503 (Del. 1939); *Globe Woolen Co. v. Utica Gas & Elec. Co.*, 243 N.Y. 483, 121 N.E. 378 (1918). See also *In re Cady Roberts & Co.*, 40 S.E.C. 907 (1961) (director was member of broker-dealer firm).

defense treats a bond issuance like an arms length bargain between two equal parties. The realities of the bond market may be somewhat different, at least where the issuer is a public company and the bonds are traded on public securities markets. Although institutions are capable of exerting considerable power on issuers, in recent years this has occurred in the form of determining the interest coupon, not the term of the indenture.⁶⁵ As debt and equity become less distinct,⁶⁶ bondholders of public companies would appear to be deserving of protection similar to suppliers of equity capital.

At one time bondholders and other creditors were protected by regulation of corporate capitalization.⁶⁷ As such protections eroded, fiduciary duties to creditors were imposed on directors in bankruptcy and near bankruptcy situations.⁶⁸ The view that bondholders are creditors rather than security holders leads to the principle that they need to be protected only to the extent of guaranteeing interest and principal payments. Therefore, insolvency is the only contingency where directors become liable for a breach of duty. If it is recognized, however, that bondholders are also investors of capital who are concerned about market gains and losses, event risk such as a control transaction can also become a contingency for which directors are held to a fiduciary standard, especially if the directors are in a position of knowledge and power superior to that of the bondholders.

2. *The new activism of bondholders*

Until recently, bondholders have been silently suffering losses in control transactions, although the subject of bondholders' rights began receiving scholarly attention.⁶⁹ The RJR Nabisco, Inc. ("RJR") leveraged buyout, however, represented such a large gain for shareholders and such a large loss for bondholders in a transaction initiated by management involving huge management profits,⁷⁰ that certain bondholders were prompted to take action. It is noteworthy that these activist bondholders were insurance companies, the leader of which was Metropolitan Life Insurance Company ("MetLife").⁷¹ Suits were instituted alleging breaches of an implied covenant of good faith and fair dealing, violations of the antifraud provisions of the federal securities laws and breaches of fiduci-

65. Stine & Herman, *Investor Fears of Takeovers, Buy-Outs May Force Companies to Pay More in Issuing New Bonds*, Wall St. J., Oct. 24, 1988, at C21, col. 1; McDaniel, *supra* note 59, at 238-45.

66. McDaniel, *supra* note 59, at 221.

67. Bratton, *supra* note 62, at 107. For an additional source discussing directors' duties and liabilities toward bondholders and creditors, see *infra* note 106.

68. *Id.* at 110-11.

69. Bratton, *The Economics and Jurisprudence of Convertible Bonds*, 1984 Wis. L. Rev. 667; McDaniel, *supra* note 59; Coffee, *supra* note 32.

70. *History of the RJR Takeover*, N.Y. Times, Dec. 2, 1988, at D15, col. 3.

71. Logan & Lamb, *Pending Bondholder Suits Could Have Broad Ramifications*, N.Y.L.J., June 5, 1988, at 37, col. 4.

ary duty.⁷²

Thus far, the plaintiff bondholders have not enjoyed much success. Judge Walker in the Southern District of New York dismissed the federal cases against RJR and its chief executive officer brought for equitable relief, on cross summary judgment motions, on the grounds that given the sophistication of the plaintiff bondholders there was no justification for deviating from the express terms of the bond indenture.⁷³

There being no express covenant between the parties that would restrict the incurrence of new debt, and no perceived direction to that end from covenants that are express, this Court will not imply a covenant to prevent the recent LBO and thereby create an indenture term that, while bargained for in other contexts, was not bargained for here and was not even within the mutual contemplation of the parties.⁷⁴

A similar case involving the takeover of Federated Department Stores, Inc. ("Federated") by Campeau Corporation ("Campeau") was brought by Hartford Fire Insurance Company ("Hartford") against Federated, Campeau, various officers and directors of Federated and investment banking houses which acted as the underwriters for an issuance of \$500 million of Federated debt securities, in the form of five-year 9.375% notes ("Notes").⁷⁵ Hartford had purchased \$25 million of the Notes at face value on October 22, 1987, pursuant to a shelf registration offering. The Notes were investment grade, rated "AA-" by Standard & Poor's and "Aa2" by Moody's. After the Campeau takeover of Federated in early 1988, the Notes were downgraded to "B" by Standard & Poor's and "B2" by Moody's, with a resulting drop in the market value of the Notes. Hartford sold its Notes in November 1988 at a loss of \$4.33 million.

Hartford sued for alleged violations of the federal securities laws and for a variety of state law claims, but the defendants' motion for summary judgment was granted by Judge Sweet in the Southern District of New York. The gist of the fraud charges in the complaint was that Federated's registration statement and related documents were misleading because they failed to disclose that Federated was a potential takeover target and that a leveraged transaction would destroy the value of the Notes as investment grade securities. The court granted summary judgment on this claim on the ground that any possible takeover of Federated was not, as of the date of the allegedly misleading documents, "material" under the test of materiality set forth in *Basic Inc. v. Levinson*.⁷⁶ This holding

72. *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504 (S.D.N.Y. 1989); *Hartford Accident & Indemnity Co. v. RJR Nabisco, Inc.*, 721 F. Supp. 534 (S.D.N.Y. 1989).

73. *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504-05 (S.D.N.Y. 1989).

74. *Id.* at 1508. This case was on appeal to the Second Circuit as of the date of this article.

75. *Hartford Fire Ins. Co. v. Federated Dept. Stores, Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,744 (S.D.N.Y. Oct. 13, 1989).

76. 485 U.S. 224 (1988).

seems to give short shrift to the centrality of ratings to bond offerings, but also seems to be based on the hostile nature of the Campeau offer.

The state law claims for breach of an implied covenant of good faith and fair dealing, promissory estoppel and mistake were dismissed on the ground that the indenture covering the Notes did not prohibit mergers and expressly permitted Federated to incur additional debt provided it secured the Notes "equally and ratably" with any new debt guaranteed by Federated's assets. A claim for unjust enrichment on the grounds that the defendants "expropriated" Hartford's investment, enriching themselves and their stockholders at Hartford's expense was dismissed on the ground that there was no express contract governing the subject matter that was breached. Similarly, a claim against Campeau for tortious interference with contractual relations was dismissed because there was no breach of contract.

The message of the Metlife and Hartford cases is that bondholders should protect themselves against leveraged transactions by negotiating appropriate covenants in indentures. Such covenants could, for example, bar mergers; or in the event of a "bad" merger harmful to bondholders, make the bonds convertible or require their redemption; or restrict additional debt or debt to equity ratios that would impair an investment grade rating. While such covenants could protect future bondholders against the type of downgrading involved in the RJR and Federated takeovers, the cases do not address the basic questions of why common shareholders should be so strongly preferred over bondholders or why directors should not be held accountable for actions that inflict serious damage on bondholders.

The stakeholder statutes discussed above⁷⁷ are a statutory response to the plight of bondholders and other creditors in takeovers and permit, but do not require, directors to consider the interests of bondholders in a control transaction. The common law in Delaware (which does not have a stakeholder statute) would appear to be to the contrary. Yet, the very case frequently cited for the proposition that directors cannot prefer the interests of bondholders to shareholders, *Revlon Inc. v. MacAndrews and Forbes Holdings, Inc.*,⁷⁸ was utilized by the chief executive officer of MetLife, John J. Creedon, Jr., to argue that a duty to treat bondholders fairly in leveraged transactions should be imposed on directors.⁷⁹ Creedon has also urged an amendment to the federal securities laws which would require issuers to disclose the probable consequences of a tender offer on all a corporation's constituencies.⁸⁰

MetLife's legislative proposals have gone beyond the stakeholder statutes. A bill introduced at its behest in New York State would require an issuer to repurchase bonds as maturing more than two years from the

77. For a discussion of "stakeholder" issues, see *supra* notes 29-43 and accompanying text.

78. 506 A.2d 173 (Del. 1986).

79. *Hearings, supra* note 46, Pt. 3, at 26-32 (testimony of John J. Creedon, Jr.).

80. *Id.* at 27.

date of issuance if there is an announcement of a control transaction, and thirty days after the announcement that the bonds have dropped more than ten percent in value.⁸¹ The bill essentially treats the control transaction as a tort against bondholders. What effect such a law might have on the duty of directors to bondholders in a takeover or restructuring is an interesting question. The bill is a signal, however, that influential institutional investors are not satisfied with permitting directors to consider bondholder interests. They are seeking more affirmative protection.

II. DUTIES OF DIRECTORS UNDER U.K. LAW

A. Generally

Directors in the United Kingdom, like directors in the United States, owe duties of care and loyalty to their corporations. The duty of care can be expressed as the duty of skill and care a person of the director's knowledge and experience is capable of exercising.⁸² In addition, a director has a duty of absolute loyalty and utmost good faith.⁸³

1. Duties to the corporation

One difference between U.K. and U.S. law is that in Britain, the duty of directors is owed to the corporation as a whole, rather than directly to shareholders.⁸⁴ It may be argued that this difference is only one of emphasis since the U.K. director's duty to the company is basically a duty to shareholders.⁸⁵ Moreover, in the United States, a director owes duties to the shareholders as a body, not a duty to individual shareholders.⁸⁶ Nevertheless, a U.K. director's duty is enforceable only in an action by the corporation, not in an action by shareholders.⁸⁷

In the specific context of a takeover bid, the duty of care has been interpreted as a duty to the shareholders not to act recklessly in deciding between two rival bids.⁸⁸ Yet, a U.K. board has no duty to get the best price for shareholders through an auction. Rather, the general process followed in takeovers encourages the board to deal with one bidder at a

81. S. 6326, 212th Leg. Sess., N.Y. (1989). See Franklin, *MetLife Looks for Help*, N.Y.L.J., May 11, 1989, at 5, col. 3.

82. P. LOOSE & J. YELLAND, *THE COMPANY DIRECTOR* § 4.8.1 (1987).

83. *Id.* at § 4.3.

84. *Percival v. Wright*, 2 Ch. 421 71 L.J. ch. 846 (1902).

85. *E.g.*, *Hutton v. West Cork Ry. Co.*, 23 Ch. D. 654, 671 (1883).

86. *Goodwin v. Agassiz*, 283 Mass. 658, —, 186 N.E. 659, 660 (1933). *But see* *Strong v. Repide*, 213 U.S. 419, 431 (1909) (director may have duty to individual shareholder in some circumstances). Under the federal securities laws it is easier for individual shareholders to enforce the obligations imposed on directors. See, e.g., Securities Exchange Act of 1934, § 20A, 15 U.S.C. § 78t(a) (1982).

87. *Foss v. Harbottle*, 2 Hare 461, 490, 67 Eng. Rep. 189, 202 (1843). See J. FARRAR, N. FUREY & B. HANNIGAN, *FARRAR'S COMPANY LAW* 382-84 (1988).

88. *Heron Int'l Ltd. v. Lord Grade*, B.C.L.C. 244, 261-62 (1983). This duty runs directly to shareholders. See J. FARRAR, *supra* note 87 at 325-26.

time.⁸⁹ Insofar as the duty of loyalty is concerned, directors of a target company have a duty to act bona fide in the best interests of the company as a whole and therefore are precluded from taking such defensive measures as diluting control by the issuance of new share.⁹⁰

The conduct of directors in contests for corporate control in the United Kingdom is regulated not only by company law and judicial decisions, but also by the City Code on Take-overs and Mergers ("City Code"), which is supervised by the Panel on Take-overs and Mergers ("Panel").⁹¹ The Panel is a self-regulatory body and the City Code does not have the force of law. Nevertheless, because of the acceptance and support given to the City Code and Panel by securities and banking regulators, the Panel's decisions are obeyed. In addition, since the Panel is a semi-public body, its opinions are subject to judicial review.⁹²

The City Code sets forth a limited number of general principles and then detailed rules for the conduct of a takeover bid. Nevertheless, considerable latitude is left to the Panel to interpret the propriety of a board's conduct in the context of a particular bid. The two most important general principles in the City Code are that the shareholders of an offeree company are to decide whether or not an offer should succeed, and that all equity holders must be treated equally.⁹³ The board of a target company is obligated to seek independent outside financial advice when a bid is made, and then communicate the substance of such advice to the company's shareholders.⁹⁴

In addition, after an offer is communicated to the board, or even if a board has reason to believe an offer is imminent, the offeree board is prohibited from taking any action, without the approval of shareholders in a general meeting "which could effectively result in any bona fide offer being frustrated or in the shareholders being denied an opportunity to decide on its merits."⁹⁵ Because of this anti-frustration provision the law in the United Kingdom would appear to favor shareholders, or at least their freedom of choice when presented with a takeover, to a greater extent than the law in the United States.⁹⁶

89. Bartos & Sellars, *Buyouts: Contrasting Techniques in the US and UK*, 8 INT'L FIN. L. REV. 24, 28-29 (1989).

90. *Hogg v. Cramphorn Ltd.*, 1967 Ch. 254; PALMER'S COMPANY LAW 940-43 (C. Schmitthoff ed. 1987).

91. The City Code on Take-overs and Mergers (1988) [hereinafter "City Code"] (for an old text (pre-revision) of the City Code, see A. JOHNSTON, *THE CITY TAKEOVER CODE* (1980)). See Brayne, *Tender Offers Involving U.K. Companies*, 21 REV. SEC. & COMM. REG. (Standard & Poor's), Apr. 27, 1988, at 67, 70.

92. MacLachlan & Mackesy, *Acquisitions of Companies in Europe—Practicability, Disclosure, and Regulation: An Overview*, 23 INT'L LAW. 373, 386-87 (1989). See *R. v. Panel on Take-overs and Mergers, Ex Parte Datafin PLC* 1 All E.R. 564 (1987).

93. MacLachlan, *supra* note 92, at 387-88.

94. City Code, *supra* note 91, Rule 3.1.

95. City Code, *supra* note 91, General Principle 7. Prohibitions against specific types of "poison pills" are enumerated in Rule 21. These include the issuance of new shares, the disposition of material assets and contracts not in the ordinary course of business.

96. See *Takeovers—The Right Way to Regulate the Market*, *The Economist*, Sept.

2. *Duty to employees*

In contrast to the United States, the board of a U.K. corporation has a specific, statutorily imposed duty to employees.⁹⁷ At one time, this was not true, and directors were not permitted to consider the interests of shareholders.⁹⁸ This principle arose in cases involving payment to terminated employees in connection with a sale or winding up of a business. The courts held that such payment would not further any business purpose of the corporation and therefore was the payment of a benefit to employees belonging to the shareholders.⁹⁹

In 1980 these cases were specifically overruled by statute so that U.K. law now provides that:

The matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company's employees in general, as well as the interests of its members.¹⁰⁰

This duty, like a director's duty to shareholders, is owed to the company alone and "is enforceable in the same way as any other fiduciary duty owed to a company by its directors."¹⁰¹

The statute thus requires, and does not merely permit, directors to take into account employee, as well as shareholder interests. However, it gives no guidance as to how to reconcile these interests if they conflict, and no enforcement power to employees. Presumably this is a matter for the business judgment of the directors.¹⁰² The potential conflict between a duty to employees and a duty to shareholders in a takeover does not appear to have surfaced as a basis for recommending against a takeover, or even trying to defeat a takeover, perhaps because of the anti-frustration provision of the City Code. In the event a board determined to use the duty to employees as a weapon in a contest for corporate control, it is interesting to speculate whether the general statutory duty to employees would supersede the specific anti-frustration provisions of the non-statutory City Code.

23, 1989 at 21-22; *A Tale of Two Takeovers*, Wall St. J., July 17, 1989, at A10, col. 1. The latest draft of the ALI corporate governance project provides that directors of U.S. corporations "may take an action that has the foreseeable effect of blocking an unsolicited tender offer . . . unless the action would materially disfavor the long-term interests of the shareholders." ALI PRINCIPLES, *supra* note 8, at § 6.02 p. 27 (Discussion Draft No. 2, Apr. 20, 1989).

97. Companies Act 1985, § 309.

98. Note, *The Companies Act, 1980: Its Effects on British Corporate Law*, 4 Nw J. INT'L L. & Bus. 551, 568 (1982).

99. *Parke v. Daily News Ltd.*, [1962] Ch. 927; *Hutton v. W. Cork Ry. Co.*, [1883] 23 Ch. D. 654.

100. Companies Act of 1985, § 309 (1). *See also* § 719 (1).

101. Companies Act of 1985, § 309 (2).

102. PALMER, *supra* note 90, at 937.

3. Duty to creditors

The traditional U.K. view is that directors do not owe a fiduciary duty to creditors.¹⁰³ This view was questioned by the House of Lords in *Winkworth v. Edward Baron Development Co.*,¹⁰⁴ which involved a claim by a wife, who also was a director and stockholder, trying to enforce an equitable interest in the matrimonial home, owned by the company, against a mortgagee seeking possession. The husband was the other director and shareholder. The case seems to have been decided on the law relating to equitable interests and its peculiar facts, without discussion of prior authorities on a director's duty to creditors. However, in passing, the court stated:

A duty is owed by the directors to 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 the directors themselves to the prejudice of the creditors.¹⁰⁵

In the United Kingdom, as in the United States, directors owe a fiduciary duty to creditors in an insolvency or voluntary winding up.¹⁰⁶ Indeed, a statutory duty to creditors is imposed when an insolvency becomes inevitable.¹⁰⁷ In addition, the protection of creditor interests through statutory regulation of company capitalization probably is more stringent in the United Kingdom than in the United States.¹⁰⁸

The issue of whether a duty to creditors could arise in a highly leveraged takeover or restructuring that diminished the value of outstanding bonds does not appear to have arisen in the United Kingdom, perhaps because of the relative lack of leverage in takeover financings. The potential for such a question was demonstrated in the proposed takeover by Sir James Goldsmith for B.A.T. Industries ("B.A.T."), which did involve sufficient leverage to cause B.A.T. to pull back a planned debenture offering after the takeover bid was announced.¹⁰⁹

103. *Multinational Gas and Petrochemical Co. v. Multinational Gas and Petrochemical Services Ltd.*, [1983] Ch. 258, 288.

104. [1987] 1 All E.R. 114.

105. *Id.* at 118. See also *Nicholson v. Permakraft (NZ) Ltd.*, [1985] N.Z.L.R. 242.

106. C. RYAN, *COMPANY DIRECTORS' LIABILITIES, RIGHTS AND DUTIES* 121 (1987).

107. *Insolvency Act 1986*, § 214.

108. See PALMER, *supra* note 90, at 492-97 (description of capital controls). As a general matter, U.S. corporate and securities law has not regulated corporate capitalization, although some state "Blue Sky" merit statutes block corporations with unfair capital structures from making public offerings. See generally Karmel, *Blue-Sky Merit Regulation: Benefit to Investors or Burden on Commerce?*, 53 BROOKLYN L. REV. 105 (1987). Early and rather crude creditor protection devices like par value have generally fallen into disuse, and more recent creditor protection concepts like equitable subordination and veil piercing permit creditors to seize assets no longer held by an insolvent corporation. See generally R. CLARK, *CORPORATE LAW* § 2.1-6, at 35-92, § 17.1.2, at 707-15 (1986). None of these devices are of much help to bondholders confronted by a leveraged restructuring that downgrades bond ratings.

109. Peers & Forman, *B.A.T. withdraws \$400 Million Issue of Eurobonds in Wake of Hostile Bid*, Wall St. J., July 14, 1989 at C14, col. 1; See *Bridging the Mezzanine Gap*, The

III. DEVELOPMENTS IN THE EC

A. *Company Law Harmonization*

A discussion of the duties of directors in countries other than the United States and the United Kingdom is beyond the scope of this article. Nevertheless, the possible impact of European Community developments on company law in the United Kingdom and the future conduct of takeovers is too important not to mention. In particular, controversial proposals for worker participation in the corporate management structure could alter the way in which directors balance shareholder, employee, and creditor interests.

For approximately two decades, the EC has been attempting to harmonize the company and capital laws of its member states. This project is based on two premises. First, companies are the most important economic actors within each member state and second, harmonization of the company and capital laws will advance the goal of economic integration set forth in the Treaty of Rome.¹¹⁰ Moreover, if these efforts serve to standardize the protections of shareholders and creditors who operate under a variety of legal systems, investors will presumably be more willing to provide capital and credit which will encourage economic development.¹¹¹ Many of the EC Directives on capital and company law therefore deal with disclosure and accounting standards¹¹² as well as mergers and split ups.¹¹³ Also of some interest with regard to protection of creditor interests is the Second Directive which provides for the maintenance of a company's minimum or stated capital.¹¹⁴

Of relevance to the question of a director's duty to non-shareholder constituencies are the proposed Fifth Directive on the harmonization of company law of EC member states,¹¹⁵ the Vredeling Proposal,¹¹⁶ and the recent proposals for a Council Regulation¹¹⁷ and Council Directive¹¹⁸ on a statute for a European company, which is called a *Societas Europaea*

Economist, Apr. 22, 1989, at 73, col. 1.

110. R. BUXBAUM & K. HOPT, *LEGAL HARMONIZATION AND THE BUSINESS ENTERPRISE* 167 (1988).

111. *Id.* at 201. Federal chartering in the United States has never gathered much political support, despite criticisms of state chartering as a race to the bottom. See Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 *YALE L.J.* 663 (1974). See also Romano, *The State Competition Debate in Corporate Law*, 8 *CARDOZO L. REV.* 709 (1987).

112. *E.g.*, First Directive 11, *J.O. COMM. EUR.* (No. L 65) 8 (Mar. 14, 1968) (uniform minimum disclosure); Fourth Directive, 21 *O.J. EUR. COMM.* (No. L 222) 11 (Aug. 14, 1978) (accounting and publication of annual reports); Seventh Directive, 26 *O.J. EUR. COMM.* (No. L 193) 1 (July 18, 1983) (accounting of groups); Eighth Directive, 27 *O.J. EUR. COMM.* (No. L 126) 20 (May 12, 1984) (auditor qualifications).

113. *E.g.*, Third Directive, *O.J. EUR. COMM.* (No. L 295) 36 (Oct. 20, 1978) (mergers); Sixth Directive, *O.J. COMM. EUR.* (No. L 378) 47 (Dec. 31, 1982) (divisions).

114. *O.J. EUR. COMM.* (No. L 26) 1 (Jan. 30, 1977).

115. *O.J. EUR. COMM.* (No. C 131) 49 (Dec. 13, 1972).

116. *O.J. EUR. COMM.* (No. C 297) 3 (Nov. 15, 1980).

117. *O.J. EUR. COMM.* (No. C 263) 41 (Aug. 25, 1989) [hereinafter "SE Statute"].

118. *O.J. EUR. COMM.* (No. C 263) 69 (Aug. 25, 1989) [hereinafter "SE Directive"].

("SE"). All of these proposals are very controversial because they attempt to inject some form of labor co-determination into the structure of a corporation.¹¹⁹ In particular, the British have resisted the concept of worker participation on corporate boards, or even labor consultation on significant corporate decisions.¹²⁰

Worker participation is an amorphous concept which ranges from the German model of equal representation of employees and shareholders on the supervisory boards of corporate decision-making bodies to any institution through which labor may limit management prerogatives, including collective bargaining.¹²¹ The Fifth Directive would have mandated a two-tier corporate board structure, with a supervisory board and a management board. Labor would have been represented on the supervisory board in some way. However, the European Parliament expressed reservations about the worker participation provisions and the proposed Fifth Directive could not be adopted.¹²² After more than a decade of political maneuvering, an amended Fifth Directive¹²³ which was more flexible was proposed, allowing companies to choose a two-tier or single-tier board structure. This amended proposal would only have applied to companies with more than 1,000 employees. In addition, four options for worker participation were put forward, ranging from employee participation on the supervisory board to collective bargaining.¹²⁴

Because of the controversy over worker participation, prospects are uncertain for the adoption of the Fifth Directive as a technique for harmonizing company law. In the meantime, however, a proposal for an SE, which would be a company incorporated under EC rather than national law, has been put forward.¹²⁵ The SE Statute is based on national company law and the amended Fifth Directive and provides that management of the SE can be either by a management board, with a supervisory board monitoring its activities, or an administrative board.¹²⁶ The worker participation provisions of the SE Statute and SE Directive have been watered down, but not eliminated. An SE will be able to choose one of three systems for worker participation: labor representatives on the supervisory board,¹²⁷ a separate workers' representative body,¹²⁸ or any

119. See BUXBAUM, *supra* note 110, at 259-62; See also, Note, *The Proposed Vredeling Directive: A Modest Proposal or the Exportation of Industrial Democracy?*, 70 VA. L. REV. 1469 (1984) (discussion of legislative protection for corporate employees).

120. See Dawkins, *Brussels Company Law Plan Threatened*, *Fin. Times*, July 19, 1989 at 1, col. 8; Jones, *Managers Attack EC Proposals*, *Fin. Times*, May 30, 1989, at 4, col. 4.

121. Constat, *The Developing European Community Law of Worker Participation in Management*, 11 N.Y.U. J. INT'L L. & POL. 93, 94 (1978).

122. BUXBAUM, *supra* note 110, at 259.

123. 26 O.J. EUR. COMM. (No. C 240) 2 (Sept. 9, 1983).

124. See Note, *supra* note 119, at 1475.

125. SE Statute, *supra* note 123.

126. *Id.* at 25-29.

127. SE Directive, *supra* note 118, at Articles 3-4.

128. *Id.* at Article 5.

other agreement concluded between management and labor.¹²⁹ Although this third model would appear to sanction collective bargaining as worker participation, it makes clear that employees will at least have rights of information and consultation so that they can participate in supervision of management and the strategic development of the SE.¹³⁰

The SE uses a carrot, rather than a stick, approach to injecting worker participation into European companies. An SE will have significant tax and other advantages over national companies, and therefore even U.K. business organizations may decide to form SEs, despite Mrs. Thatcher's general opposition to worker participation.¹³¹ In any event, the relationship of U.K. directors and employees necessarily will be influenced by the strong sentiments in Brussels favoring worker participation. What effect this will have on takeovers remains to be seen. The political premises underlying the U.S. stakeholder and plant closing notification statutes are very similar to the EC initiatives on labor participation in strategic decisionmaking. The difference is that European directors may be compelled, rather than merely permitted, to take employee interests into account in control transactions.

B. *The Takeover Directive*

An EC proposed Thirteenth Directive on Company Law concerning Takeover and Other General Bids¹³² could change the manner in which takeovers are regulated in the United Kingdom and other European countries as well. In general, the anti-frustration provisions of the City Code are not mirrored in the regulations or practices of continental European countries, where a variety of takeover defenses are common and lawful.¹³³ The Thirteenth Directive generally would adopt the U.K. model of takeover regulation in substance, but would substitute a statutory method of regulation for the City Code and Panel.

Of particular relevance to this article are provisions relating to conduct of offeree companies following receipt of a notice of a bid. As soon as an offeree company received such notice, it would be prohibited, without shareholder approval at a general meeting, from issuing voting securities or securities convertible into voting securities or "engaging in transactions which do not have the character of current operations concluded under normal conditions," unless authorized by a competent supervisory regulatory authority.¹³⁴ Other features of the U.K. regulatory scheme include

129. *Id.* at Article 6.

130. *Id.* at Articles 2, 6.

131. See Gapper, *Fowler Attacks EC's Proposal to Enforce Worker Involvement*, *Fin. Times*, Oct. 23, 1989, at 12, col. 4; *Carrots for Euroco*, *The Economist*, July 15, 1989, at 66, col. 1.

132. O.J. EUR. COMM. (No. C 64) 8 (Mar. 14, 1989) [hereinafter "Takeover Directive"]. This article will not discuss EC proposals concerning concentration in mergers and acquisitions, which deal with antitrust concerns.

133. MacLachlan, *supra* note 92, at 375-80.

134. Takeover Directive, *supra* note 132, at Article 8.

provisions for the equal treatment of shareholders, mandated independent advice for boards, a timetable for the completion of bids and a trigger for circumstances under which a full bid must be made. In many respects, the Thirteenth Directive would conform to the Williams Act in the U.S. However, one significant difference in addition to the anti-frustration provision is the requirement for anyone with 33⅓% of a company's voting securities to make a 100% bid for the Company.¹³⁶ Although the British are resisting the Thirteenth Directive, primarily because it would abolish the self-regulatory scheme of the City Code and Panel,¹³⁸ the Directive already is influencing legal initiatives in other member states.¹³⁷

One interesting feature of the Thirteenth Directive is a provision that would require the target board to communicate with its workers' representatives concerning the bid and the board's response to it.¹³⁸ The likelihood of mandating meaningful employee participation in takeover transactions appears slim, however.¹³⁹

CONCLUSION

There are a variety of reasons for a comparative law analysis. One is that new and better solutions to common problems may be discovered. Another reason for comparing law that regulates business activity, in the context of a global economy, is that different regulation may promote or disadvantage business activity in a particular country.

This article suggests two potentially contradictory trends in the law concerning control transactions in the United States, the United Kingdom, and the EC. As a general matter, mergers and acquisitions, including transnational business combinations, are viewed as an efficient mechanism for restructuring businesses and to some degree as a check on management. To enhance efficiency in the allocation of resources, and the traditional duty of directors to shareholders, investor protection regulation has been enacted. Current takeover regulation in the United King-

135. *Id.* at Article 4. The Williams Act is contained in §§ 13(d) and (e), and 14(d), (e) and (f) of the Securities Exchange Act of 1934, 15 U.S.C. 78m(d) and (e) and n(d), (e) and (f), and the regulations thereunder. The Williams Act has no mandatory bid provision. Consequently, because the Securities and Exchange Commission ("SEC") has not defined the term "tender offer," control can be acquired without equal treatment of shareholders. See *Hanson Trust PLC v. SCM Corp.*, 774 F.2d 47 (2d Cir. 1985).

Corporate defenses against takeover bids do not violate federal law and SEC views on this subject have been rejected by the Delaware Supreme Court. See *Moran v. Household International, Inc.*, 500 A.2d 1346 (Del. 1985). Further, state statutes which operate as defensive mechanisms for target corporations have been upheld as constitutional and not preempted by the Williams Act. *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69 (1987).

136. Lambert, *Brussels Fights for Accord on Takeover Bids*, *Fin. Times*, Oct. 2, 1989, at 6, col. 4.

137. See, e.g., Dawkins, *New French Takeover Code*, *Fin. Times*, Sept. 30-Oct. 1, 1989, at 2, col. 1.

138. Takeover Directive, *supra* note 132, at Article 19.

139. Lambert, *supra* note 136.

dom would appear to better protect shareholders in a control transaction than the Williams Act. If the proposed EC Takeover Directive is adopted, it will move continental countries in the direction of U.K. law and the substance of U.K. law will not change.

At the same time, the demands of labor to have a voice in major corporate decisions, including control transactions, are being translated into law in the United States and the United Kingdom. Developments in the EC appear likely to move U.K. law further in this direction. Creditors, like employees, can assert they have been disadvantaged by a control transaction. While such claims have received less attention and sympathy, developments serving to protect labor interests, like the U.S. stakeholder statutes, may have the ancillary effect of also assisting creditors.

These moves to protect shareholders, employees, and creditors are difficult to reconcile with one another or with the traditional fiduciary duty which directors owe to shareholders. Changing this duty to allow directors to balance employee, creditor, and shareholder interests could give directors a wide latitude with inadequate accountability to any constituency. If the law continues to move in this direction, some standard for judging directors' conduct, beyond the platitudes of fiduciary duty, will have to be developed. Providing specific protections to employees and creditors injured by a control transaction, possibly by granting them a share in the control premium, might be better public policy.

