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Editorial

Corporate Reorganization and Bankruptcy

This volume arose out of an October 2003 Conference on Corporate Reorganizations and Bankruptcy organized by the Faculty of Law and Center for Company Law at Tilburg University. The principal focus of the issue is corporate governance and bankruptcy reform, but also highlights the European Company (SE) and the theory and practice of cross-border reorganizations and inter-state competition in corporate structures. The special issue has four major sections.

The first part of this issue examines the Post-Enron reforms to the United States reporting system and European Commission initiatives on corporate governance and disclosure. In William Bratton's article, he identifies the difficulties of employing principles-based reporting systems to constrain opportunistic actions of managers and recommends that the US move to principles be delayed until institutional reforms have succeeded. Karel Lannoo and Arman Khachaturyan provide a critical analysis of the proposals contained the European Commission's Communications on corporate governance and reinforcing the statutory audit.

In the second part of the issue, attention shifts to the importance developing the legal rules and institutions that facilitate the development of a venture capital market in Europe. Joseph McCahery and Erik Vermeulen, in focusing on inter-state competition in the EU, show the extent to which the competitive pressures have led lawmakers to create limited partnership structures that meet the needs of venture capitalists. John Armour, in examining relationship between legal rules and the incidence of venture capital, views a nation's insolvency law as having a potentially a positive impact on the demand for venture capital. In the third part of the issue, Ian Fletcher examines the potential impact of Enterprise Act 2002 on corporate insolvency practice in the UK. Daniel Prentice focuses on the different ways that the Enterprise Act 2002 will affect the bargaining strategies of secured lenders. Finally, in the fourth part of the issue, Theo Raaijmakers examines the European Company (SE), the issues surrounding board structure and corporate governance, and whether the SE is a suitable vehicle that could enhance regulatory competition.

Overview of the Articles

The first article, by William Bratton, focuses on the debate over the reform of financial reporting and the factors that are responsible for the move toward

principles-based accounting. It begins by highlighting the recent audit-based accounting crises, discussing in detail: (1) the significant increase in earnings restatements and whether rules-based US GAAP is a causal factor contributing to opportunistic and aggressive reporting and (2) the substantial reporting failures at Enron and the central role played by its managers and auditors in giving rise to its financial collapse. Whilst the aggressive and abusive treatment of GAAP's rules is widespread, Bratton attributes the recent audit failures and restatements to strategic noncompliance, as opposed to a failure of the rules-based accounting under GAAP. Bratton assesses the relative merits of articulating GAAP in terms of rules and principles, and emphasizes that, in an ideal institutional framework, there are several reasons to think that a principles-based regime might lead to an effective system of financial reporting. It is suggested that for a principles-based system to operate effectively, the independent auditor would also have to possess significant professional power over the client and its treatment choices. In his conclusion, Bratton highlights the promise of the newly-created Public Company Accounting Oversight Board (PCAOB) with respect to fulfilling the need for more professional regulation of auditors, and explains that until the enforcement mechanism works effectively to ensure the increased accountability and effectiveness of auditors, we would be better off delaying the shift to principles-based accounting.

Karel Lannoo and Arman Khachaturyan critically evaluate the recently proposed EU level corporate governance reforms. They argue that the initiatives have been shaped and structured by the difference in company law mechanisms, ownership structures and the level of capital market development. Their paper deals with the main policy recommendations of the High Level Group of Company Law Experts for the reform the key elements of the corporate governance structure and the European Commission's Communication on Corporate Governance. The EC's Action Plan on Modernizing Company Law and Enhancing Corporate Governance in the EU contains a series of provisions designed to develop Community law in the area of board structure, disclosure, and audited accounts. The Action Plan aims to strengthen shareholders' rights and protection for employees, creditors and other interested parties and to foster the efficiency and competitiveness of European firms. The Action Plan pursues the introduction of an Annual Corporate Governance Statement, the development of a legislative framework to help shareholders to exercise various rights and the Adoption of a Recommendation that promotes the role of (independent) non-executive or supervisory directors. Having reviewed the main elements of the Action Plan, Lannoo and Khachaturyan welcome the move towards the harmonization of national systems of the auditing profession and endorse the creation of an EC enforcement mechanism. Besides the reforms to the audit system, the authors suggest that the EC's reforms in the area of corporate governance are misdirected and will likely increase political conflict over company

law harmonization. From this analysis, they conclude that it is questionable whether the Commission can make further progress in harmonizing EU company law.

The next article shifts the emphasis to an analysis of the legal arrangements that support the development of an EU-wide venture capital market. With respect to taking steps to eliminate the barriers in the financing of entrepreneurial firms in Europe, Joseph McCahery and Erik Vermeulen argue that the limited partnership, which is form typically used by venture capital funds, has become important to the success of the venture capital market in the US. This structure combines limited liability for limited partners with flow-through taxation with respect to capital gains. Despite several limitations, such as limited partnership shares not being publicly tradable and the archaic law governing this form, the UK limited partnership for has become the main structure used by European venture capitalists. McCahery and Vermeulen note that state competition for limited partnerships has led to the enactment of LP legislation that creates substantial cost savings for investors. These pressures will presumably also induce European jurisdictions to enact reforms that will satisfy investor demand. To this end, the UK and Scottish Law Commission has recently recommended: (1) to abolish the rule on the maximum number of partners, and (2) introduce 'safe harbour' provisions that clearly establish that limited partners may participate in the control of the company. The UK law reform story implies that European governments may have sufficient incentives to innovate in the presence of jurisdictional competition.

In his article, John Armour, examines the wider issues surrounding the relationship between law and finance, and shows the implications of this literature for facilitating investment by venture capital. It offers an account of the complex relationship between insolvency law—personal and corporate – and the demand for venture capital. Whilst Armour's analysis demonstrates that personal insolvency law may be an important factor that affects the demand for venture capital, the impact of corporate insolvency law is shown to be more ambiguous. In terms of potential entrepreneurs, Armour argues that if personal insolvency law imposes harsh consequences, then ex ante entrepreneurs will have a less compelling set of incentives to create start-ups. Moreover, it is clear enough to see that personal insolvency law that allows a 'fresh start' for former insolvents is likely to affect the ability of inframarginal entrepreneurs to return to the market. In order to test the theory, he compares the severity of eleven different personal insolvency regimes to ascertain whether there is a correlation between severity of legal regime and the level of venture capital investment. The evidence supports the hypothesis that there is negative correlation between severity of personal insolvency laws and levels of venture capital investment. Finally, Armour concludes that the evidence further highlights the importance

of legal and institutional factors on level of entrepreneurial activity, and consequently should interest national and EU level policymakers who have recently launched initiatives designed to reduce the harshness of personal insolvency and provide a 'start start' for former insolvents.

In the next article, Ian Fletcher evaluates the changes to administrative receivership, administration and company voluntary arrangements under the Insolvency Act 2000, and the Enterprise Act 2002. The reforms were intended to curb the harmful effects of administrative receivership and to supply rescue-oriented procedures designed for the reorganization of financially troubled companies. Fletcher argues that whilst the reform legislation has introduced some worthwhile improvements in the refashioned administrative procedure, this has been accompanied by a significant dilution of the government's preferences with respect to the attenuation of the rights and powers of creditors holding security in the form of a floating charge. In this respect, the new administrative procedure mandates the abatement of the right of the floating charge holder to appoint a receiver. Fletcher describes the main element of the new 'streamlined' administrative procedure, which include: (1) criteria for entry into administration, (2) entry routes into administration–administrative order, direct appointment by floating charge under paragraph 14, and by direct appointment by the company or its directors under paragraph 22. Under the new rules there are reasons to think that companies may engage in opportunistic behavior. In order to limit abuse, an administrator cannot be appointed within less than twelve months of an earlier administration by the company. There are also restrictions preventing companies using other delaying tactics. Fletcher, moreover, shows that there are sufficient safeguards to protect the holders of the 'Qualifying Floating Charge' (QFC) and limit administrator misconduct. Yet, despite these changes, it remains to be seen whether the new regime will supply a more cost effective system of resolving financial distress.

In 'Bargaining in the Shadow of the Enterprise Act 2002', Daniel Prentice begins with an account of how English law provides significant contractual autonomy to parties to a corporate security agreement. Prentice distinguishes the three basic elements of party autonomy: characterization of the security, choice of substantive terms of agreement, and timing of enforcement. He thus clarifies that the Enterprise Act does not interfere with these rights of corporate security holders. Nevertheless, the Enterprise Act is likely to have significant implications for those dealing with distress companies. For example, the effect of the new administrative procedures, which mandate the receiver to perform his functions with the objective to rescue the company as a going concern, is likely to have a far-reaching impact on the rights of qualifying floating rights holders. Whilst the Enterprise Act may have little direct impact on party

autonomy, Prentice concludes that the legislation may entail the loss of autonomy in respect of the terms of the security.

In the final article, Theo Raaijmakers examines the legislative history of the European Company (Societas Europea, SE) and the core provisions of the statute. It offers an account of: (1) cross-border restructuring, (2) the basic organizational elements of the SE, and (3) the rules of the SE's board. Raaijmakers argues that main achievement of the SE is that allows for cross-border reorganizations (i.e., merger or conversion into a SE), which may lead to more freedom of choice in EU company law. He notes, however, that the SE in practice is likely to have the greatest positive effect on cross-border combination and little impact on takeovers, joint ventures and subsidiaries. As a consequence, Raaijmakers concludes that statute may be a limited stimulus to jurisdictional competition in the EU.

Joseph A. McCahery[*]

[*] Professor of International Business Law, Faculty of Law, Tilburg University, Research Fellow, Center for Company Law, Tilburg Center for Law and Economics (TILEC), and Research Associate, European Corporate Governance Institute (ECGI). The author is grateful to his co-organizers, Theo Raaijmakers and Erik Vermeulen, and to the Anton Philips Fund for its support and to conference participants for their helpful comments.