Rover, the 'Phoenix Four' and Limited Liability

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Introduction

The extraordinary debacle surrounding the collapse in April 2005 of British car manufacturer MG Rover Group (MGRG), five years after its sale in May 2000 by BMW to the Phoenix Consortium of John Towers, Peter Beale, Neil Stephenson and John Edwards (referred to informally as the 'Phoenix Four') ought to focus the mind on the crucial issue of corporate identity and the limited liability this gives its owners. The critical questions are:

1) What are legally-constituted business entities for?

2) Who has responsibility for the actions of businesses?

3) What *are* the rights of the public at large in relation to business entities, and if different, what should they be?

MG Rover and the 'Phoenix Four'

The background to this sorry tale is that following their unsuccessful attempts to make MG Rover a going concern, BMW were so keen to offload the firm that they agreed, following intervention from the UK government, to pay a substantial cash sum for this to happen. The group they paid to do this were an ad-hoc partnership of businessmen friends lead by John Towers, a former managing director and chief executive of MGRG, who was known personally by the local MP and as a consequence introduced to the then Trade and Industry Secretary Stephen Byers. The other members of the Phoenix Consortium were Nick Stephenson, an engineer and former director of MGRG, John Edwards, owner and manager of a Rover dealership in Stratford-upon-Avon and Peter Beale, an accountant and finance director of Edwards Cars. In contrast to any alternative bidders for Rover, they were apparently willing to attempt to keep Rover going in its entirety, rather

than shrinking the business to provide solely for a niche market such as sports cars.

In paying the Phoenix Consortium to take on the business, it seems that arrangements as to how this payment was to be used by its recipient(s) was seriously flawed. The payments were in two parts. Firstly there was £75 million paid to indemnify BMW against any future legal action by MG Rover or its new owners against BMW. Secondly, there was £427 million in the form of a 49-year interest-free loan. (Taking inflation into account even at its current low levels, the length of the loan period made this loan essentially a gift.)

Presumably the expectation was that the sums paid by BMW would go to guarantee the future of MG Rover for as long as possible, or at least as long as took to find the strategic partner deemed necessary to its long-term survival. In the event there was considerable discussion by the Phoenix Four and their advisors as to whether the £75 million warranty fee should be reserved for payment to them on the subsequent sale of the business and how this should be done in a way that minimised the appearance of greed on the part of the Consortium. In the event this did not happen, perhaps because it was thought that BMW would object, but £10 million *was* earmarked for them in the form of 'loan notes' that were subsequently ‘repaid’ to the tune of £2.5 million for each of the four partners, and there was evidence that subsequent sums paid to the Phoenix Four were at least in part intended to make up the £65 million difference between these sums.

There seems to have been fewer qualms about the decision to direct the £427 million not to MG Rover itself, but to the holding company established by the Consortium on subscription of £60,000 of share-capital by each of the Phoenix partners. This holding company, going by the name of ‘Techtronic’, then lent the bulk of this money to MG Rover at interest, despite the fact that they had received it interest-free. Since this holding company received interest income while paying none, it made a profit despite being the owner of the loss-making MGRG. This profit was

transferred in the form of dividends to a higher tier holding company, Phoenix Venture Holdings (PVH) of whom the controlling and main beneficiary owners were Towers, Stephenson, Edwards and Beale.

The Phoenix partners were directors of all three of these companies, and so were more or less free to shift assets and cash flows between them and to themselves as individuals as they thought fit. This freedom seems to have been enhanced by the informality with which board decisions were taken, the laxness in recording the details of meetings and even the regular failure to inform non-executive directors of the occurrence of board meetings. In the event, over the five years they owned MG Rover Group, the Phoenix Four paid themselves around £280,000 each in salaries and benefits from MG Rover, £1,125,000 in salaries from PVH, £1,000,000 in bonuses from PVH, and paid for themselves £3,600,000 each into a tax-minimising Guernsey trust. As noted above, each of the four also received a £2.5 million loan 'repayment'. This, combined with the interest accrued on this loan, amounted to another £2,939,000 for each of the partners. The total each of them received up until the collapse of MG Rover was thus around £8,900,000. Moreover, by making sure that MGR Capital (acquirer of the MG Rover loan book) belonged not to MG Rover, but to the Phoenix Four, they both protected it from bankruptcy and made sure that they could and still can each receive benefits calculated at £3,239,000 each. If these benefits are fully realised the total financial gain made by each of the Phoenix Four from their acquisition of MG Rover will amount to around £12,100,000 each.

This gain was made for 5 years of running a firm that made total losses in this period of over £950 million and at the end of that period went bankrupt owing £1.2 billion to its creditors, including the pension fund of its own workers. It seems to be the case that the four worked very hard over this time to ensure the continuation of MG Rover as part of a joint venture with an another car company, but their own financial resources put at risk only amounted to the £60,000

share subscription to set up Techtronic at the time of their acquisition of MG Rover. The authors of the DTI report point out that the highest paid directors of European automotive companies generally received between £200,000 and £400,000 annually in 2000-2004, and that the median remuneration for main board professional roles of UK plcs with turnover of £1bn to £5bn was £695,000 in 2004. Excluding the MGR Capital funds, each of the Phoenix Four received the equivalent of £2,225,000 per annum. Even in the context of the complete success of their efforts this remuneration would have been grossly excessive; in the context of the failure encountered it seems absurd. And yet it appears unlikely to be criminal since the Serious Fraud Office have declined to prosecute.

The mismatch between the financial losses of MG Rover and the financial gains of the Phoenix Four are largely a function of the concept of *limited liability*. This enshrines in law the ability of companies to limit the liabilities of their shareholders to no more than the cost of their holding. Moreover, company directors also escape liability, being agents of the shareholders. This generally applies even when, as in the case of PVH and Techtronic, the sole shareholder is another company. The Phoenix Four were in fact 3 times removed from the MG Rover losses, through their shareholdings in PVH, through PVH's ownership of Techtronic and through Techtronic's shareholding in MG Rover. As a consequence their personal financial loss was only their initial £60,000 stake in Techtronic. Clearly this was dwarfed by their financial gains.

Limited Liability

In the US the Supreme Court granted in 1886, without justification or argument, the status of natural persons to corporations. This entitled them to claim all those rights granted to individuals under the Bill of Rights, such as free speech and privacy, and to be regarded as distinct entities, separate and independent of their investors, directors and managers. Ten years later the House of Lords established the same principle for companies in the United Kingdom, in their interpretation of the limited liability decreed by the Companies Act of 1862. The argument in favour of limited

liability is that, by reducing the potential costs to investors, it promotes the raising of equity finance and increases the resources available for corporate and national economic growth. The costs reduced would include those of monitoring the wealth position of other shareholders, monitoring the riskiness of management actions and the cost and difficulty for shareholders of diversifying their investments.

A report by Plesch and Blankenberg for the Royal Society of Arts argues, however, that any theoretical advantage of limited liability for society at large has not been borne out by economic history. Their view is that in the US and UK, industrialisation preceded rather than followed from the development of limited liability; and that in later industrialising countries, such as Germany, Japan and South Korea, equity finance did not play a significant part in financing. Indeed, they point out that as the importance of stock markets and the size of speculative capital flows have increased since the early 1980s world growth rates and labour productivity have fallen as income inequality has risen.[1]

On the other hand there are strong arguments against limited liability for shareholders, some of which have been made since Adam Smith, writing in the Wealth of Nations. His objection was that

> ...to exempt a particular set of dealers from some of the general laws which take place with regard to all their neighbours, merely because they might be capable of thriving if they had such an exemption, would certainly not be reasonable.[2]

Plesch and Blankenberg go on to point out that this violation of the principle of equality before the law goes against the granting of rights to companies on the basis that they should share the status of personhood. Moreover, those that benefit from the exemption of liability tend to be the

1 Plesch and Blankenberg (2007)
2 Wealth of Nations V,III,I

more wealthy and more powerful in society who are direct or indirect beneficiaries of equity holdings. In 2001 the wealthiest 10% of the US population owned (directly and indirectly through pension funds etc.) around 77% of corporate equity. The bottom half of the population owned only 1.4%. Exact figures for the UK are more difficult to come by and interpret but also show that the direct share holdings and financial wealth in general are highly skewed to the wealthiest 5-10% of the UK population.[3]

There is much evidence that corporate entities, by providing anonymity and liability protection to shareholders, irrespective of whether they are simply passive investors or are actually the controllers of the company, enable money laundering, bribery, corruption, shielding assets from creditors, tax evasion and other legally and morally dubious activities. Any civil action launched cannot proceed beyond the 'veil' of limited liability, frequently allowing shareholders to escape responsibility by the declaration of bankruptcy or shutting down of the company. Clearly when the shareholder is yet a further limited liability company the proper apportioning of responsibility becomes yet more difficult. Plesch and Blankenberg identify episodes where these sort of incidents have occurred including the collapse of Christmas savings company Farepak, Union Carbide and the Bhopal disaster and TeGenero and the serious harm caused by a drug trial to six subjects at Northwick Park hospital.

Rare exceptions to the rule of the limited liability of shareholders to the actions of their companies can in theory be made in the case of 'sham' companies or in the case of fraud, but in reality this only occurs in a haphazard and unsatisfactory way, even when it is clear that the shareholder is the controlling parent company of an integrated subsidiary, as is common in modern multinational enterprises.[4] The latter is clearly a very different situation from the case of individual investor shareholders, who themselves have no power of management or supervision of the

3 Ireland (2005)
4 Strasser and Blumberg (2007)

company. The effect is to make compensation from or regulation of actually responsible entities particularly difficult, and this may indeed be used as a strategy in the structuring of an enterprise. This certainly seems to have been the effect if not the intention of the corporate structures established by the Phoenix Consortium following their takeover of MG Rover Group.

Possible Reforms

There are two attitudes one can take of the excessive benefits of limited liability to the controllers and main investors of companies. Firstly, changes in the law can be proposed that recognise the extent to which companies are directly controlled by and integrated with each other and/or directly apportion financial responsibility to shareholders according to the size of their holding. Secondly, limited liability can be left intact, but effort made to ensure that its full benefit is felt by society as intended. This would seem to imply that stakeholders other than purely financial beneficiaries have input into corporate decision-making, reducing the current pure focus of companies on financial profit and shareholder value. To achieve this we should see representation on company boards not just of employees, as in the German *Mitbestimmung* system, but also of suppliers, customers and residents of the area(s) of operation of the company.

Conclusion

To return to the questions I asked in the introduction. With the regard to the question of who benefits from companies established with legally limited liability, it is clear that existence of limited liability implies a benefit to society from a thriving business with access to investment from as many sources as possible, including small investors without the resources to monitor the actions of a large company or the environment in which it is operating. Society at large thus has a legitimate interest in considering whether limited liability does, in its present form, serve to its benefit. With regard to the question of responsibility for corporate actions, it frequently seems that no humans can be ascribed such responsibility, since shareholders are absolved and managers also, as the agents of

shareholders. As a person in law, responsibility is thus focussed on the company, but if it suits the human beneficiaries of the company the company can be dissolved. In this way responsibility for actual and severe harm and satisfactory redress can be effectively absent. From the previous two answers we can go on and formulate an answer to our third question, and find that the rights of the public at large are unfairly circumscribed by the existence of limited liability. This should be addressed by limiting the extent of limited liability and/or counter-balancing it with control of business entities by a more diverse group of those affected by their actions than simply their financial investors.

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