INTERNATIONAL BANKING AND FINANCE LAW SERIES

Capital Structure and Corporate Governance

The Role of Hybrid Financial Instruments

Lorenzo Sasso

Wolters Kluwer
Law & Business

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Published by:
Kluwer Law International
PO Box 316
2400 AH Alphen aan den Rijn
The Netherlands
Website: www.kluwerlaw.com

Sold and distributed in North, Central and South America by:
Aspen Publishers, Inc.
7201 McKinney Circle
Frederick, MD 21704
United States of America
Email: customer.service@aspenpublishers.com

Sold and distributed in all other countries by:
Turpin Distribution Services Ltd
Stratton Business Park
Pegasus Drive, Biggleswade
Bedfordshire SG18 8TQ
United Kingdom
Email: kluwerlaw@turpin-distribution.com

Printed on acid-free paper.

ISBN 978-90-411-4843-8

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Printed and Bound by CPI Group (UK) Ltd, Croydon, CR0 4YY.

Acknowledgements

This book is the result of my years of research conducted as PhD candidate at the law department of the London School of Economics and Political Science. Those years spent in Britain, mostly between London and Oxford, were extremely stimulating for my research. I had the chance to know many people - colleagues and friends - who have challenged and helped me in many different ways to become who I am.

I would like to reiterate my gratitude to my supervisor - Professor Paul L. Davies - for encouraging me to not surrender to develop my ideas and follow my instincts. This book would not have been possible without his help. His sense of perspective and unparalleled in-depth analysis has been a source of admiration and motivation for me. Special thanks go to the jury members of my PhD defence - Professors Eva Lomnicka from King's College and David Kershaw from LSE - for their insightful and though-provoking comments on my work. I am also very grateful to all the participants to the 'Law and Finance' Seminars in Oxford organised by Professor John Armour from University of Oxford. I have learned much from discussions at these events on corporate finance law and so many other topics.

Indeed, I am very thankful to my Italian supervisor - Professor Marco Lamandini - for our challenging exchanges of ideas, for his availability and continuous support; and to the law department at the University of Bologna, Faculty of Economics - in general, for allowing me to continue my research in a highly stimulating environment. I am also very grateful to Professor Luca Enriques for his support.

Lastly, I would like to thank my partner Zeynep for all her love, unfailing support and encouragement in all my pursuits, my brother Stefano and his dog Ruben for cheering me on in moments of frustration and my parents Annamaria and Cosimo, to whom the book is dedicated, for having given me the world to play with.

Table of Contents

Acknowledgements xi

Introduction 1

Part I: Regulatory Issues of Hybrid Financial Instruments: The Classification Approach 7

CHAPTER 1
A Historical Perspective 9

§1.01 The Birth and Evolution of Preference Shares in the British Legal System 9
[A] Particular Features of the Preference Shares: The Preferential Dividend 18
[B] Priority to the Repayment of Capital in Event of Liquidation 22
[C] Conversion and Redemption of Preference Shares 27
[1] Failure to Redeem 31
§1.02 Nature of a Debenture 33
[A] The Origin and Evolution of the Subordinated Irredeemable Debentures 37
[B] Elements of Convertible Obligations 40
[C] Debt Holding Restrictive Covenants and Veto Rights 43

CHAPTER 2
Distinguishing between Equity and Debt 47

§2.01 Does Capital Structure Matter? 48
§2.02 Definition of Equity and Share Capital 50
§2.03 Why Distinguish between Equity and Debt: The Role of Accounting as Control over Regulations 52

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[A] The Accounting Standards for Classifying Hybrid Financial Instruments 54
[B] Classifying Hybrid Financial Instruments for Tax Purposes 63
[C] Re-characterization of Financial Claims in Liquidation 68
§2.04 Classification of Financial Instruments in Different Regulatory Areas 70
§2.05 Hybrid Financial Instruments' Implications for Corporate Law 73

CHAPTER 3
Setting the Theoretical Framework 75

§3.01 Transaction Costs and Company Law 76
§3.02 The Company as a 'Nexus of Contracts' and the Theory of Agency Costs 77
§3.03 Contract Incompleteness and Ex Post Conflicts 81
§3.04 The Modern Theory of Property Rights 82
§3.05 Summary of the Analysis 86

Part II: Governance Regulation of Hybrid Financial Instruments: The Functional Approach 89

CHAPTER 4
From the Classification to the Functional Approach 91

§4.01 Governance Implications of Issuing Hybrid Instruments 92
[A] Large Publicly Traded Companies 94
[B] Small Closely Held Start-Up Firms 96
§4.02 The Structure of Part II 98

CHAPTER 5
Significant Corporate Decisions 101

§5.01 Contracting for Governance Rights at a Company's Start-Up 101
[A] Limits to the Control Power of a Lender 105
[B] The Use of Hybrid Instruments to Align the 'Ex Ante' Incentives of Managers: Stage Financing and Contingent Convertible Debt 107
[1] Preference Shares as Incentive Contracts 110
[C] The Use of Hybrid Instruments to Reduce the 'Ex Post' Hold-Up Problems 111
§5.02 The Manager-Shareholder Conflict in Charter Amendments: Variation of Class Rights 113
[A] The Position of Preference Shareholders and their Protections: A UK-US Comparative Analysis 115
[B] What Constitutes a Variation of Class Rights? 119
[C] Legal Strategies for Preference Shareholders 121

§5.03 Shareholder-Convertible Bondholder Agency Problems 124
[A] The Protection of Convertible Bondholders in Mergers and Acquisitions 125
[B] The Protection of Convertible Bondholders in Assets Disposal 129
[C] Other Situations of Potential Dilution: The Distribution of Dividends 131
§5.04 An Evaluation of the Rationale and Protection for Hybrids 135

CHAPTER 6
Financing through Hybrid Instruments: Risks Opportunism and Legal Strategies for Mitigation 137

§6.01 The Use of Convertible Bonds to Reorganize and Restructure a Firm 137
§6.02 The Manager-Convertible Bondholder Conflict 139
[A] The Timing of the Conversion and the Issuer's Call Option 141
[B] Value Dilution of the Conversion Option 143
[1] Price-Based Methods of Anti-dilution 145
[2] Full Ratchet and Weighted Average Ratchet Anti-dilution Provisions 147
§6.03 The Majority-Minority Conflict in Venture Capital Financing: The Investor's Claim Dilution 150
[A] Existing Legal Remedies in the UK and US 151
[B] Loan Covenants, Veto Rights and Pay-to-Play Clauses 153
§6.04 An Evaluation of the Rationale and Protections for Hybrids 156

CHAPTER 7
Control Transactions 159

§7.01 The Agency Conflict in Control Transactions 160
[A] The Exit Event in Venture Capital Start-Up Firms 162
[B] The Use of Convertible Instruments as a Device to Allocate Control 164
§7.02 Existing Legal Strategies for Preference Shareholders Protection 167
[A] The UK Takeover Panel and the City Code on Takeovers and Mergers 167
[B] The Standard Strategy: The Duty of Loyalty in a UK-US Comparative Perspective 170
[1] Do Directors Owe Fiduciary Duties to Preference Shareholders? 173
§7.03 Financial Contract Design for Controlling the Board's Power in Exit Events: Veto Rights, Drag-Along and Tag-Along Clauses 176
§7.04 An Evaluation of Hybrid Financial Instruments' Use and Protection in the UK and US Jurisdictions 179

Conclusion 181

CHAPTER 8
Conclusive Considerations 183

§8.01 The Rationale for Hybrids and Implications for Corporate Governance 184
§8.02 Legal Strategies for Protection: The Need for Regulation or More Flexibility? 186

Bibliography 193

Table of Cases 217

Table of Legislation 225

Index 227

Introduction

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

1. See among the others: P.L. Davies & S. Worthington, *Gower and Davies' Principles of Modern Company Law* 1201 et seq. (9th ed., Sweet & Maxwell 2012); D. Kershaw, *Company Law in Context: Text and Materials* 649 and 797 (Oxford New York, 2nd ed. Oxford U. Press 2012); L. Gullifer & J. Payne, *Corporate Finance Law: Principles and Policy* Ch. 3 (Oxford and Portland, Hart Publg. 2011).

Despite a clear distinction in law between equity and debt, this has become increasingly blurred over the years, and sorting reality into clear-cut categories has become extremely difficult. Some of the financial instruments issued by companies, so-called *hybrid* instruments, fall into a grey area between debt and equity, forcing regulators to look beyond the legal form of an instrument to its practical substance. In the context of this book, I adopt a broad definition of the financial category 'hybrid financial instruments'. In particular, I consider hybrid (or of hybrid nature) any financial instrument that presents a mix of equity and debt characteristics. Therefore, this book excludes from examination all the derivative instruments that are debt whose value is derived from the performance of assets, interest rates, currency exchange rates or other external indexes, but not from the issuer's own shares. Instead, there are two main types of hybrid security that will recur in my analysis, in relation to their relevance to the situation studied: preference shares and convertible bonds. Although a third type of hybrid is included in this definition, the book does not devote as much attention to it as the others due limitations of space. This is the debenture-holding covenants or veto rights. While it is common practice to consider preference shares and convertible bonds as hybrid, it is less intuitive to include bonds with covenants or veto rights in this group, especially considering that in the British experience these covenants or appraisal rights are not commonly used, and the few that are have become standard clauses in commercial contracts. However, these securities, which are financial obligations – being generally deeply subordinated debt – retain a power of control, typical of controlling shareholders, that limits the directors' discretion in the management of the company through the use of positive and negative covenants.

The aim of the book is twofold: to assess the role of hybrid instruments in the modern company unveiling the costs and benefits of issuing these securities. It achieves it by recognizing and categorizing the different problem fields in which hybrids play an important role and by identifying the interrelationship between legal and contracting solutions to governance and finance problems. Overall, the book provides an account of the complex regulatory problems created by hybrid financial instruments and of the different ways in which regulatory regimes (UK and US) have responded to related problems. At the same time, the book also gives a comprehensive account of the relevant legal and contractual strategies employed in order to resolve contracting and governance problems arising from hybrids. The analysis compares the UK law dealing with hybrid instruments with the corresponding law of the US – in particular the laws of New York and Delaware – which are the most relevant jurisdictions in relation to company law. The comparative analysis with the US experience on this matter is extremely important to fully understand the origins and the growth of these securities over the years since they have a similar history of development. Comparing the US and UK approaches shows how different legal standards are often used in these two legal systems to reach the same results. Furthermore, although the legal jurisdiction of relevance is the UK and the issues are discussed in a UK context,

E. Ferran, *Principles of Corporate Finance Law* 49–54 and 313 (Oxford New York, Oxford U. Press 2008); R. Pennington, *Pennington's Company Law* 234–235 (London, Butterworth 2001).

many of the general principles discussed in the book apply to all common law jurisdictions. Therefore, in relation to hybrid instruments, the US market is too important to be disregarded.

A central aspect of this work is the importance of economic theory for the understanding and meaningful analysis of the relevant problems. Most of the research conducted on hybrid instruments has taken its first steps from the Modigliani and Miller (M&M) theorem, focusing on the profile of optimal leverage, namely the optimal ratio of debt-to-equity capital. Economic theory shows very little justification for a strict equity/debt distinction and it became quite clear to me that the law – by applying this distinction – creates a strong incentive for regulatory capital arbitrage. Finance theory explains this phenomenon mainly by pointing towards the differing tax and regulatory treatment of debt and equity as well as information asymmetries between the creditors, shareholders and managers. The differences in tax, accounting and regulatory treatment give rise to distortions and this can be costly for the society. Rather than focussing on the real advantages a certain capital structure offers, companies mainly try to optimize their capital structure with a view to these two areas. Much of the increase in the use of hybrids throughout the past two decades can be explained by tax and regulatory factors. Therefore, most of the empirical and theoretical research in this area has focused on the tax advantages of issuing hybrids as a way of reducing the cost of capital from a company's point of view, or on their capacity to be subordinated to all the creditors and to be unable to trigger the liquidation of the firm in case of default on its payouts. However, very little contribution has been made to the analysis of these securities with regard to their implications for corporate governance. A large part of this manuscript is dedicated to this original approach. In this sense, I propose a *functional* approach for analysing and discussing the *governance* regulation of hybrid financial instruments.

Currently, our approach is based on the traditional understanding of debt and equity as fundamentally different, opposing methods for financing a corporation's business. Starting from there, tax and accounting regulation try to define every hybrid financial instrument as merely a mix of the two opposing ends of the *capital spectrum* – pure debt or pure equity. I argue that this simplified view of hybrid financial instruments fails to properly grasp the complexity of modern corporate finance. In my view, more emphasis should be put on the agency relations and the property law claims embedded in such *unconventional* financial instruments. Economic theories on the nature of the firm have generally explored two areas of intervention in order to reduce managerial opportunism and conflicts of interest. The stream of doctrine who studied the agency costs as the main cause of inefficiency, has focused on the principal-agent relationships in the company trying to align managers' and shareholders' incentives in order to maximize the company's wealth. Other part of the doctrine instead – focusing on property rights – emphasizes the importance of ownership when it comes to allocating control powers and residual claims. As a matter of fact, companies deal with uncertainty and risk in their businesses. Changing economic conditions also companies' choices change. What has been agreed between the parties before may not work anymore and (financial) contracts are incomplete by nature. Transaction cost economics maintains that bargaining is pervasive during a business life because it is extremely

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difficult to anticipate all of the relevant bargaining action at the initial contracting stage. Thus, governance mechanisms for *ex post* regulation or measurement are needed to avoid expensive disputes or opportunistic behaviours during the life of the firm. In this sense, contractual design is essential. A more flexible contract going beyond pure equity or debt such as a hybrid security could effectively work as a very efficient compensation contract, aligning the *ex ante* incentives of managers and investors while allowing a perfect economic integration between the investors in the firm. In fact, peculiar features of hybrids are their vague terms and conditions – always observable if not verifiable by a Court – that allow the parties to re-negotiate their rights when a significant change occurs.

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

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

It is often debatable how far their protection is a matter of contract and how far it is a mandatory matter of company law. Although nowadays the UK courts seem to have reached some definitive canons of construction, some recent US cases take a different direction, opening up again the discussion of directors' fiduciary duties

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

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

The legal distinction between equity and debt can be meaningless and the results of that categorization misleading. As observable in practice, the increase in financial innovation reflects the necessity of the parties to allocate control and cash flow rights in a way that diverges from the classic allocation resulting from equity and debt. Companies and capital structures evolve continuously in conditions of uncertainty and the incentives of the parties may diverge during the years. Thus, the parties may disagree on something they agreed on before. In such situations, the law is intended to protect the weak party from any possible abuse, while at the same time facilitating the business in the best interest of the firm. The functional approach unveils an important rationale for issuing hybrids. Both the US and UK have legal systems characterized by transactional flexibility that places these two countries among the most business-friendly legal systems. Both the US and UK legal systems rely on *ex post* standards strategies to protect preference shareholders and on the judiciary to evaluate the fairness of a transaction. The choice of the regulator not to burden the market with excessive mandatory company law has left a lot of scope and given a strong incentive to the parties to contract for their rights. This has favoured the business and allowed the parties to better protect themselves with careful drafting.

Part I: Regulatory Issues of Hybrid Financial Instruments: The Classification Approach

CHAPTER 1
A Historical Perspective

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

§1.01 THE BIRTH AND EVOLUTION OF PREFERENCE SHARES IN THE BRITISH LEGAL SYSTEM

Atypical security issues, which were different from ordinary shares, can be found in the records of British companies as long ago as the seventeenth and eighteenth centuries.[1]

1. Since they appeared as an alternative to equity and evolved over the years such that preference shareholders' rights became 'somewhat more approximated to the role ... of debenture-holders' as Lord Evershed MR stated in 1949, Re Isle of Thanet Electricity Supply Co. [1950] Ch. 161 at 175. See also L.C.B. Gower, *Principles of Modern Company Law* 22–28 and 357–368 (3rd ed. Stevens & sons 1969); R. Pennington, *Partnerships and Company Law* 97–103 (Butterworths 1962); J.H. Farrar, *Farrar's Company Law* 226–235 at Ch. 18 (Butterworths 1988); R.C. Michie, *The London Stock Exchange: A History* 31 et seq. (Oxford U. Press, 1999); R. Burgess, *Corporate Finance Law* 319–323 (London: Sweet & Maxwell 1992); A. Stiebel, *Company Law And Precedents* 62–71 (Sweet & Maxwell 1929); W.R. Scott, *The Constitution and Finance of English, Scottish and Irish Joint-Stock Companies to 1720*, I, 364–365 (Cambridge U. Press 1912); C.R. Stiles, *Alphabet of Investment*, Fin. Rev. of Rev. 24–26 (May 1918). In this treatise, the author refers to the bonds issued in 1698 by the Mine Adventurers' company as 'in effect, preference shares'. For a historical analysis of preference shares in USA, see also A. Stone Dewing, *The Financial Policy of Corporations* 113–136 (3d ed., Ronald Press Co. 1921); A. Stone Dewing, *A Study of Corporation Securities: Their Nature and Uses in Finance* 134, n. (b) (Ronald Press Co. 1934); A. Stone Dewing, *Corporate Promotions and Reorganizations* Ch. 2 at 19

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